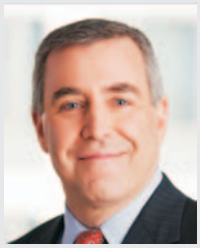
Expedited Opt-Out Needed for OVDI Participants Who Owe No Tax

By Robert B. Stack and Douglas M. Andre


Robert B. Stack


Douglas M. Andre

Robert B. Stack is a partner, and Douglas M. Andre is an associate, at Ivins, Phillips & Barker in Washington. The authors practice in the voluntary compliance area, and they acknowledge that they have clients with facts similar to the case studies presented here. However, the authors will not receive compensation for writing or submitting this article. This article was motivated by a belief that the treatment given taxpayers described here is both bad tax policy and fundamentally unfair.

The authors argue that an expedited opt-out procedure is needed for taxpayers in the IRS's offshore voluntary disclosure initiative (OVDI) who owe little or no tax. The one-size-fits-all OVDI penalty structure is a poor fit for many taxpayers who owe no or de minimis amounts of additional taxes but still failed to file a foreign bank account report or other information returns or forms.

Introduction

The IRS recently announced that more than 12,000 U.S. taxpayers voluntarily disclosed their offshore financial accounts as part of the 2011 offshore voluntary disclosure initiative (OVDI).[1] The announced objective of the OVDI was "to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws."[2] The OVDI is designed to bring "tax evaders" into compliance, and it is based on the assumption that foreign accounts were created for and indeed resulted in actual tax evasion. IRS Commissioner Douglas Shulman described the program as one that "gives those hiding money in foreign accounts a tough, fair way to resolve their tax problems once and for all."[3]

The point is reemphasized elsewhere in the IRS's frequently asked questions that accompanied the creation of the OVDI, first announced in February 2011. FAQ 17 explained that the OVDI's purpose "is to provide a way for taxpayers who did not report taxable income in the past to come forward voluntarily and resolve their tax matters." The OVDI (and its predecessor program, the 2009 offshore voluntary disclosure program (OVDP)) doubtless provided taxpayers who had material income omissions a welcome opportunity to become compliant while limiting penalty exposure for underreported tax liabilities. For persons who used foreign financial accounts to actively evade U.S. taxes for many years, the OVDI penalty scheme is often a relative bargain.

The one-size-fits-all OVDI penalty structure is a poor fit, however, for many taxpayers who owe no or de minimis amounts of additional taxes but nonetheless failed to file a foreign bank account report or other information returns or forms. Those people should not have been required to enter the program. In announcing the OVDI, the IRS emphasized that it was not seeking to impose penalties on people who do not owe tax. FAQ 17, referenced above, sensibly provided that taxpayers who reported and paid tax on all their income for prior years but did not file FBARs should file the delinquent FBARs according to the instructions and attach a statement explaining why the reports were filed late. "The IRS will not impose a penalty for failure to file the delinquent FBARs if there are no underreported tax liabilities and the FBARs are filed by September 9, 2011."[4] Despite this seemingly

[1]IR-2011-94, *Doc 2011-19648*, *2011 TNT 180-14*.

[2]IRS, "2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers," FAQ 2, *Doc 2011-18448*, *2011 TNT 169-18*.

[3]IR-2011-14, *Doc 2011-2718*, *2011 TNT 27-10*. *See also* Remarks of IRS Commissioner Douglas Shulman before the IRS/George Washington University 24th Annual Institute on Current Issues in International Taxation (Dec. 15, 2011), *Doc 2011-26413*, *2011 TNT 242-24* (describing the OVDI as designed for "those hiding money in foreign accounts a tough but fair way to resolve their tax problems").

[4]OVDI FAQ 17. FAQ 18 applied a similar rule to taxpayers who failed to file other information returns like Form 5471,

(Footnote continued on next page.)

broad carveout consistent with the announced purposes of the program, as we demonstrate below, the OVDI is being administered in a manner that nonetheless subjects taxpayers without any tax liability to the OVDI penalty regime — including the very heavy 25 percent penalty on the highest balance, with their only hope being access to a vaguely defined ''opt out'' mechanism that itself would be time-consuming, expensive for both the IRS and taxpayers, and uncertain. A recently released fact sheet, FS-2011-13, provides the IRS the basis for a win-win scenario in dealing with taxpayers already in the OVDI who owe no tax: an expedited opt-out procedure administered within the program.

Before turning to the expedited opt-out proposal, let's examine the penalty structure for three hypothetical taxpayers who entered the OVDI. John is a U.S. citizen living abroad whose foreign earned income would have been completely excluded from gross income via section 911 had he filed U.S. tax returns and made the section 911 election. Sarah is a Canadian citizen and permanent U.S. resident who owns a Canadian registered retirement savings plan (RRSP) but failed to elect treaty relief that would have excluded undistributed account earnings from current taxation. Bill is a U.S. citizen living abroad who failed to file tax returns but who has no tax liability because of the availability of foreign tax credits. None of these hypothetical taxpayers owes additional taxes, but all of them entered the OVDI to avoid applicable penalties for failing to disclose their foreign financial accounts.

These hypothetical taxpayers are all similarly situated in that while they failed to file FBARs, none would owe any additional income tax if they had timely reported their foreign financial accounts, correctly reported all income, and made applicable elections. In each case, the OVDI penalty is disproportionate to the tax noncompliance.[5] However, the taxpayers will incur significant penalty risk and considerable uncertainty if they opt out of the OVDI penalty structure.

John — Foreign Earned Income Exclusion

Subject to limitations, a U.S. citizen who is a qualified individual may elect under section 911 to exclude specified amounts of foreign earned income from *gross* income.[6] In general, a qualified individual is defined as a U.S. citizen or resident whose tax home is in a foreign country and who during the same period meets at least one of two foreign presence tests: the bona fide residence test or the physical presence test.[7] During the 2003-2010 tax years, the maximum excludable amount ranged from $80,000 to $91,500. Thus, a taxpayer who in 2010 was a qualified individual and who earned less than $91,500 could have excluded 100 percent of foreign earned income from gross income. If the taxpayer's remaining income for the year was below the filing threshold, he would have zero taxable income and no tax liability.[8]

Regulations require the taxpayer to affirmatively make the section 911 election on Form 2555, which is filed with the taxpayer's income tax return for the first year he is so electing.[9] A timely election is made if the form is filed by the due date (including extensions) for that return. Taxpayers who fail to timely elect can make a retroactive election under a regulatory provision that extends the time to elect well past the due date for filing the tax return. A taxpayer can retroactively file Form 2555 for tax years 2003-2010 if he owes no taxes after taking the section 911 election into account.[10]

John is a dual U.S. and French citizen. He is a U.S. citizen by birth but has lived overseas his entire

''Information Return of U.S. Persons with Respect to Certain Foreign Corporations,'' or Form 3520, ''Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.'' As with FAQ 17, no penalties were assessed for taxpayers who had no underreported tax liabilities and who filed those forms by the September 9, 2011, deadline. While the issues we highlight deal primarily with the FBAR penalty, the same concepts and arguments apply to those who failed to file other forms required by the code and who owe no or little tax.

[5]We are further distressed by the lack of proportion between the tax owed and the OVDI penalties that can be imposed and see that as a basic design flaw in the program. In this article we focus only on the unfairness of imposing the FBAR failure-to-file or OVDI penalties on those with no tax liability whatsoever.

[6]Section 911(a)(1). Section 911 excludes foreign earned income from gross income. This provision is important depending on one's interpretation of OVDI FAQ 17: ''The purpose for the voluntary disclosure practice is to provide a way for taxpayers who did not report *taxable income* in the past to come forward voluntarily and resolve their tax matters. Thus, if you reported and paid tax on all *taxable income* but did not file FBARs, do not use the voluntary disclosure process'' (emphasis added). Because the section 911 election excludes amounts from gross income, in cases in which 100 percent of income is excluded, the taxpayer would have no taxable income. Based on the IRS OVDI hotline responses — and despite the FAQ 17 language — those taxpayers were ineligible for FAQ 17 relief. *See* New York State Bar Association Tax Section, ''2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers,'' (Aug. 5, 2011), at n.8, *Doc 2011-17150*, *2011 TNT 153-13* (commenting on ''confusing'' FAQ 17 language).

[7]Section 911(d)(1).

[8]The ''filing threshold'' as used here is the sum of the personal exemption and the standard deduction. Section 6012(a)(1)(A). In 2010 this amount for single filing status was $9,350. For joint filers the amount was $18,700.

[9]Reg. section 1.911-7(a)(1).

[10]Reg. section 1.911-7(a)(2)(D)(1). A taxpayer, who after taking into account the section 911 exclusion owes no taxes, can make the election before or *after* the IRS discovers he failed to make the election.

adult life. During each year covered by the OVDI, his foreign earned income (as defined for purposes of section 911) fell below the maximum excludable amount. John maintained both checking and savings accounts in a foreign bank in France, and the aggregate balance in those accounts peaked at $150,000 during the OVDI period. In each year, John's gross income from his bank accounts (and from all other sources other than foreign earned income) has consistently fallen below the U.S. income tax filing threshold. Because John has spent his entire adult life working and living in France, he has regularly filed French income tax returns and properly paid French taxes. He was unaware of any requirement to file U.S. income tax returns or report income. He was also unaware of his FBAR filing obligations.

Alerted to his U.S. filing obligations, John decides to enter the OVDI.[11] Because he can retroactively elect to exclude his foreign earned income from his U.S. gross income, his income from all sources (after making the election) falls below the filing threshold. Thus, his taxable income is zero, and he owes no taxes. Once John files the late section 911 election (expressly permitted by the regulations), he is literally within FAQ 17 — and yet, for some unfathomable reason, the IRS announced on its hotline that he is not! Because John qualifies for the 5 percent penalty provision in FAQ 52,[12] he has a choice between paying the $7,500 miscellaneous OVDI penalty and opting out of the OVDI penalty regime.[13] If he opts out, he avoids the OVDI penalty but faces a potential FBAR failure-to-file penalty of $160,000 and a full audit of all years.[14] If he opts out, his penalty exposure is far from certain, and he may or may not benefit from a reasonable cause defense.

Because he wants certainty and quick closure, John accepts the 5 percent OVDI penalty.[15] Even though he owes no U.S. taxes in any year, John's "toll charge" for being an ill-advised U.S. citizen is one-twentieth of his life savings.

Sarah — Canadian RRSP Accounts

RRSP accounts are used by Canadian taxpayers to accumulate retirement savings on a tax-deferred basis.[16] In several ways, RRSP accounts are similar to U.S. IRAs except that RRSP accounts are not qualified plans for U.S. tax purposes. Thus, the default rule applicable to U.S. taxpayers with RRSP accounts requires inclusion of account earnings in current income even if no distributions are made. In the absence of a relief provision, undistributed account earnings would be taxed in the United States in year 1 and again in year 2 in Canada when the owner makes withdrawals. Because the U.S. and Canadian taxes would relate to different tax years, the FTC may be unavailable, and distributed earnings could end up being double taxed.[17]

In response, Article XVIII of the Canada-U.S. tax treaty[18] provides relief from double taxation. In conjunction with the treaty provision, Rev. Proc. 2002-23 provides that undistributed RRSP account income that meets specified requirements is not subject to U.S. tax in the year earned if the taxpayer affirmatively elects to defer recognition of income. The election is made on Form 8891, which must be filed with the taxpayer's U.S. income tax return. For taxpayers who fail to timely file the election form, retroactive relief is available, but only if the taxpayer applies for an extension to file via reg. section 301.9100-3. Thus, an uninformed taxpayer must incur the expense and delay of a private letter ruling to make the election for previous years.

Sarah is a Canadian citizen who lived and worked in Canada for many years. During that time she managed to save $200,000 toward her retirement in an RRSP account. In all years, she timely filed her Canadian income tax returns and paid all

[11]Inquiries to the OVDI hotline revealed John is ineligible for FAQ 17.

[12]Under OVDI FAQ 52, a taxpayer is eligible for the 5 percent OVDI penalty if, for all OVDI years he (1) was a foreign resident, (2) makes a good-faith showing that he has timely complied with all tax reporting and payment requirements in his country of residence, and (3) had $10,000 or less of U.S.-source income.

[13]John's OVDI miscellaneous penalty may be more than 5 percent of the current balance in his accounts. That would be the case if his highest balance occurred in a year when the currency exchange rate favored the euro (*i.e.*, the ratio for converting euros to U.S. dollars was relatively high). When he pays the OVDI penalty in 2011 using funds from his foreign bank, his out-of-pocket cost will exceed 5 percent (assuming a constant balance) because the exchange rate is lower.

[14]If the FBAR penalty is applied on a per-account basis, the civil, non-willful $10,000 penalty could be assessed on each account (or $10,000 x 2 accounts x 8 years = $160,000), 107 percent of his account balance. The IRS has taken the position that the FBAR penalty will be assessed on a per-account basis. Internal Revenue Manual section 4.26.16.4(7).

[15]This would likely be an easy decision for John given that he will incur significant, additional legal and accounting fees if he opts out.

[16]For a more detailed description of RRSP accounts and the issues faced by their owners in the OVDI, see Marie Sapirie, "Clarification on Retirements Plans Needed in OVDI," *Tax Notes*, Sept. 26, 2011, p. 1333, *Doc 2011-20207*, or *2011 TNT 186-4*.

[17]*See* Rev. Proc. 2002-23, 2001-1 C.B. 744, section 2.01, *Doc 2002-7446*, *2002 TNT 59-7*.

[18]Convention Between the United States of America and Canada With Respect to Taxes on Income and Capital, Art. XVIII(7), Sept. 26, 1980.

tax liabilities. Sarah's RRSP accounts earned interest and dividends, all of which were reinvested.

In 2000 Sarah is transferred by her employer to an affiliated company, which requires her to move to Arizona. In conjunction with her move, Sarah closes all her Canadian bank accounts except for the RRSP account. Sarah applies for and is granted permanent legal U.S. resident status, and she establishes a habit of timely filing U.S. income tax returns and paying taxes on her U.S.-source income. Because her RRSP account is tax deferred under Canadian law, she mistakenly believes it is treated similarly in the United States. She is unaware of the Canada-U.S. income tax treaty provision that would permit her to defer recognition of RRSP account earnings until distributions are made. She is also unaware that the RRSP account is a foreign financial account for purposes of the FBAR filing requirement. Her U.S. CPA fails to advise her of the Form 8891 or FBAR filing issues.

When Sarah engages a new CPA to prepare her U.S. income tax return, he promptly informs her of the U.S. tax liabilities and FBAR reporting requirements related to the RRSP account. Because she is worried that requesting retroactive treaty relief through the letter ruling process could be deemed a quiet filing, Sarah decides to enter the OVDI. Once in the OVDI, she submits a letter ruling request. Subject to approval of the request, her income tax liability will be zero, but she faces a 25 percent miscellaneous penalty on the balance of her retirement savings.[19] Alternately, she may opt out of the OVDI penalty structure. Because her RRSP has multiple subaccounts, she fears that if the FBAR failure-to-file penalty is assessed on a per-account basis, her penalty exposure on opting out could exceed the balance in the account.

Bill — Foreign Tax Credits

The section 901 FTC provides relief from double taxation of foreign-source income earned by U.S. persons. The credit generally reduces the U.S. tax on income taxed by other countries by the amount paid to foreign governments. Although limits apply, the FTC can reduce U.S. taxes to zero.

Bill is a U.S. citizen whose income is 100 percent foreign source. Because the tax rate in the applicable foreign country is higher than his effective U.S. rate, he owes no U.S. tax. Bill did not file U.S. tax returns during the OVDI years, and he failed to include earnings from a foreign bank account in income. However, because his foreign bank withholds and pays foreign income taxes from account earnings, he owes no additional U.S. taxes as a result of properly including the account income. Bill failed to file FBARs for 2003-2010. FAQ 51.1 (Example 1) describes Bill's circumstances, thus he was not eligible to late-file his FBARs under FAQ 17. Bill entered the OVDI and must now choose between paying a 25 percent penalty on the account balance and subjecting himself to the uncertainty of a full examination for all years.

OVDI Penalties Inconsistent With Objectives

In none of the above three examples is tax avoidance or evasion an issue. The circumstances of all three hypothetical taxpayers are radically dissimilar from intended OVDI participants. All three were "noncompliant" from the standpoint that they failed to file tax returns (showing zero tax owed), election forms, or FBARs. However, in none of the cases was tax avoidance or evasion an issue because no taxes were ultimately owed. In none of these cases did the use of foreign financial accounts have anything to do with tax evasion. These taxpayers opened foreign accounts simply because they worked and resided outside the United States. They are the functional equivalent of taxpayers who paid all their taxes but failed to file an FBAR — in other words, someone eligible for FAQ 17.

Yet, to date, the program is not being administered in the common-sense fashion suggested by FAQ 17 to further its announced goal of focusing on tax evaders. Rather, in the three case studies outlined above, the IRS has apparently taken the position that taxpayers who either literally fall within the meaning of FAQ 17 (in the case of some taxpayers with section 911 exclusions) or do not fall literally within the provision but nonetheless owe no back taxes must lose 25 percent (or, as applicable, 5 percent) of their life savings or face an ill-defined full audit and a full panoply of FBAR (and other)

[19]IRS OVDI hotline personnel have said that taxpayers in the OVDI who own RRSP accounts may apply for reg. section 1.9100-3 relief. If approved, undistributed earnings will be deferred and need not be included in taxable income. However hotline personnel have said that even if no taxes are owed, the aggregate RRSP account balance will be included in the OVDI penalty base. A recent announcement by U.S. Ambassador to Canada David Jacobson indicates that the IRS may provide some relief to dual U.S.-Canadian citizens who live in Canada with facts similar to Sarah's. *See* Kristen A. Parillo, "IRS to Minimize Penalties on Dual U.S.-Canadian Citizens Unaware of U.S. Tax Filing Obligations," *Doc 2011-25282*, or *2011 TNT 233-9*. Jacobson said the IRS intends to make clear that those dual citizens who owe no U.S. taxes will not be assessed any penalties for failing to file returns or for failing to file FBARs if reasonable cause is shown (a requirement not imposed on other OVDI FAQ 17 taxpayers). It is unclear whether this is an oblique reference to the existing OVDI opt-out election or whether some new policy announcement is imminent. It is also unclear whether any new relief provision would apply to permanent legal residents (*i.e.*, green card holders) with the identical issue (like Sarah).

penalties. Administering the program in this manner has proved to be an embarrassment to the IRS and a discredit to the outstanding professionals who work there.

We believe the IRS should reconsider the scope of cases that fall within FAQs 17 and 18 and permit taxpayers in the situations above to qualify under those FAQs. Stated differently, a fast-track opt-out procedure is needed for OVDI participants who owe no tax. Taxpayers who previously were required to pay the OVDI penalty in those situations should be offered a refund of the amounts imposed.[20]

To its credit, the IRS seems to be moving in that direction. FS-2011-13 provides some hope that the reasonable cause exception will be applied fairly to taxpayers who owe little or no tax but who failed to file FBARs. The fact sheet, ''Information for U.S. Citizens or Dual Citizens Residing Outside the U.S.,'' offers several examples in which penalties may not apply to taxpayers with offshore income who owe little or no taxes.

Example 3 of the fact sheet describes a person like John above who owes no taxes (after taking into account the section 911 exclusion) but who is subject to the penalty for failing to file an FBAR. The example explains that the taxpayer's reasonable cause claim is strengthened by the fact that he owes little or no additional tax. Other favorable reasonable cause factors include that the taxpayer had a legitimate purpose for maintaining a foreign account (he was a resident there) and that there were no indications of efforts to intentionally conceal the reporting of income or assets.

While this would seem to be welcome news for taxpayers with overseas accounts, what effect, if any, the fact sheet will have on OVDI participants is unclear. Neither the OVDI nor the OVDP program is mentioned, leaving taxpayers who participated in those programs still subject to the miscellaneous penalty or the uncertainties of the opt-out procedure. The fact sheet examples are helpful in defining the contours of a valid reasonable cause argument, but the guidance falls short of the relief needed for taxpayers in OVDI who owe no additional tax. Those taxpayers need an abbreviated procedure on par with FAQs 17 and 18 under which an automatic rule presumes reasonable cause exists when no taxes are owed. While taxpayers who owe no taxes may ultimately be able to show reasonable cause for not filing an FBAR, they shouldn't be required to do so to avoid the OVDI penalty. Nor should they be subjected to the emotional turmoil and legal fees associated with opting out as it is currently construed.

The guidance provided in the fact sheet seems to apply to dual-citizen taxpayers who owe little or no taxes regardless of whether they are participating in OVDI.[21] Although few procedural details are included, the fact sheet supports the need for an abbreviated procedure for showing reasonable cause and a shortened overall adjudication process for these taxpayers.[22] Such a procedure (similar to that offered to taxpayers under FAQ 17) is the right answer for all these taxpayers, especially those who are participating in OVDI.

Requiring individuals who have no tax liability to enter the OVDI is bad enough, but the error is compounded by two additional — but more subtle — problems. First, FAQ 17 is not a model of clarity, so tax professionals in good faith might have interpreted some of these cases to fall within the FAQ. The taxpayer with the section 911 exclusion and the green card holder with the RRSP seem quite similar to the no taxable income case discussed in FAQ 17.[23] Based on this good-faith interpretation, these professionals may have advised their clients that they need not enter the program — either because they believe cases similar to these fall literally within the FAQ or because, reasoning from the logic of the FAQ, the professionals may have concluded that the IRS did not intend to require individuals who could establish within the confines of the IRS's regulations and past practice that they had no taxable income to enter the program.[24] Thus, only well-advised and

[20]This retroactive approach was taken for the 5 percent reduced penalty criteria of the 2011 OVDI, insofar as taxpayers who participated in the 2009 OVDP and who satisfied the criteria for the new 5 percent penalty announced in connection with the 2011 OVDI were made retroactively eligible for this 5 percent penalty treatment. *See* OVDI FAQ 52.

[21]The fact sheet makes no mention of the IRS voluntary compliance program, leaving open the question whether taxpayers are now permitted to quiet file past year returns and FBARs if they owe no or little tax. Both the OVDI and the OVDP provided warnings against quiet filing. *See, e.g.*, OVDI FAQ 15-16, 47; OVDP FAQ 10.

[22]IR-2012-5, *Doc 2012-444*, *2012 TNT 6-6*, also supports such a regime. IR-2012-5 announced a third voluntary disclosure program, which imposes a maximum 27.5 percent penalty on foreign accounts. The announcement states that the IRS is developing procedures for delinquent taxpayers who owe no tax.

[23]OVDI FAQ 51.1 expressly considered the FTC case and concluded for reasons that are unclear that those taxpayers needed to enter the program. Those taxpayers had taxable income to be sure, which was then eliminated through the use of credits — but query whether taxable income really should have been the touchstone for the policy.

[24]Ironically, the choice not to enter OVDI may have been the better one given that FS-2011-13, *Doc 2011-25752*, *2011 TNT 237-12*, now provides a roadmap for taxpayers who owe no tax to disclose their accounts and income penalty free. Certainly this route should be available to participants in the OVDI and OVDP.

hypercareful taxpayers (who happened to get through to the often overwhelmed OVDI hotline) will wind up paying a substantial penalty that many in practice will avoid — sometimes in blissful ignorance. This effect of a policy requiring people with no tax liability to enter the OVDI and pay substantial penalties was entirely foreseeable, and the failure of policymakers to take it into account is indefensible.

Second, the consequences of opting out of the OVDI penalty and into the normal audit process are unclear and without any effective, announced guidance. And in any event, the ability to opt out does not address the original policy choice to subject these people to the OVDI penalty in the first place. One reason opting out may not be a realistic alternative is that the IRS has announced that it is ready to impose a $10,000 non-willfulness penalty for failing to file FBARs. Stretched over eight years of the program, that results in a minimum of $80,000 in penalties. Opting out is further complicated by the IRS's apparent position that the $10,000 penalty applies on a per-account basis, even though the language in earlier versions of the FBAR form implied otherwise[25] and the only statement of the IRS's position to this effect can be found in the Internal Revenue Manual — hardly fair notice to affected taxpayers. The unfairness is further compounded by the lack of definition of an account (and specifically how the penalties might apply to subaccounts), so individuals who owe no taxes in reality could be subject to multiples of the $80,000 just mentioned if they opt out and cannot meet the reasonable cause requirement. As discussed, there is no upfront guidance on how these determinations will be made.[26] Because the decision to opt out is a one-way door, this lack of predictability makes the choice untenable for many taxpayers in OVDI. In any event, it is difficult to fathom a policy justification for using scarce IRS resources to audit and administer the appeals of taxpayers of modest means with no past income tax liability while imposing stiff penalties in the process.[27]

We note with concern that the opt-out regime for OVDI participants is colored by the IRS's past warnings to taxpayers who were considering opting out. OVDP participants were urged not to opt out, and even as late as June 2011 IRS personnel warned taxpayers that opting out from the OVDI penalty regime would result in a full audit of all open years and possible exposure to criminal liabilities.[28] The OVDI opt-out has been widely criticized as unfair and uncertain, which ''will likely discourage most taxpayers from using it.''[29] This unfairness is magnified for taxpayers in the OVDI who owe little or no taxes.

OVDI Penalties vs. Increasing Compliance

If the goal of the OVDI is to increase taxpayer compliance regarding FBARs and foreign account income reporting, assessing the OVDI miscellaneous penalty on taxpayers with no tax liability is counter to that goal. Despite the large number of OVDI participants, it is likely there are many more persons who chose not to enter OVDI (or who were unaware of the program). The question becomes how to best incentivize those who have not disclosed their foreign accounts to do so.

While there is an existing voluntary disclosure program in effect,[30] the applicable maximum penalty for foreign accounts is 27.5 percent of the account balance. Thus, the incentives to keep accounts hidden (or perhaps quiet file) grow stronger. If, however, persons with no tax liability are permitted to file late FBARs without penalty and without any requirement to show reasonable cause (that is, FAQ 17), similarly situated persons would have a positive incentive to disclose now.

Persons who are eligible for the section 911 exclusion and those with RRSP accounts currently have no incentive to come forward and declare offshore accounts. Regarding the section 911 exclusion, the regulations permit delinquent taxpayers to

---

[25]We note that the IRS, in its November 2011 update to Form TD F 90-22.1, has attempted to remove some of this ambiguity.

[26]Presumably, if our recommendation for an expedited opt-out program is not adopted, the reasonable cause factors outlined in FS-2011-13 will apply to OVDI participants who opt out.

[27]The potential strain on resources is exacerbated by the fact that the FBAR penalty, which is codified in Title 31, is not a tax penalty and thus is not collectible via normal tax collection methods. To collect the FBAR penalty from recalcitrant taxpayers, the government generally must bring a suit in court.

[28]*See* OVDI FAQ 51; and Jeremiah Coder, ''No Traditional Disclosure Practice Allowed for Offshore Cases,'' *Tax Notes*, June 20, 2011, p. 1214, *Doc 2011-12756*, or *2011 TNT 113-3* (quoting John McDougal, special trial attorney and division counsel in the IRS Small Business/Self-Employed Division as saying the IRS ''will audit whatever years are open under the statute of limitations'' and warning that taxpayers who opt out are making an irrevocable decision). McDougal acknowledged that taxpayers opting out of the initiative would face normal exams in which agents consider all potential penalties and years. *See also* Coder, ''Taxpayer Advocate Criticizes Offshore Disclosure Program,'' *Tax Notes*, July 4, 2011, p. 16, *Doc 2011-14238*, or *2011 TNT 126-1* (''as the TAS report notes, taxpayers have already incurred substantial representation costs in entering the OVDP, and if they withdraw from the program, they could face criminal action and penalty amounts several times greater than the value of the offshore account'').

[29]*See* Scott D. Michel and Mark E. Matthews, ''OVDI Is Over — What's Next for Voluntary Disclosures?'' *Tax Notes*, Oct. 17, 2011, p. 369, *Doc 2011-21263*, or *2011 TNT 201-3*.

[30]*See* IRM section 9.5.11.9. *See also* IR-2012-5.

submit late returns and elect to exclude foreign earned income from gross income. If John filed late and made the election, there would be no failure to file or failure to pay penalties because these are calculated as a percentage of the taxes owed.[31] Outside the OVDI the only applicable penalty is for failing to file FBARs. Thus, taxpayers like John have every incentive to quietly file (or alternately to become compliant going forward).

Similarly, for U.S. persons who failed to file Forms 8891 to defer income from RRSP accounts, there is a well-established letter ruling process for filing this election late. Once a letter ruling request has been approved and the late election made (and assuming the RRSP is the only foreign account), there would be no additional taxable income and no tax. Here again the only remaining issue is the FBAR penalty, which serves as a disincentive to persons who recently became aware of their reporting obligations and want to voluntarily disclose their accounts. For those taxpayers, the rational choice will be compliance starting now or quiet filing. This same logic extends to persons who would have no taxable income because of FTCs.

Conclusion

An expedited procedure for processing OVDI cases when the taxpayer owes little or no taxes is needed to provide certainty and fairness. That procedure could be conceptually similar to the passive foreign investment company procedure implemented during the OVDP and continued in the OVDI.[32] Persons with no taxes due should receive a penalty-free pathway that rewards their disclosure and incentivizes others with similar circumstances to do the same. OVDI examiners could be empowered to initiate an abbreviated opt-out procedure whereby taxpayers with no or de minimis tax liabilities receive an FAQ 17/FS-2011-13 penalty-free exit without requiring them to undergo an audit or show reasonable cause (or perhaps on a minimal showing that there was no intentional failure to file). Such a program could be easily adopted into ongoing voluntary disclosure programs and could help bring thousands of people into compliance.

Administering the OVDI in a way that penalizes individuals who never sought to evade U.S. tax liabilities, who owe no taxes, and who construe the existing guidance conservatively in an effort to comply with the tax laws is simply unfair. There can be little doubt that a significant percentage of OVDI participants who owe no tax for past years (whether due to a section 911 exclusion, treaty relief, or FTCs) will decide to opt out of the OVDI penalty regime. The IRS will then be faced with the prospect of full, multiyear audits lasting months in the appeals process because these taxpayers will resist the imposition of draconian FBAR penalties.

A more rational and fair approach would be to offer OVDI participants who owe no taxes an administratively expedient method to file delinquent returns and FBARs without penalty. Such an approach should be made available retroactively to taxpayers who previously participated in the 2009 OVDP and were required to pay penalties, even though they had no tax liability for the period in question.

---

[31]Section 6651(a)(1), (2).

[32]*See* Marie Sapirie, ''More Written Guidance Needed as OVDI Deadline Nears,'' *Tax Notes*, Sept. 5, 2011, p. 1001, *Doc 2011-18425*, or *2011 TNT 168-1*.