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News Analysis: More Written Guidance Needed as OVDI Deadline Nears

by Marie Sapirie

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In news analysis, Marie Sapirie looks at several aspects of the IRS's offshore voluntary disclosure initiative that can and should be clarified through written guidance soon.

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Several critical issues remain unresolved in the IRS's offshore voluntary disclosure initiative (OVDI) as the new September 9 deadline for making submissions and requests for extensions approaches, according to practitioners.

Interest in the OVDI has spiked in recent weeks after a slow initial response from taxpayers with offshore accounts to the announcement of the new program. Practitioners speculate that recent developments such as the announcement of the investigation of Credit Suisse Group in July and the renewed interest of the foreign press in the OVDI are contributing factors to the last-minute rush. (For prior coverage, see *Doc 2011-17418* or *2011 TNT 157-1*.)

From a compliance perspective, the increased interest is excellent news for the IRS. But unless some key changes are made, it could soon result in a major administrative headache for the agency. The IRS could prevent some of the problems that are percolating by issuing more substantive written guidance, according to Caroline D. Ciraolo, a partner at Rosenberg Martin Greenberg LLP.

One effect of the lack of guidance is that participating taxpayers who are eager to provide complete information to quickly resolve their cases are submitting prodigious quantities of paper in an effort to be fully compliant. G. Michelle Ferreira, a shareholder with Greenberg Traurig LLP, said it is not unusual for a taxpayer's submission to fill two boxes. "I don't know how they're going to read through them. I don't know how they possibly could," she said. "If thousands of people turn in two boxes, who is going to go through that stuff?"

Another indication of the need for written guidance occurred earlier this summer when the volume of calls to the OVDI hotline overwhelmed the voicemail inbox, making it impossible for callers to leave messages.

Despite the temporary inaccessibility of the hotline, practitioners view it as a useful but limited resource in the absence of written guidance. The IRS staff members answering the hotline have been helpful, but they are not always able to answer questions, said Ciraolo. A bigger problem with the hotline for practitioners and clients seeking certainty "is that you are not getting any of this guidance in writing," she said.

The dearth of written guidance is especially frustrating because the only guidance the IRS has issued on the program is in the form of frequently asked questions, which are subject to change as the agency reconsiders its policies. An example of that occurred in February when the reasoning behind FAQ 35 of the 2009 offshore voluntary disclosure program was withdrawn from the FAQs governing the OVDI.

The IRS has made some additions to the FAQs that govern the OVDI, but those additions have left some large issues unresolved. The last substantive set of changes to the FAQs was made in early June. The update was accompanied by guidelines for opt-out and removal procedures. (For prior coverage, see *Doc 2011-12011* or *2011 TNT 107-1*.)

On August 19 the IRS quietly updated FAQ 52.1 to correct an error pointed out by the New York State Bar Association in comments submitted to the agency. However, the NYSBA report included 12 additional substantive points that the IRS has not yet addressed, as well as a request for formal published guidance on the program. (For the NYSBA report, see *Doc 2011-17150* or *2011 TNT 153-13*.)

Practitioners are hopeful that the IRS will continue to consider changes to the OVDI. They say the IRS seems willing to engage in dialogue but may view some issues as resolved. For example, Bryan C. Skarlatos, a partner at Kostelanetz & Fink LLP, pointed to the reduced 5 percent offshore penalty carveout for the financial assets of nonresidents that was included in the June updates to the FAQs. "I think [IRS officials] have already gone as far as they are willing to go with respect to nonresident citizens living abroad," he said.

Practitioners are also frustrated by the evolution of the IRS's positions, as dispensed through the hotline. Ciraolo said that after the examples in FAQ 52 regarding the application of the reduced 5 percent penalty were released in June, it was unclear whether the IRS would include exempt income or reported income in calculating whether a foreign resident received more than $10,000 of U.S.-source income.

"We would call the hotline and the first couple of times we were told it's all income, which seemed a bit harsh," Ciraolo said. Later in the summer the answer from the hotline changed, and the IRS started giving new guidance that exempt income was not included in the U.S.-source income computation, she said.

Ciraolo said that she and others were happy about the change but that it would have been better to have that guidance in writing.

Filing Questions

One question that has become more urgent as the deadline approaches is whether the mailbox rule applies to a request for the 90-day extension, Ciraolo said. FAQ 25.1 says the request must be sent by the deadline, but practitioners are trying to interpret other, anecdotal responses from the IRS. Some practitioners were told by IRS staff on the hotline before the announcement of the September 9 extension that they should mail in the request by August 31 but that they should also fax it to the Philadelphia office. Others have heard that the request has to be received by the deadline.

Similar questions have come up regarding the application of FAQs 17 and 18, which address taxpayers who failed to file foreign bank account reports or information returns but who reported all their taxable income. The 90-day extension does not apply to that type of submission, but it remains unclear whether the mailbox rule applies. The mailbox rule does not apply to normal FBAR filings, which must be received by the IRS by the annual June 30 deadline.

The filing questions are ripe for resolution in written guidance. "There is an ambiguity on some of these issues that is having an impact on how practitioners are handling these cases," said Ciraolo.

The extension of the deadline from August 31 to September 9 because of Hurricane Irene gives the IRS a slightly larger window in which to provide uniform guidance on remaining issues. The IRS announced on August 29 that the extension also applies to delinquent FBARs under FAQs 17 and 18.

Overseas Retirement Plans

How to deal with foreign retirement plans that are tax-exempt in the foreign country, but reportable by U.S. taxpayers living abroad, is a question that would benefit from a pragmatic written solution like the workaround that was created for passive foreign investment companies last September, say practitioners.

"This is a real problem, and it's going to become a huge issue inside the program," said Ciraolo.

The problem is particularly acute in the case of some Canadian retirement accounts such as registered retirement savings plans (RRSPs). The income in those plans is not taxable in the United States as long as the taxpayer timely files a tax return and attaches a Form 8891, "U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans," to report the account. To file a late Form 8891, however, taxpayers must seek relief through the private letter ruling process. Without a streamlined solution for late filings, taxpayers entering the OVDI are faced with yet another hurdle -- and expense -- in becoming compliant.

Ciraolo said it would be helpful for the IRS to issue guidance allowing people who are in the program to make a late election to defer U.S. taxation on income accrued in the retirement plan under Rev. Proc. 2002-23 and based on the Canada-U.S. treaty by filing the Form 8891 without having to seek a private letter ruling. (For Rev. Proc. 2002-23, 2002-1 C.B. 744, see *Doc 2002-7446* or *2002 TNT 59-7*.)

Of greater importance is the exclusion of the value of retirement plans from the calculation of the miscellaneous offshore penalty. The assumption by many practitioners is that if a Form 8891 was timely filed for an offshore retirement account, or is permitted to be filed late, "that not only will you be able to exclude the income from the [taxpayer's] 1040, but also exclude from the account balance for purposes of computing the offshore penalty," said Robert E. Ward, principal at Robert E. Ward and Associates.

Because practitioners have nothing in writing from the IRS to confirm that assumption, it can be difficult to convince taxpayers with these accounts to enter the program. The retirement accounts tend to have substantial balances, so if they are included in the computation of the offshore penalty it can make difference, said Ward.

"If US-source income in an RRSP is included in the computation of U.S.-source income for purposes of qualifying for the 5 percent penalty, that impacts a lot of taxpayers in Canada," said Ward. Richard S. Chisolm, also of Robert E. Ward and Associates, said that the concern is that taxpayers could have to include income earned inside their RRSPs from stock in U.S. companies, and that could push the taxpayer's U.S.-source income from the investments over the $10,000 threshold to qualify for the reduced 5 percent penalty. "At that point, it really starts to look confiscatory," he said.

Also, the definition of "US-source income" in the context of the OVDI is not clear.

Chisholm said that if the IRS could settle these issues regarding the treatment of retirement plans, it would convince many more taxpayers to step forward. "For clients with these retirement plans, these are fundamental questions," he said.

In many cases, Canadian residents will owe no U.S. tax, so their concern is with the penalty on their retirement funds. Ciraolo said she and her colleagues have talked with many Canadians who were unaware of their U.S. reporting obligations and who therefore did not willfully fail to file their returns or their FBARs. She said that mistakes regarding many of those retirement accounts had no cost to the U.S. treasury.

"We need these FBARs filed, and the education campaign that came out of the 2011 program is very helpful," Ciraolo said. However, she predicted that in October or early November many taxpayers will opt out because they view the 5 percent penalty on all of the assets in an otherwise nontaxable retirement account (assuming a late election for deferral is granted) as too high a price for an unfiled FBAR.

Domestic Noncompliance Issues

Taxpayers must make a full disclosure in the OVDI of any past tax misdeeds, and not just foreign income-related failures. However, the program was not designed to handle domestic deductions, losses, and credits that may apply to unreported domestic income. Consequently, some agents have told taxpayers that the program cannot handle any domestic issues, practitioners said. That inconsistency -- between the need to make a full correction of all past noncompliance and the agents' belief that no domestic issue can be considered -- needs to be resolved.

Structural Problems

Written guidance will go a long way toward resolving the problems in the OVDI, but a principal stumbling block may be structural. Taxpayers whose noncompliance was not willful and who want additional review of their circumstances are offered only one solution: the opt-out procedure.

"Many taxpayers did not willfully fail to report. To require them to go through the program and then opt out doesn't seem to be the right way to go," said Skarlatos. He cited nonresident citizens as an example. Many nonresident citizens find themselves subject to penalties that constitute a large percentage of their entire net worth just for failing to accurately file, which seems disproportionate to their mistakes.

In a response to the Global Organization of People of Indian Origin (GOPIO), an Indian community group that requested revisions to the program so that participants with less than $250,000 in their bank accounts during the years covered by the OVDI are not subjected to the 25 percent penalty, Heather Maloy, commissioner of the IRS Large Business and International Division, reiterated the IRS's position: "If the offshore penalty is unacceptable to a taxpayer, he or she may opt out of the OVDI and request that we refer the case for an examination of all relevant years and issues." (For GOPIO's letter, see *Doc 2011-14581* or *2011 TNT 129-22*. For Maloy's response, see *Doc 2011-17649* or *2011 TNT 159-16*.)

The IRS's position that taxpayers can opt out is not satisfying to many taxpayers who entered the program seeking certainty in the resolution of their tax troubles. The opt-out procedures add an element of risk for taxpayers and the prospect of extra work for the IRS. Ferreira argued that the opt-out procedures are vague.

Templates Abroad?

Although the principal design of the OVDI is unlikely to change much, other governments have set up different programs for recovering taxes on offshore income. One feature that the United Kingdom embraced in its agreement with Liechtenstein is a written memorandum of understanding detailing the operation of the program.

Since 2009, U.K. taxpayers with unreported accounts in Liechtenstein have had the opportunity to turn themselves in and pay back taxes, interest, and a fixed penalty of 10 percent to HM Revenue & Customs. The terms of the MOU between the U.K. and Liechtenstein regarding the disclosure program include a requirement, similar to one in the Foreign Account Tax Compliance Act, that Liechtenstein financial intermediaries review their accounts and identify those that may not be in compliance with U.K. tax laws. If the account holders do not provide evidence that they are in compliance or working on coming into compliance, their accounts are to be closed. (For the announcement of the program, see *Doc 2009-18142*. For prior coverage, see *Doc 2009-18139*.)

The U.K. program also provides an "innocent error" exception for taxpayers who are able to show they had reasonable cause for making the error and that the error was made by the taxpayer, not a third party. In contrast to the OVDP and OVDI, which provided comparatively short windows for taxpayers to enter the program, the U.K. program is open through 2015.

Shamik Trivedi contributed to this article.

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