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Taxpayers Face Hurdles and Risks When Opting Out of OVDP

by Jeremiah Coder

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Foreign bank account holders who are considering entering the IRS's offshore voluntary disclosure program (OVDP) face numerous potential obstacles to reaching a fair civil resolution, practitioners and officials said during a January 16 webcast sponsored by the American Bar Association Section of Taxation.

Mark E. Matthews of Caplin & Drysdale said that an early fundamental question that taxpayers must confront in evaluating whether to enter the disclosure initiative is how likely they are to opt out of the program's special penalty regime. Taxpayers who did not commit willful actions or who lack criminal exposure might have a strong incentive not to participate, because entering the OVDP requires filing eight years of amended returns, paying large professional fees, and undergoing an IRS review, he said.

For small-dollar offshore cases involving negligence and reasonable cause, an account holder may decide to simply file three years of amended returns and any unfiled foreign bank account reports and "face the strong chance" that the IRS will process them without question, Matthews said. Although the taxpayer should know that the returns could be selected for examination, the same defenses exist outside the OVDP that exist within it, he said. The IRS has had to make threats regarding qualified amended returns (QARs) to put taxpayers on notice that they won't be receiving protection from criminal prosecution outside the OVDP, he said.

"My view is that not every amended return is an old quiet disclosure, which you normally think of as someone with criminal exposure," Matthews said. "Not every international tax compliance issue has to go through OVDP. There is still room for a disclosure outside of OVDP. It is a complicated analysis." He added that some taxpayers may want to use the program for certainty and to avoid criminal prosecution.

David Breen, senior counsel, IRS Small Business/Self-Employed Division, agreed that tax professionals must carefully analyze what a client's penalty exposure is likely to be. The IRS wants a decision to opt out to be made while considering all of the facts and circumstances, because opting out subjects the taxpayer to the Criminal Investigation division's normal voluntary disclosure practice, which includes expansive discretion to perform examinations, he said.

Even if the taxpayer has little or no deficiency for the tax years covered by the OVDP, opting out won't protect him from potential liability for prior fraudulent actions, Breen said, adding, "There are a number of criteria that you need to consider before opting out." The IRS requires requests to be delivered in writing to the revenue agent, resulting in a preliminary report that presents the agency's opinion, he said. Because a decision to opt out is irrevocable, the IRS forwards the request to a committee for evaluation to help alert the taxpayer of possible consequences, he said.

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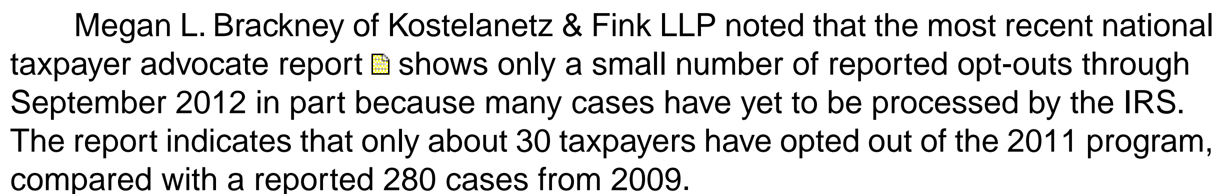
Breen rejected concerns that a decision to opt out will necessarily hurt a taxpayer, saying that "no one gets handled differently for opting out." Rather, an opt-out exam follows the path of a traditional civil tax exam, meaning that all taxes and penalties are possible, including FBAR and fraud penalties, he said. "That's how regular exams proceed; there's no stricter scrutiny here," he added.

Breen said the OVDP ensures that previous filing mistakes and underpayments are handled properly, which is why the IRS discourages QARs. A QAR "doesn't purge fraud," he said, adding that if a John Doe summons has already been filed covering the taxpayer, a QAR cannot be filed.

John McDougal, special trial attorney and division counsel, SB/SE, noted that the IRS has already issued John Doe summonses for lists of account holders at UBS, Stanford Group, and HSBC India. "Don't overlook having a heart-to-heart with the agent over the future of the case if you are trying to decide to opt out," he said, adding that taxpayers should discuss whether to opt out of the OVDP with the revenue agent who handles the case to determine how the case might proceed under a traditional examination.

Breen said that some taxpayers opting out of the OVDP have had to execute statute of limitation waivers as well as FBAR extensions. The IRS views the FBAR extension as the waiver of an affirmative defense by the taxpayer to raise that defense in subsequent litigation, he said.

Richard J. Sapinski of Sills Cummis & Gross PC said that entering the OVDP is like "crossing the Rubicon" because if a taxpayer later decides to opt out, there is little chance that the IRS will return taxes and interest paid from tax years that would have been closed had the taxpayer not entered the program. "The IRS is not returning tax returns or money to those taxpayers having second thoughts," Breen said, adding that taxpayers should "not assume that opting out gives you a mulligan."



Megan L. Brackney of Kostelanetz & Fink LLP noted that the most recent national taxpayer advocate report shows only a small number of reported opt-outs through September 2012 in part because many cases have yet to be processed by the IRS. The report indicates that only about 30 taxpayers have opted out of the 2011 program, compared with a reported 280 cases from 2009.

With an average civil FBAR penalty of $15,737 assessed against taxpayers who opted out of the 2009 program, the IRS required many of the least culpable individuals to face large administrative burdens because their cases took nearly twice as much time to close as other offshore cases, Brackney said.

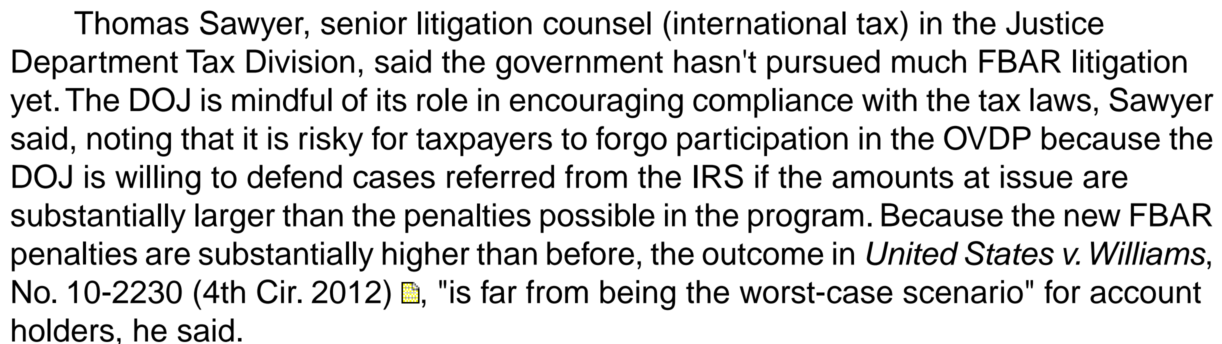
FBARs and Willfulness

McDougal said that in the civil FBAR penalty context, reckless disregard can amount to willfulness. IRS agents make a full appraisal of the facts surrounding taxpayer actions, he said, noting that the IRS is training its agents to undertake thorough inquiries. Rather than simply reviewing the check-box for foreign bank accounts, agents should be investigating what passed between the taxpayer and return preparer, interviewing

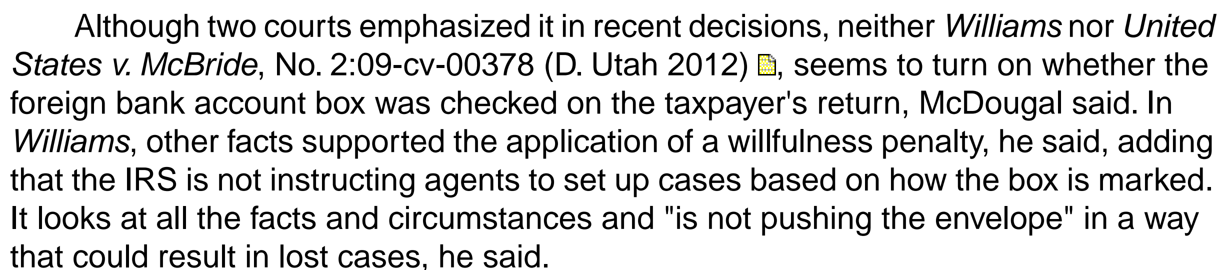
the preparer, and examining the taxpayer's filing history, he said, adding, "You have to take all those into account in deciding whether to assert a [willfulness] penalty."

Asked to explain why the IRS believes a non-willful FBAR penalty can be applied to each unreported account, McDougal said that the statute, 31 U.S.C. 5321(a)(5), refers to a single account. "The use of the singular is the basis for the Service's position that you look at each account in deciding if a penalty applies," he said. "But I don't think it's been briefed and decided in a careful way by a court yet," he added, citing the absence of "reasoned analysis" in recent judicial decisions on the issue.

Caroline D. Ciraolo of Rosenberg Martin Greenberg LLP said a reasonable argument can be made that a civil non-willful FBAR penalty applies on a per-FBAR basis rather than for each unreported account. Only one FBAR must be filed per year, so the IRS's stacking of penalties per account conflicts with the statute's notion of a maximum penalty cap, she said.


Thomas Sawyer, senior litigation counsel (international tax) in the Justice Department Tax Division, said the government hasn't pursued much FBAR litigation yet. The DOJ is mindful of its role in encouraging compliance with the tax laws, Sawyer said, noting that it is risky for taxpayers to forgo participation in the OVDP because the DOJ is willing to defend cases referred from the IRS if the amounts at issue are substantially larger than the penalties possible in the program. Because the new FBAR penalties are substantially higher than before, the outcome in *United States v. Williams*, No. 10-2230 (4th Cir. 2012), "is far from being the worst-case scenario" for account holders, he said.

McDougal said the IRS Office of Chief Counsel initially took a conservative position when it advised field agents on the standard of proof the government must satisfy to show willfulness for the FBAR penalty, in part because the issue had not been litigated. But courts have since agreed with the IRS that preponderance of the evidence, rather than clear and convincing evidence, is the correct standard to apply in the civil context, he said.


Although two courts emphasized it in recent decisions, neither *Williams* nor *United States v. McBride*, No. 2:09-cv-00378 (D. Utah 2012), seems to turn on whether the foreign bank account box was checked on the taxpayer's return, McDougal said. In *Williams*, other facts supported the application of a willfulness penalty, he said, adding that the IRS is not instructing agents to set up cases based on how the box is marked. It looks at all the facts and circumstances and "is not pushing the envelope" in a way that could result in lost cases, he said.

Sawyer said it would be unusual for a taxpayer to receive a pre-suit notice from the government when it is seeking to enforce the assessment of an FBAR penalty, because the individual already had a chance to settle the issue with the IRS and the notice could provide an opportunity to dissipate or hide assets. However, the DOJ gives each case another look before filing suit, he said.

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