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Opting Out of the IRS Offshore Disclosure Programs

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In 2009, the IRS had introduced an Offshore Voluntary Disclosure Initiative/Program (OVDI/OVDP). In the years that followed, the program was reintroduced and revised. Soon enough, thousands of practitioners started jumping on the foreign tax repair bandwagon. Many had no foreign tax experience or held limited knowledge of the foreign tax reporting and compliance requirements. They merely heard there was some form of amnesty being provided and instantly touted services to assist clients in rendering their submission. But often, they themselves didn't understand the full implications or content of what they were submitting.

When it comes to addressing offshore filing deficiencies, several issues exist in connection with the statute of limitations, the nature of the error/omission, and the taxpayer's intent. Many clients have been receiving conflicting advice and it's easy to see how they can become confused. This discussion attempts to clarify the measures associated with addressing and correcting these foreign tax reporting matters.

A Tax Preparer's Endorsement

A common fact pattern starts when clients visit their accountant. They indicate that they've heard of a foreign tax crackdown and are wondering if it applies to them. Befuddled, the accountant recognizes that there were several years of unreported foreign income and filings. The accountant was either unaware of the offshore activity's disclosure requirements or of the fact that the client had engaged in that activity.

A kneejerk reaction among some accountants has been to recommend that the client keep it nondescript. They advised their client to consider preparation and "quiet" submission of corrected back-year or deficient tax returns to the IRS processing center, rather than to the Criminal Investigation Division. In effect, they were hoping the submission would sneak into and be buried in a pile of paper at the IRS offices, never to be seen again. But because electing to proceed quietly was not viewed by the IRS as a formal disclosure, there were no protections from prosecution.

Technically, IRS Circular 230 mandates that the accountant not formally endorse anything other than a "loud" disclosure anyway. But despite that instruction, more than 10,000 taxpayers arranged for the preparation of quiet disclosures for their foreign bank accounts under the 2009 OVDI Program. As a result, on Apr. 26, 2013, the U.S. Government Accountability Office (GAO-13-318) recommended that the IRS more effectively detect and pursue quiet disclosures and first-time filers. Since that time, the IRS has been using data mining techniques to trail them. Based upon this development, taxpayers must carefully weigh their criminal exposure before contemplating the quiet path or only initiating corrections prospectively.

A Common Attorney Recommendation

Afterward, the clients commonly turn to their attorney. Besides, a voluntary disclosure submission, if made, is directed to the IRS Criminal Investigation Division. Civil liberties could potentially be at stake, and the client is seeking the safest path to reindoctrinate back into the tax system. Along those lines, the voluntary disclosure becomes recommended and a large penalty is assessed to close the matter. The attorney considers advising the client to opt out of the disclosure program framework, but might pause after receiving a warning letter from the IRS. The letter describes that if an opt out is undertaken, exposure to all penalties "in full" would be back on the table (even the willful one for one-half of the balance per year). Adverse to risk, the attorney might get scared and instead direct the client to accept the high flat rate penalty imposed on the value of the assets under the disclosure program. Often, it ends there. But what is unfortunate is that the large penalty payment may not even have been necessary or in the client's best interest to make.

The Client's Dilemma

Therein lies the dilemma for the client—often caught between the tax preparer who might have caused (or not known about) the problem and the attorney without the necessary background in international tax to resolve it correctly. And between those two points of direction lies the opt out that the client was brought closer to but ultimately scared away from, even though they may have been better served by giving stronger consideration to that option.

Opting Out

If the client did not carry the indicia of willful intent, then the decision to opt out of the voluntary disclosure program should be given strong attention. It offers the comfort that a loud disclosure, in good faith, was still made, while maintaining the appeals rights afforded under the traditional audit process. After all, not every offshore account was secretly and intentionally established in Switzerland.

Many practitioners fear that opting out would invite criminal exposure or retribution. But based upon the National Taxpayer Advocate's report to Congress, the IRS had not initiated any criminal proceedings against those who had opted-out of the 2009 program at all. And the average penalty asserted on 2009 OVDI opt-outs was a mere $15,737—far less than the hundreds of thousands that were often imposed and consented to under advice of counsel in the OVDI.

When a taxpayer opts out, the IRS agent assigned will typically conduct a multi-hour interview with the taxpayer. There are always risks, but unlike the OVDI program, which imposes rigidity on its examiners, opt-out auditors are given more leeway in the assessment of the foreign reporting penalties. In fact, they are *expected* to take facts and circumstances into account. This is not something mentioned when the client gets the threatening letter saying that opting out puts all available penalties (including willful) back on the table. In fact, penalty "mitigation" guidelines were even provided to minimize the consequences on smaller violations. If convinced, the IRS is even authorized to issue a Letter 3800 (a warning letter) that abates the foreign reporting penalties for one or many of the tax years entirely. To clarify the process, the IRS has updated its appeals procedures for the resolution of contested foreign bank account reporting (FBAR) assessments outside the OVDI (Revised IRM 8.11.6).

Protective Refund Claims

Tax advisors should remain aware of the significant distinctions between the FBAR and income tax assessment statutes. The statute of limitations for assessment of FBAR penalties is governed by Title 31 of the U.S. Code and can be extended even after expiration. Signing the statutory extension can reopen closed years because it is considered a waiver of an affirmative defense; however, Title 26 of the US Code governs the assessment of income taxes derived from offshore activity. Once expired, the income tax statute typically stays closed, even if an extension is subsequently executed by agreement.

This past December presented a critical deadline. It had been two years from Dec. 9, 2011, the extended due date under the 2011 OVDI program. Prior to that date, taxpayers who had submitted under OVDI would have been wise to watch the timing of their submissions against the clock very closely. The 2011 OVDI mandated payment for eight years of back income taxes at the time of submission, including payments for expired tax years. These submissions often take years to run through the process and there is uncertainty in relying on an expired statutory assessment extension to preserve clients' refund options if they choose to opt out.

The Internal Revenue Code (IRC) holds that the statute of limitations for filing a claim for refund is the later of three years from the tax return's original filing or two years from the date the tax was paid. As a result, advisors were wise to institute protective refund claims prior to the lapse of their two-year payment anniversary. Those who hadn't or who had trusted the stale statutory extensions might encounter problems. When the client opts out without timely refund claims in place, the tax payments for years expired at submission face the prospect of being surrendered. This is unfortunate because those dollars could instead have been applied to any mitigated penalties, or even better, refunded.

Caveat for CPAs

CPAs may want to think twice before representing their own client during the opt-out process. The Internal Revenue manual states, "For violations occurring after October 22, 2004, a penalty, not to exceed $10,000, may be imposed on any person who violates ***or causes** any violation* of the FBAR filing and recordkeeping requirements" (IRM 4.26.16.4.4). This can create danger during the lengthy IRS opt-out interview because a common theme that surfaces is FBAR penalty abatement for "reliance upon preparer advice." In addition to the lack of attorney-client privilege, a conflict of interest can arise when the CPA-preparer and client are left to point the finger at each other in front of the IRS agent, each to avoid bearing the brunt of the penalty.

Although the loud voluntary disclosure option is the only path that Circular 230 allows tax advisors to affirmatively endorse, it does not mean that the client should be railroaded into voluntarily surrendering a draconian penalty (and expired income taxes) for unwillful and unintentional omissions—especially if it's being done solely because of the advisor's trepidation with the path not taken. Granted, many clients are willing to pay a premium for closure; however, the unfitting threat of all penalties back on the table should not supersede the independent judgment that their advisors are being paid to provide. When deciding to opt out, the difference in tax dollars owed can be significant. In the tax controversy arena, familiarity with foreign tax audits and appeals is critical. This is not the time to dabble.

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