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August 5, 2011

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
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The Honorable Emily S. McMahon
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(Tax Policy)
Department of the Treasury
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Re: 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers

Mr. Shulman, Mr. Wilkins and Ms. McMahon:

We are writing to provide comments on the 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers (the "FAQs") as posted on the Internal Revenue Service (the "Service") website.[1]

[1] The principal author of this letter is Bryan C. Skarlatos. Significant contributions were made by Andrew Braiterman, Kimberly Blanchard, Alice Joseffer, Michael Miller, Marc Orlofsky, Michael Sardar, and Michael Schler. This letter reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates. This letter may be cited as New York State Bar Association Tax Section, Letter on the 2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers (Report No. 1246, August 5, 2011).

We recognize that the deadline for participating in the 2011 Offshore Voluntary Disclosure Initiative (the "2011 OVDI") is fast approaching and that the Service may not be in a position to revise the FAQs prior to that deadline. Nevertheless, taxpayers, their representatives and revenue agents will continue to refer to the FAQs for guidance throughout the 2011 OVDI process and, therefore, we believe that the Service should continue to revise and up-date the FAQs as it deems appropriate in order to provide guidance to the parties involved.

This letter represents the view of the New York State Bar Association Tax Section, but has not been reviewed by the Executive Committee or the House of Delegates of the New York State Bar Association.

Background

In the wake of the UBS prosecution and related proceedings, thousands of taxpayers inundated the Service with requests to participate in the Service's long-standing voluntary disclosure program so that they could disclose their previously unreported offshore bank accounts, entities and arrangements. The Service was forced to develop procedures to process the huge volume of voluntary disclosures in a way that insured that appropriate penalties were imposed on non-compliant taxpayers and that similarly situated taxpayers were treated consistently and fairly. A natural tension developed between the need to have streamlined procedures that would allow the Service to process a large volume of cases efficiently, on the one hand, and the need to distinguish between taxpayers with differing levels of culpability for purposes of imposing penalties, on the other hand.

In determining the appropriate penalty structure, the Service had to consider many different penalties. Taxpayers who fail to report foreign bank accounts or entities face two types of penalties: tax penalties and information return penalties. The tax penalties include accuracy, delinquency and fraud penalties that can range from 20% to 75% of the underpaid tax.[2] In addition, there are penalties for failure to file or falsely filing information returns such as TD F 90-22.1, also known as a Report of Foreign Bank Account ("FBAR"), and Forms 3520, 3520A, 5471, 5471, 926 and 8865.[3] Some of these information return penalties can be quite large. For example, the penalty for willfully failing to file or falsely filing a FBAR can be 50% of the amount in the unreported account per year. Surprisingly, in most cases involving unreported foreign accounts or entities, the potential information return penalties are many multiples of the income taxes, tax penalties and interest that due.

On March 23, 2009, Linda Stiff, Deputy Commissioner for Services and Enforcement for the Service issued a memorandum outlining a relatively simple penalty framework to be applied

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[2] Sections 6651, 6662 and 6663 of the Internal Revenue Code of 1986, as amended (the "Code").
[3] 31 U.S.C. 5321(a)(5) and Code sections 6677, 6038(b) and 6038B(c).

to voluntary disclosure requests involving offshore issues (the "Stiff Memo"). The Stiff Memo required taxpayers to pay all taxes and interest due for the prior six years plus a 20% accuracy penalty[4] and a miscellaneous penalty in lieu of all other information return penalties equal to 20% of the highest balance in the foreign bank account or entity. The Stiff Memo provided that the 20% miscellaneous penalty could be reduced to 5% in certain circumstances.

On May 6, 2009, the Service posted Frequently Asked Questions to its website providing more detail regarding the procedures that taxpayers should use to make a voluntary disclosure involving off-shore arrangements and how applicable taxes and penalties would be computed (the "2009 FAQs"). The 2009 FAQs were up-dated several times and applied to taxpayers making a voluntary disclosure under the 2009 Offshore Voluntary Disclosure Program that ended on October 15, 2009 (the "2009 OVDP").

The 2009 FAQs essentially adopted the penalty structure outlined in the Stiff Memo with a few modifications. First, the 2009 FAQs provided that, if a taxpayer did not have any unreported income in connection with the unreported foreign account, the taxpayer could simply file past-due information returns and no penalties would be imposed. Second, the 2009 FAQs expanded the types of assets on which the 20% miscellaneous penalty would be computed to include all foreign assets, including real estate and personal property, related to the tax non-compliance. Third, the 2009 FAQs stated that, under no circumstances would a taxpayer be required to pay a penalty greater than he or she would otherwise be liable for under existing statutes.

Many taxpayers and practitioners interpreted this third modification to mean that the Service would consider whether a taxpayer should be subject to non-willful FBAR penalties as opposed to a 20% miscellaneous penalty, but the Service later clarified that it would not make any determinations regarding willfulness in the context of the 2009 OVDP. Thus, taxpayers who entered the 2009 OVDP are deemed to have acted willfully and are offered a settlement based on a reduced willful penalty for failure to file information returns. By imposing a 20% miscellaneous penalty on most taxpayers who participate in the 2009 OVDP, the Service chose to emphasize information return penalties over tax penalties, even though the information return penalties will be substantially higher than the tax penalties in almost every case.

On February 8, 2011, the Service posted a new set of Frequently Asked Questions on its website (the "FAQs"). The FAQs have been up-dated several times and govern voluntary disclosures made as part of the 2011 Offshore Voluntary Disclosure Initiative (the "2011 OVDI") which ends on August 31, 2011. The FAQs adopt essentially the same penalty structure from the 2009 FAQs with the following modifications. First, taxpayers are required to pay income taxes, penalties and interest from 2003 forward. Second, the miscellaneous penalty is increased from 20% to 25% of the unreported foreign accounts and assets. Third, the 25% penalty is reduced to 12.5% for accounts under $75,000. Forth, the circumstances in which the miscellaneous penalty

[4] The Stiff Memo also provided for a potential delinquency penalty in appropriate cases

can be reduced to 5% have been expanded. Finally, the FAQs, together with a separately issued Opt-Out and Removal Guide, specify procedures that a taxpayer can use to opt-out of the 2011 OVDI if the taxpayer believes he or she will receive more favorable treatment outside of the program.

Through the evolution of the Service's voluntary disclosure program from the 2009 OVDP and the 2011 OVDI, the Service has established what is essentially a five-tier penalty framework for voluntary disclosures of offshore accounts and other assets: 1) a 25% miscellaneous penalty for most taxpayers; 2) a 12.5% miscellaneous penalty for taxpayers with unreported accounts under $75,000; 3) a 5% penalty for some taxpayer who meet certain narrowly defined conditions; 4) no penalty for taxpayers who have no unreported income associated with the foreign accounts or entities; and 5) taxpayers who believe that they can prove that they owe no penalties or smaller penalties because they did not act willfully or have reasonable cause may opt-out and face a full audit.

General Comment

We commend the Service for developing procedures that have enabled it to process tens of thousands of voluntary disclosures over the past two years. The 2009 OVDP and the 2011 OVDI have done a good job of balancing the need to process the huge number of voluntary disclosures against the need to differentiate between taxpayers with differing levels of culpability. At the same time, the current penalty framework is limited in its ability to differentiate between taxpayers with different levels of culpability and therefore produces some inequitable results. For example, taxpayers who have been willfully evading taxes on domestic business activities and stashing their unreported gains in unreported foreign structures may get a relatively light FBAR penalty under the 2011 OVDI because the penalty framework emphasizes penalties on foreign accounts and assets over penalties on unreported income. On the other hand, taxpayers who negligently failed to report small amounts of income are subject to a relatively harsh FBAR penalty because there is no mechanism within the 2011 OVDI program to evaluate the taxpayer's willfulness.

We recognize that the Service cannot evaluate the willfulness of every taxpayer who wishes to participate in the 2009 OVDP or the 2011 OVDI and that is why the Services has created a mechanism for taxpayers to opt out of the programs and undergo an audit. We agree that, given the large number of voluntary disclosures, this is an appropriate way to evaluate the culpability of particular taxpayers who believe that they did not act willfully. However, we are concerned that certain statements have been made by Service personnel that strongly encourage taxpayers to participate in the voluntary disclosure programs or face maximum criminal and civil penalties under the law.[5] In addition, FAQ 15 states that "[t]axpayers are strongly encouraged to

[5] E.g., "For those hiding assets offshore, there is an obvious reason to come in now. If we find you, you face harsher penalties and the possibility of jail time. If you come in voluntarily, you pay a steep price but avoid going to jail." Commissioner Schulman's Statement on the 2011 OVDI, February 8, 2011; "[H]arsh civil and criminal penalties could await those who engaged in quiet disclosure". Statement attributed to the Service by Robert Goulder in "Quiet Disclosures Get No Love From IRS," Tax Notes May 11, 2010.

come forward under the 2011 OVDI…Those taxpayers making 'quiet' disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years." While these statements and procedures refer to taxpayers who have not made voluntary disclosures, taxpayers and practitioners have expressed concern that taxpayers who opt out of a voluntary disclosure program will face the same level of scrutiny and skepticism by the Service as if they had never participated in the program in the first place. Indeed, many revenue agents in the field have indicated that taxpayers who opt out of the voluntary disclosure programs will have a very difficult time convincing the Service not to impose maximum civil penalties.

As a result, many taxpayers feel compelled to stay in the voluntary disclosure programs and accept inappropriately large penalties because they fear that if they opt out, they automatically will be assessed with huge information return penalties. Even innocent taxpayers with meritorious cases are hesitant to opt out and face crippling assessments that are many times the value of their foreign account and that could render them insolvent in the hope that they can convince an agent that they did not act willfully. To remedy this inequity, we urge the Service to issues guidance clearly stating that, when a taxpayer opts out of either the 2009 OVDP or the 2011 OVDI, evidence regarding willfulness will receive a full and impartial review by revenue agents and any adverse determinations will be subject to full and impartial review by the Appeals Division of the Service.

Specific Comments

1. **FAQ 5 - Potential Penalties for Failure to Report an Off-Shore Bank Account**

FAQ 5 outlines the potential penalties that can be imposed on taxpayers who have failed to file a FBAR and other information returns such as Forms 3520, 3520A, 5471, etc. Many practitioners have encountered taxpayers as well as revenue agents who seem to believe that taxpayers are subject to the maximum penalties for failing to disclose foreign accounts on an FBAR, or failing to file other information returns, without regard to whether the taxpayers acted willfully or had reasonable cause. This misunderstanding has caused a lot of confusion about whether a taxpayer should enter the 2011 OVDI, whether the taxpayer should opt out and what is likely to happen if the taxpayer does opt out.

We recognize that FAQ 5 does refer to the penalties for willful and non-willful failures to file FBARs, but the reference is very brief and there is no discussion of what happens if a taxpayer has reasonable cause and good faith in the context of the failure to file FBAR or other information returns. Accordingly, we suggest that FAQ 5 expressly define willfulness for purposes of the FBAR penalty as "a voluntary, intentional violation of known legal duty" and

make reference to the standards for determining willfulness in IRM 4.26.16.4.5.3 (07-01-2008) as well as the FBAR penalty mitigation guidelines in IRM 4.26.16.4.6. Similarly, we suggest that the FAQ expressly refer to the reasonable cause and good faith exceptions to the penalties for failure to file FBARs and other information returns.

In addition, FAQ 5 is confusing because it refers to "the penalty for failing to file the Form TD F 90-22.1 ..." Many taxpayers interpret this to mean that the Service can impose only one penalty per unfiled FBAR and do not understand that it is the Service's position that FBAR penalties are imposed for each failure to disclose a foreign account.[6] The FAQ does state that the applicable penalties are imposed "per violation," but many taxpayers mistakenly interpret this to mean that the failure to disclose multiple accounts on a single FBAR is a single violation. We suggest that the FAQ be revised to clarify the Service's position that the FBAR penalties are determined per account, not per unfiled FBAR.

2. FAQ 8 – The OVDI Penalties and Examples

FAQ 8 provides that if a taxpayer has multiple accounts or assets and the highest value of some of the accounts or assets is in different years, the value of the accounts and other assets are aggregated for each year and a single penalty is calculated at 25% of the highest year's aggregate value. Many revenue agents have interpreted this to mean that properly reported foreign accounts should be included in the penalty base if such properly reported accounts were owned by the taxpayer during the voluntary disclosure period. For example, if a taxpayer failed to report a foreign account for 2003 through 2007, but properly reported it in 2008 through 2010, some agents will include the high balance in the account during 2008, 2009 or 2010 in the penalty computation even though the account was properly reported during these years. This is inconsistent with FAQ 31, which refers to the "highest amount in each undisclosed foreign account" and with the last sentence of FAQ 38, which provides that no penalty will be imposed with respect to an account if there is no unreported income with respect to that account. Accordingly, we suggest that FAQ 8 expressly state that an account will not be included in the penalty base for computation of the 25% miscellaneous penalty with respect to a given year if the account was properly reported on a FBAR and there is no unreported income with respect to such account for such year.

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[6] The penalties under 31 U.S.C. § 5321 apply for each violation of the obligation to file a FBAR when such person "makes a transaction or maintains a relation for any person with a foreign financial agency." We are not aware of any authority addressing the question of whether the failure to disclose multiple accounts necessarily constitutes multiple violations of 31 U.S.C. § 5334(a), particularly when the accounts are with the same foreign financial agency. Nevertheless, IRM 4.26.16.4 (07-01-2008) states the Service's position that "FBAR penalties are determined per account, not per unfiled FBAR, for each person required to file."

3. FAQ 10 – PFIC Computations

FAQ 10 recognizes the difficulty of reconstructing the tax basis and other information needed to perform calculations under Code section 1291[7] and allows taxpayers to elect a modified version of the mark to market ("MTM") rules in Code section 1296. The modified MTM method requires the taxpayer and the Service to agree on the value of the PFIC shares as of the end of each year in order to calculate any mark-to-market gain or loss. FAQ 10 goes on to require that "[f]or any PFIC investment retained beyond December 31, 2010, the taxpayer must continue using the MTM method, but will apply the normal statutory rules of section 1296 as well as the provisions of IRC §§ 1291-1298, as applicable." The fallback of using a MTM method is completely reasonable, as it requires much less information and fewer calculations than either of Code sections 1291 or 1293. Nevertheless, it is not clear how this MTM method will operate going forward, and how a taxpayer can be required to use a method that is not, by the terms of the statute, applicable in cases where the PFIC shares are not marketable. During the OVDI period, of course, the Service has the power to settle and can agree with the taxpayer on the valuations necessary to calculate the MTM gains or losses. Following an exit from the program, however, it is not clear how a taxpayer can "apply the normal statutory rules" and how a taxpayer goes about calculating value in the absence of a market for the shares and without the cooperation of a revenue agent who can "agree" on a value for purposes of using this MTM convention.

4. FAQ 14 - What Happens When a Taxpayer is Under Examination

FAQ 14 states that, when a taxpayer is under examination, the taxpayer cannot make a voluntary disclosure and directs the taxpayer or the taxpayer's representative to discuss the off-shore account with the examining agent. In practice, the prohibition against initiating a voluntary disclosure while the taxpayer is under examination has been applied to situations in which an entity, such as a subchapter S corporation or a partnership, in which the taxpayer has a direct or indirect interest, is under examination. This means that a taxpayer who is not directly under examination nevertheless is precluded from making a voluntary disclosure. In such cases, it may not be possible for the taxpayer to discuss the off-shore account with the revenue agent who is examining some other entity, such as a hedge fund or a real estate partnership, that is only remotely related to the taxpayer. Accordingly, we suggest that the prohibition against making a voluntary disclosure of an off-shore bank account be applied only to those taxpayers who are themselves under examination or when an entity in which they own or control more than 50% of the vote or value (including through attribution) is under examination. If this suggestion is adopted, we further suggest that taxpayers who have been precluded from making voluntary disclosures under the OVDI by reason of such third-party examinations be given additional time to come forward.

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[7] References to the "Code" refer to the Internal Revenue Code of 1986, as amended.

5. FAQs 17 and 18 – Procedures to Report Off-Shore Accounts and Entities When All Income and Tax Has Been Reported and Paid

FAQs 17 and 18 provide a streamlined procedure and penalty relief for certain taxpayers who failed to file FBARs or other information returns. Specifically, the FAQs state that taxpayers who "reported and paid tax on all their taxable income" but who failed to file FBARs or other information returns should not participate in the 2011 OVDI and may simply file delinquent FBARs and other information returns, together with an explanation of why the returns are filed late. In such cases, no penalties will be imposed.

The streamlined procedure and penalty relief under FAQs 17 and 18 are available only to those taxpayers who reported all of their income in the U.S. regardless of whether they owe tax in the U.S.[8] There are many non-resident citizens who live in foreign countries such as the U.K or Canada who failed to report income earned on their accounts in the U.S. but who owe no U.S. tax because the U.S. tax is offset by foreign tax credits. Similarly, there are many taxpayers who earned income in their foreign accounts that was not reported in the U.S. but owe no additional U.S. tax because of offsetting losses, either from the foreign account or from other sources. We believe that the overwhelming majority of taxpayers in this situation did not willfully fail to report the income or disclose the account in the U.S. because they did not avoid the payment of any U.S. taxes on their foreign account. Of course, it is possible that a small minority of such taxpayers did willfully fail to report their foreign account and the income from the foreign account in the U.S. even though they had offsetting loss carryforwards from unrelated domestic activity because they wished to preserve those loss carryfowards. Nevertheless, we believe that a strong argument can be made that taxpayers who failed to report tax in the U.S. but who owe no additional U.S. tax did not act willfully and should be entitled to use the streamlined procedures and receive the penalty relief provided by FAQs 17 and 18 or, alternatively, such taxpayers should be offered a 5% penalty.

We recognize that FAQ 51.1 suggests that a taxpayer who failed to report income in the U.S. but owed no tax because foreign tax credits offset the tax liability should consider opting out of the 2011 OVDI. Nevertheless, we believe that such taxpayers who are willing to come forward and disclose their failures to file tax and information returns even though no tax is due should not be required to undergo a full audit with the attendant cost and uncertainty regarding potentially huge penalties. We also believe that the 2011 OVDI program would attract more taxpayers to become compliant without any additional cost to the fisc if these situations were treated with more leniency.

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[8] Revenue agents regularly impose maximum penalties under the 2011 OVDI on these taxpayers. Also, FAQ 51.1 suggests that a taxpayer who has not reported income in the U.S. but has no tax liability because of foreign tax credits may consider an opting out of the 2011 OVDI, implying that the simplified procedures in FAQs 17 and 18 are not available to the taxpayer. This interpretation of the language at the beginning of FAQs 17 and 18 is confusing because it is inconsistent with language at the end of both FAQ 17 and 18 which clearly states that the Service will not impose a penalty "if there are no underreported tax liabilities…"

6. FAQ 25 – Information to be Provided

FAQ 25 outlines the information that must be provided as part of the 2001 OVDI process and includes detailed information regarding foreign accounts. Some taxpayers are participating in the 2011 OVDI because they are beneficiaries of foreign non-grantor trusts and they failed to report distributions from the trust and/or they failed to file Forms 3520. In many cases, these taxpayers do not have access to information regarding foreign bank accounts held by the trust, especially when the beneficiary does not have a large enough interest in the trust to require the filing of FBARs for the trust's bank accounts. Accordingly, we suggest that FAQ 25 be revised to state that the U.S. beneficiary of a foreign non-grantor trust who does not have a FBAR filing obligation must provide information regarding distributions from the trust and the amount properly includable in income, but that such beneficiary does not have to provide information regarding the trust's foreign bank accounts.

7. FAQ 25.1 - Good faith Attempt to Comply by the August 31st Deadline

FAQ 25.1 allows a taxpayer to request an extension of the August 31st deadline to complete his or her submission if the taxpayer can demonstrate a good faith attempt to fully comply with FAQ 25 on or before August 31st. We agree that it is appropriate to give taxpayers who wish to disclose their non-compliance additional time to collect and submit the required information. At the same time, the extension procedure will create some complications that should be addressed in the FAQs. FAQs 23, 24 and 25 outline procedures involving the submission of a pre-clearance letter, receipt of pre-clearance from the Service, submission of an Offshore Voluntary Disclosure Letter, preliminary acceptance of the disclosure and then submission of the remaining materials to the Service by August 31st. It is not clear how these various stages will be handled for people who initiate their disclosure just before the August 31st deadline. Further, the extension of the August 31st deadline appears to be discretionary, depending on the IRS' acceptance of the taxpayer's demonstration of a good faith attempt to comply with the August 31st deadline.

We believe that many people will come forward to initiate a voluntary disclosure in the days leading up to August 31st. These late-comers may be procrastinators, they may have just learned of the program, or they may have been confused about the amount of information required to be provided by August 31st. We believe that taxpayers who just learned of the program or who did not understand the amount of information required to be submitted by August 31st should not be denied the opportunity to participate in the program. Accordingly, we suggest that the Service consider allowing taxpayers who submit an Off Shore Voluntary Disclosure Letter on or before August 31st to be accepted into the program. Alternatively, we suggest that the Service develop a truncated procedure for taxpayers who are requesting additional time to complete their disclosure. The truncated procedure could specify that the taxpayer should mail the Offshore Voluntary Disclosure Letter together with a request for an extension on or before August 31st and that the Service will notify the taxpayer within 45 days whether their extension request and voluntary disclosure has been preliminarily accepted. Finally, we urge the IRS to be

flexible in determining whether a taxpayer has demonstrated a good faith attempt to comply with the requirements of FAQ 25 and is entitled to an extension.

8. FAQ 35 - What Kinds of Assets are Subject to the 25% Penalty

FAQ 35 provides that the 25% offshore penalty applies to all offshore holdings that are related in any way to the taxpayer's noncompliance. This potentially includes all assets held by the taxpayer, including financial accounts, securities, tangible assets such as real estate or art, intangible assets such as patents or stock, or other interests in U.S. or foreign businesses. The FAQ does not provide any guidance on how the value of the property will be determined for purposes of computing the 25% penalty. Many assets are subject to loans, such as a margin loan in a securities account, or a mortgage on real estate. We suggest that the amount of any loan or mortgage used to purchase the asset, or secured by the asset, be subtracted from the gross value of the asset for purposes of accurately measuring the base to which the 25% penalty applies.

Further, many revenue agents have taken the position that, if unreported funds were deposited into an otherwise reported bank account, or were used to purchase a non-reportable asset, the entire bank account or asset should be included in the base for the computation of the 25% offshore penalty. We recognize that the commingling of "dirty" money with "clean" money or assets presents difficult tracing issues. Nevertheless, we believe it is inappropriate to inflate the size of the penalty by including properly reported accounts or assets in the penalty base. Accordingly, we suggest that the Service adopt a methodology to limit the penalty computation to include only unreported funds. One way to do this is to include in the penalty base only that percentage of the value of an account or asset that corresponds to the amount of unreported money deposited into the account or used to purchase the asset. For example, if a taxpayer uses $100,000 of unreported funds and $200,000 of reported funds to purchase an apartment, only one-third of the value of the apartment should be included in the penalty base.

Finally, FAQ 35 provides that, if a taxpayer owns or controls assets through an entity such as a trust, the 25% offshore penalty may be applied to the taxpayer's interest in the entity. We believe that it would not be appropriate to impose a penalty on a beneficiary's interest in a foreign non-grantor trust if the beneficiary's interest in the trust was not sufficient to require the filing of an FBAR because such a beneficiary should not be considered to own or control the assets in the trust. We suggest that the FAQ be revised to expressly state that if a beneficiary of a non-grantor foreign trust was not required to file a FBAR then the beneficiary's interest in the trust will not be included in the base for computing the 25% offshore penalty.

9. FAQ 40 - Jointly Owned Accounts

FAQ 40 provides that a co-owner of a joint account will be liable for the 25% penalty only on his or her percentage interest in the highest balance in the joint account. The FAQ goes on to expressly provide that the Service may examine other co-owners of the joint account, presumably to insure that the full balance of the account is taxed and subject to penalties, if appropriate. In

some cases in which a taxpayer co-owns an account with a nonresident alien, revenue agents have attempted to include the entire value of the account in the penalty base, presumably because the portion of the account owned by the nonresident alien otherwise would escape tax and penalty. We suggest that FAQ 40 expressly provide that, if a taxpayer co-owns an account with a non-resident alien, the taxpayer will be subject to the 25% offshore penalty only on the taxpayer's percentage interest in the highest value of the account.

10. FAQ 49 - Mediation with Appeals

FAQ 49 provides that, if the taxpayer and the Service cannot agree to the terms of the OVDI closing agreement, there will be no mediation with the Appeals Division and the taxpayer's only option is to accept the Service's position or to opt-out of the program and subject himself or herself to a complete audit and the full range of penalties. In some cases, the revenue agents do not compute the tax liability or the 25% offshore penalty correctly. For example, in several cases revenue agents have refused to allow net operating loss deductions. In other cases, issues relating to Alternative Minimum Tax have been erroneously computed. In such cases, it is inappropriate to force the taxpayer to accept an incorrect computation or forego the benefits of the OVDI program. We recognize that taxpayers can request that a manager or technical advisor review the issue. However, review by a manager or a technical advisor is not the same as an independent consideration by more neutral mediator and there are situations in which the manager and technical advisor simply adopt the position of the revenue agent without a full review of the issues. Further, although computation of the penalty arguably is a matter of negotiation with the Service, computation of the proper tax liability can be complex and should be subject to some form of appeals-type review. Accordingly, we suggest that computations of tax and penalty computations under the 2011 OVDI, other than determinations of willfulness and reasonable cause and good faith, be subject to an expedited review by the Appeals Division to address those cases in which the taxpayer alleges that the Service has erroneously computed the tax or the 25% offshore penalty.

11. FAQ 51 - Opt Out Procedures

FAQ 51 and the Opt Out and Removal Guide provide that a taxpayer may opt out of the OVDI program and that the case will be reviewed by a centralized review committee and may be referred for a full-scale audit under the standard audit process. As noted above in our general comment regarding the program, we believe that the opt out alternative is a very important part of the 2011 OVDI. Accordingly, we suggest that the FAQ and the Opt Out and Removal Guide expressly state that if the taxpayer does not agree with the result reached by the revenue agent or the centralized review committee under the standard audit process, the taxpayer will be given the opportunity to take the case to the Appeals Division pursuant to the procedures in IRM Section 4.26.17.4.3-7 (07-01-2008).

In addition, many practitioners have encountered taxpayers who have strong cases for non-willfulness but who nevertheless feel pressured to stay in the OVDI because they fear that, if they

opt out, the Service will attempt to impose the maximum penalties permissible under law without regard to the mitigation guidelines in the Internal Revenue Manuel. IRM 4.26.16.4.7 provides that an examiner "may determine that the facts and circumstances of a particular case do not justify asserting a penalty." The guidelines also state that, "[g]iven the magnitude of the maximum penalties permitted for each violation, the assertion of multiple penalties and the assertion of separate penalties for multiple violations with respect to a single FBAR form, should be considered only in the most egregious cases." Further, IRM 4.26.16.4.6 and Exhibit 4.26.16-2 provide, among other things, for reduced penalties for smaller accounts in certain circumstances. We believe that taxpayers should not be forced into the OVDI penalty structure by the threat that a revenue agent will automatically attempt to impose the maximum penalties permissible under law. We suggest that FAQ 51 expressly state that, for taxpayers who opt out of (or decline to participate in) the OVDI, examiners are directed to apply the mitigation guidelines and related penalty provisions of the Internal Revenue Manual.

12. FAQ 51.2 – Circumstances in Which Opting Out Might Be a Disadvantage to the Taxpayer

FAQ 51.2 Example 4 illustrates a situation in which a taxpayer failed to report an account that contained $10 million for only one day during 2008 and concludes that, if the taxpayer opted out, the taxpayer could face a willful FBAR penalty of 50% or $5 million with respect to the account. This example is not correct. 31 USC § 5321(5)(C) and (D) provide that the penalty amount for a willful FBAR violation is 50% of the "balance in the account *at the time of the violation*." (Emphasis added). When a taxpayer fails to disclose an account on a FBAR, the violation occurs on June 30 of the following year, i.e. the day that the FBAR filing was due. Therefore, the balance in the account at the close of June 30th is the amount to be used to calculate the penalty. See IRM § 4.26.16.4.5.5 (4). Accordingly, we suggest that the example be either deleted or revised to reflect the correct computation of the FBAR penalty outside of the program.

13. FAQ 52 – Circumstances Qualifying for a Reduced 5% Penalty

FAQ 52, paragraph 1 outlines four conditions that must be satisfied to qualify for a reduced 5% penalty. The fourth condition requires the taxpayer to establish that "all applicable U.S. taxes have been paid on funds deposited to the account (only account earnings have escaped U.S. taxation.) Although not expressly stated, it seems implicit that the requirement was generally intended to apply solely to *income* taxes. FAQ 52, Example 1 illustrates the operation of FAQ 52, paragraph 1 by outlining a situation in which "the taxpayer's father died" and the taxpayer inherited two offshore accounts. In the example, the taxpayer qualifies for the reduced 5% penalty even though no mention is made of whether the taxpayer's father paid estate tax on the undisclosed off-shore account. It is logical to assume that the account described in the example was not reported on the decedents estate tax returns because no mention is made of the estate tax return and because the account was an undisclosed account. Indeed, there are very few, if any, undisclosed accounts involved in the voluntary disclosure progress that would have been reported on the estate tax return of a deceased relative because the account is, in fact, undisclosed

by definition. There are many situations like this in which a relative or a parent of the taxpayer died and left the account to the taxpayer and the taxpayer otherwise would qualify for the reduced 5% penalty. However, in such cases, examiners have refused to give the taxpayer the benefit of the 5% penalty because the decedent did not include the account on an estate tax return and did not pay estate tax, so "all applicable taxes" were not paid on the account (as opposed to funds deposited to the account as required by the FAQ 52). This interpretation seems to run counter to the examples in the FAQ which allow the 5% penalty without any reference to payment of estate taxes. Further, this interpretation of the FAQ essentially would prevent every taxpayer who inherited an undisclosed foreign account from qualifying for the 5% penalty. We suggest that the FAQ be revised to expressly provide that the failure to pay estate tax on the decedent's estate does not disqualify the taxpayer from receiving the benefit of the 5% penalty unless the taxpayer was an executor of the estate at the time the estate tax return was due.

FAQ 52, paragraph 3 provides a reduced 5% penalty for foreign residents who, for all the years covered by the disclosure (a) reside in a foreign country; (b) make a good faith showing that he or she has timely complied with all tax reporting and payment requirements in the country of residency; and (c) have $10,000 or less of U.S. source income for each year. We believe that the $10,000 limitation on U.S. source income may preclude certain taxpayers who clearly did not act willfully from receiving the benefit of the 5% penalty. Accordingly, we suggest that there be an exception to the $10,000 limitation for cases in which the total unreported accounts are under some maximum amount (e.g. $500,000 or $1 million) and the taxpayer has U.S. source income that is less than (i) $50,000; or (ii) 10% of the taxpayer's worldwide gross income.

Finally, the FAQ provides that "[t]his exception only applies if the income tax returns filed with the foreign tax authority included the offshore-related taxable income that was not reported on the U.S. tax return." Based in particular on this further proviso, several practitioners have raised concerns about whether the Service will give the benefit of this reduced 5% penalty to taxpayers who otherwise meet all the requirements and who reside in a country that has no reporting or tax requirements, or that otherwise does not require the offshore income at issue to be reported on the local income tax returns. For example, some countries do not require certain pension income to be reported but such income is reportable in the U.S. Accordingly, we suggest that FAQ 52 expressly state that the taxpayer must make a good faith showing that the taxpayer has timely complied with all income tax reporting and payment requirements, IF ANY, in the country of residence.

14. Further Guidance

To date, the procedures to be used in the 2009 ODVP and the 2011 OVDI have been promulgated in the form of Frequently Asked Questions posted to the Service web site. We recognize that this relatively informal method was used because of the time constraints and the potentially temporary nature of the two voluntary disclosure programs. However, experience has demonstrated that there is a more lasting need for guidance regarding voluntary disclosures of

foreign bank accounts and assets. Even after the 2011 OVDI formally ends on August 31, 2011, taxpayers will be coming forward over the next several years to report foreign bank accounts and assets under the Service's general voluntary disclosure program. It is very likely that many of the procedures and concepts developed in the 2009 OVDP and the 2011 OVDI will be applied to these "late" disclosures. Accordingly, we suggest that the 2011 FAQs be incorporated into some type of more permanent guidance such as a Revenue Procedure and that such guidance be subject to public comments.

Respectfully submitted,

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