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Tax Evasion

Questions Surround Standards of Willful Path Conduct Under Streamlined Version of OVDP

BNA Snapshot

Key Development: IRS may be setting tough hurdles to get into new voluntary program.

Key Takeaway: Tax professionals say more guidance is needed to help taxpayers navigate a somewhat opaque process.

By Alison Bennett

Sept. 17 — The IRS may be setting tough hurdles for taxpayers to qualify for the newly expanded streamlined version of its Offshore Voluntary Disclosure Program, tax practitioners said.

In a series of interviews, practitioners said guidance would be welcome on both procedural aspects of applying to the program and possible guidelines on the type of conduct the IRS might consider willful.

One litmus test could be the government's apparently strict view on willfulness in cases where taxpayers are trying to transition from the formal version of the OVDP to the streamlined version, said Bryan Skarlatos, a partner with Kostelanetz & Fink LLP in New York.

That option was offered during a brief window when the expanded streamlined program was first announced in June, but the IRS has set the bar high for those who applied, Skarlatos said.

Skarlatos said in his experience, in the transition process, "most streamlined applications are being rejected," and he has already had this happen to clients.

"We see evidence as to how the IRS interprets non-willfulness and they're going to hold taxpayers to a pretty high standard," he said. "The test is, did you know in your stomach that you were supposed to be telling the government about these accounts?"

The expanded streamlined program is intended to make it easier for taxpayers to disclose offshore assets in cases where they weren't willfully trying to hide the money from U.S. tax authorities, offering simpler procedures with little or no penalty.

The program is now open to those owing more than \$1,500 in taxes and is available to those living in the U.S. as well as abroad, but requires taxpayers to certify, under penalty of perjury, that their conduct was non-willful (118 DTR GG-1, 6/19/14).

Process Marked by Risk

Practitioners said in August and September interviews that they were pleased to see an alternative to the IRS's previous "one size fits all" approach to the OVDP, but the process of getting into the program is marked by risk and uncertainty—and more guidance is needed.

"I keep getting phone calls from taxpayers who want to go into the program and then we get into the issues," Martin Press, a shareholder with Gunster, Yoakley & Stewart PA in Fort Lauderdale, Fla., said. "The question of whether they can, in good faith, sign an affidavit that their conduct was non-willful is a difficult one."

The penalties are far lighter than the 27.5 percent penalty faced by participants in the more formal version of the program. Penalties for non-U.S. taxpayers will be waived, while U.S. residents who qualify will pay a one-time "miscellaneous offshore penalty" of 5 percent of the foreign account's highest aggregate account balance and asset value.

Kostelanetz & Fink's Skarlatos said it appears that not many U.S. individuals will be accepted. "Very few people who are actually residents will qualify," he said. Those people may be held to a tougher standard because there is a greater expectation of awareness of IRS requirements.

In the broader picture, a key risk of the streamlined program, practitioners said, is that taxpayers don't get the same protection against criminal prosecution as they do in the regular OVDP, and the process remains somewhat opaque.

Little Protection

"We are getting no sense at this point how the government is reacting to this," Press said. "The big issue is, if you fail the willfulness standard, you have no protection, and that is a very substantial risk."

With no firm guidance as to how the willfulness test will be applied, "that puts advisers in a very difficult position," he said.

Michael Danilack, then deputy commissioner (international) of the IRS Large Business & International Division, told reporters when the program was announced in June that it was unlikely the IRS would be providing examples of conduct it would consider as willful noncompliance to help with the self-certification process.

"These are all very human stories," Danilack said. "Everyone has a different set of facts. It's really up to the taxpayer to make that determination and tell us their story." He suggested if taxpayers have questions as to whether their conduct was willful, they should consult with their tax advisers.

An IRS spokesman said Sept. 17 that agency officials are expected to speak on the streamlined version of the OVDP at a meeting of the American Bar Association Section of Taxation in Denver Sept. 19.

'Serious Review' Key

James Mastracchio, head of the tax controversy practice at Baker & Hostetler LLP in Washington, said he has clients who have entered and will be entering the streamlined OVDP, but he too said non-willfulness "is not an easy standard to meet."

"I do think you have to work with the client and really understand their facts and circumstances. They have no criminal protection. It's a very serious review that you have to undertake, and the client has to understand the ramifications of not being truthful," Mastracchio said.

He said the process the IRS is using to consider applications for the streamlined program isn't clear, and that too could carry risks.

With regard to applications to transition from the formal OVDP to the streamlined version, "It's pretty much a black box," he said, adding that it appears it isn't possible to appeal a rejection. "It's a bit of a mystery and I don't think it's very transparent."

Jeffrey A. Neiman, a former federal prosecutor now with Marcus Neiman & Rashbaum LLP in Fort Lauderdale, Fla., said, "For those applying to the streamlined program, it is the great unknown as to how the IRS will handle these cases and what the agency would consider willful."

For new clients, he said, "You're walking into the lion's den and you need to be aware of what you're facing." As a general rule, Neiman told Bloomberg BNA, "I think they're going to aggressively prosecute these cases."

He said layers are added by the fact that the IRS and the Justice Department started putting pressure on foreign banks in 2009. "You saw movement of accounts to other banks, sending cash to family members, large withdrawals of cash, all of which would raise red flags with the IRS."

'Willful Blindness' a Concern

Several practitioners said the process of entering the streamlined program requires a multifaceted review of whether a taxpayer's conduct is considered willful—one that also encompasses the concept of "willful blindness."

Josh O. Ungerman, a partner with Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP in Dallas, said the government will crack down on those who deliberately avoided knowing the rules for telling the government about their foreign accounts.

The IRS is likely to attribute willfulness to "a person who made a conscious effort to avoid learning about the reporting requirements," Ungerman, who chairs the Civil & Criminal Tax Penalties Committee for the American Bar Association Section of Taxation, said.

"You'd better be prepared to address why your client is not willful and you must be prepared to address why your client is not willfully blind," Ungerman told Bloomberg BNA. "You're being asked to disprove a negative."

Some may be concerned, he said, that the IRS may consider it willful blindness simply because a taxpayer didn't check the box on Schedule B of the Form 1040, which is the section that asks whether the taxpayer has a foreign bank account.

However, he said, the Internal Revenue Manual indicates that "the mere fact that you don't check the box is not enough to constitute willful blindness."

That said, there are other indicators the IRS is likely to view as demonstrating willfulness, Ungerman noted. Anything that shows the taxpayer made efforts to conceal the existence of the account, such as lying to their accountant when asked if they had a foreign account, is a red flag, he said.

Promotional materials for an offshore bank would be another, he said, as would statements for a debit or credit card that showed taxpayers paid for everyday living expenses using unreported income. Another indicator would be copies of tax returns before and after the account was opened that show a precipitous drop in income.

“Due diligence is going to be of extreme importance,” Ungerman said.

Questions Raised

Some practitioners said although it is still relatively early in the process, there are numerous questions about how the program operates and more guidance is needed.

Scott D. Michel, a member of Caplin & Drysdale LLP in Washington, said some questions relate to the version of the streamlined program offered to taxpayers living in the U.S.

One is whether a 5 percent penalty would be available in cases where taxpayers only had signature authority over a foreign account, Michel told Bloomberg BNA.

He said taxpayers also want to know whether the domestic version of the program is available for those who didn't file tax returns at all for their foreign accounts. Right now, he said, it appears it may only apply to those who want to file amended returns.

Another key area of uncertainty, he said, is how far back the IRS will look to assess willfulness. The streamlined program calls for taxpayers to submit three years of delinquent returns and six years of delinquent FBARs, or Reports of Foreign Bank and Financial Accounts, also known as the Financial Crimes Enforcement Network (FinCEN) 114.

In considering willfulness, Michel said, it isn't clear whether the government would look three years back, six years back, or to the start of the account. Another question is how the IRS will handle situations where a parent was willful and their son or daughter is now dealing with the account.

“We're struggling with these questions,” Michel said.

The Caplin practitioner said in the bigger picture, many taxpayers are in a difficult position because they have accounts in Swiss banks that are preparing to hand over a huge amount of information to the IRS under a program that allows the banks to escape prosecution if they pay hefty fines and disclose their U.S.-owned accounts.

“These taxpayers would like to be able to signal to the IRS, in a way that would protect them from disclosure by a bank, that they're entering the OVDP,” Michel said.

Guidance Needed

William M. Sharp, of Sharp Partners in Tampa, Fla., told Bloomberg BNA that while he is pleased that the IRS has developed a more flexible alternative to the stricter terms of the formal OVDP, broad, general guidelines on what the government would consider willful conduct would be helpful.

Currently, that question is “up to you as a practitioner,” Sharp said. In addition, he said, “it would be helpful to know what their ‘secret sauce’ is going to be with their review process.”

Alan W. Granwell, of counsel to Sharp Partners in Washington, said “The stakes are very high. You really need the advice of someone who's knowledgeable about the issues. There are lots of moving parts and you have to be diligent about examining each one.”

Gunster, Yoakley & Stewart's Press said specific answers are needed from the government on several issues. He said the IRS should provide guidance on how to complete an “annual questionnaire” for the account.

In addition, Press said, guidance is needed on whether several specific issues would be considered a factor when the IRS is determining willfulness.

One, he said, is whether setting up an offshore entity would be considered a factor. Another, he said, is whether the IRS will take the original source of funds into consideration—specifically, the treatment of funds generated from unreported activities by a U.S. person.

A third, Press said, is how the IRS would view the situation if the taxpayer wasn't a U.S. person when the account was opened, but didn't report the account to the IRS until several years after becoming a U.S. person.

'Inconsistent and Unclear.'

Dennis Brager, a former IRS senior trial attorney who now heads Brager Tax Law Group APC in Los Angeles, also said the picture is murky on several significant issues.

"There are unresolved technical issues and places in the streamlined guidance that are inconsistent and unclear," Brager said in an interview.

For example, he said, the IRS appears to have changed the procedure for handling delinquent international tax returns for those who want to enter the streamlined program. Previously, if there was no unreported income and no tax due, all taxpayers had to do was file the information return, Brager said.

Now, it appears taxpayers must include a "reasonable cause" statement along with the return and it isn't clear what the IRS might do if the reasonable cause statement isn't satisfactory, he told Bloomberg BNA.

Brager said questions are also raised by the requirement that taxpayers turn in three years of delinquent returns and six years of FBARs. It isn't clear what taxpayers should do if they closed their accounts more than three years ago, he said.

He said in the interview that he believes more comprehensive guidance is needed to help taxpayers and their advisers negotiate the process.

"What I'd like to see is revised guidelines, posted on the Web for everybody to see," Brager said.

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