August 16, 2011

MEMORANDUM FOR HEATHER C. MALOY, COMMISSIONER,
LARGE BUSINESS & INTERNATIONAL DIVISION
FARIS FINK, COMMISSIONER,
SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Nina E. Olson
National Taxpayer Advocate

SUBJECT: Taxpayer Advocate Directive 2011-1 (*Implement 2009 Offshore Voluntary Disclosure Program FAQ #35 and comply with the Freedom of Information Act*).

TAXPAYER ADVOCATE DIRECTIVE

I am issuing this Taxpayer Advocate Directive (TAD) to direct that within **15 business days** the Commissioner, Large Business and International Division (LB&I) and the Commissioner, Small Business/Self-Employed (SB/SE) Division take the actions described in the numbered sections below. Within **10 business days** please also provide me with a written response to this TAD discussing the action(s) you plan to take and whether you plan to appeal.[1]

1. Disclose the March 1, 2011 memo for Offshore Voluntary Disclosure Initiative (OVDI) Examiners that addresses the use of discretion in 2009 Offshore Voluntary Disclosure Program (OVDP) cases (the "March 1 memo") on IRS.gov, as required by the Freedom of Information Act (FOIA) (whether or not it is revoked).[2]

2. Revoke the March 1 memo and disclose such revocation as required by FOIA.

3. Immediately direct all examiners that when determining whether a taxpayer would be liable for less than the "offshore penalty" under "existing statutes," as required by 2009 OVDP FAQ #35 (described below), they should not assume the violation was willful unless the

[1] *See* IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).
[2] Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDI Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011).

taxpayer proves it was not. Direct them to use standard examination procedures to determine whether a taxpayer would be liable for a lesser amount under existing statutes (*e.g.*, because the taxpayer was eligible for (a) the reasonable cause exception, (b) a non-willful penalty because the IRS lacked evidence to establish its burden to prove willfulness, or (c) application of the mitigation guidelines set forth in the IRM) without shifting the burden of proof onto the taxpayer.[3] Post any such guidance on IRS.gov.

4. Commit to replace the March 1 memo and all OVD-related frequently asked questions (FAQs) on IRS.gov with guidance published in the Internal Revenue Bulletin, which describes the OVDP and OVDI.[4] This guidance should incorporate comments from the public and internal stakeholders (including the National Taxpayer Advocate). It should reaffirm that taxpayers accepted into the 2009 OVDP will not be required to pay more than the amount for which they would otherwise be liable under existing statutes, as currently provided by 2009 OVDP FAQ #35. It should also direct OVDP examiners to use standard examination procedures to make this determination, as provided in item #3 (above); and

5. Allow taxpayers who agreed to pay more under the 2009 OVDP than the amount for which they believe they would be liable under existing statutes the option to elect to have the IRS verify this claim (using standard examination procedures, as described above), and in cases where the IRS verifies it, offer to amend the closing agreement(s) to reduce the offshore penalty.[5]

I. AUTHORITY

Delegation Order No. 13-3 grants the National Taxpayer Advocate the authority to issue a TAD to mandate administrative or procedural changes to improve the

[3] OVDI FAQ #27 already provides that “the examiner has the right to ask any relevant questions, request any relevant documents, and even make third party contacts, if necessary to certify the accuracy of the amended returns, without converting the certification to an examination.”

[4] This directive is consistent with recent comments from external stakeholders. *See, e.g.*, Letter from New York State Bar Association Tax Section to Commissioner, IRS, Chief Counsel, IRS, and Acting Assistant Secretary (Tax Policy) Department of the Treasury, *2011 Offshore Voluntary Disclosure Initiative Frequently Asked Questions and Answers*, *reprinted as*, NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative, 2011 TNT 153-13 (Aug. 9, 2011) (recommending public guidance). Moreover, settlement initiatives are often published in the Internal Revenue Bulletin. *See, e.g.*, Rev. Proc. 2003-11, 2003-1 C.B. 311 (Offshore Voluntary Compliance Initiative (OVCI)); Ann. 2004-46, 2004-1 C.B. 964 (“Son-of-Boss” settlement initiative).

[5] The IRS is already offering to amend 2009 OVDP agreements for taxpayers who would qualify for the reduced 5 percent or 12.5 percent offshore penalty rates under the 2011 OVDI. *See* OVDI FAQ #52; OVDI FAQ #53.

operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) "when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment or provide an essential service to taxpayers."[6] For the reasons described below, the IRS's failure to implement 2009 OVDP FAQ #35 violates taxpayer rights, imposes undue burden, results in inequitable treatment of taxpayers, and has likely undermined respect for the IRS and the tax system.

Prior to issuing this TAD, the Taxpayer Advocate Service (TAS) raised concerns about 2009 OVDP FAQ #35 with the IRS on multiple occasions. On March 18, 2011, my staff met with the Deputy Commissioner's staff to express my concerns. I also personally discussed the problem with the Commissioner of Internal Revenue. On April 26, 2011, I issued a Taxpayer Assistance Order (TAO) to the LB&I Commissioner, which described my concerns in writing. On April 27, 2011, in a memo that requested both IRS executives and subject matter experts for my staff to work with, I informed each operating division, the Commissioner, and the Deputy Commissioner that we had heard complaints about the OVDP, and would likely discuss the problem in the National Taxpayer Advocate Annual Report to Congress.[7] My staff have contacted SB/SE and LB&I at various levels seeking to address these concerns in cases involving taxpayers who sought assistance from TAS. On June 30, 2011, I raised my concerns again in the National Taxpayer Advocate's Fiscal Year 2012 Objectives Report to Congress.[8] To date, the IRS has not adequately addressed these concerns. Therefore, the procedural requirements for issuing this TAD are satisfied.[9]

II. DISCUSSION

Background

U.S. persons are generally required to report foreign financial accounts on Form TD F 90–22.1, *Report of Foreign Bank and Financial Accounts (*FBAR) and to report income from such accounts on U.S. tax returns. Leaving aside criminal penalties, the maximum civil penalty for a series of missed FBAR filings can be financially devastating – an amount equal to the greater of $100,000 or 50 percent of the account balance for each violation each year, potentially accruing to the greater of $600,000 or 300 percent of each account balance over a six

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[6] Internal Revenue Manual (IRM) 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev. 1), *Authority to Issue Taxpayer Advocate Directives* (Jan. 17, 2001). *See also* IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).
[7] Memorandum from National Taxpayer Advocate, *The National Taxpayer Advocate's 2011 Annual Report to Congress-Contact and Subject Matter Expert Request for Potential Most Serious Problems* (Apr. 27, 2011).
[8] National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 23-24 (*IRS's Inconsistency and Failure to Follow Its Published Guidance Damaged Its Credibility with Practitioners Involved in the Voluntary Disclosure Program*).
[9] IRM 13.2.1.6.1 (July 16, 2009).

year period – an amount that the Internal Revenue Manual (IRM) acknowledges "can greatly exceed an amount that would be appropriate in view of the violation."[10]

With significant FBAR penalties as leverage, the IRS "strongly encouraged" people who failed to file these and similar returns and report income from foreign accounts to participate in the 2009 Offshore Voluntary Disclosure Program (OVDP), rather than quietly filing amended returns and paying any taxes due.[11] It warned that taxpayers making "quiet" corrections could be "criminally prosecuted," while OVDP participants would generally be subject to a 20 percent "offshore" penalty in lieu of various other penalties, including the FBAR penalty.[12] While the OVDP appeared to be a great deal for those involved in criminal tax evasion, it was a terrible deal for many whose violations were not willful or who would be eligible for reasonable cause exceptions.

<u>Example</u>. Compare person A, a U.S. citizen and resident, who evades tax on income that he hid in an offshore account in Country A, with person B, a U.S. resident and citizen of Country B, who paid tax to Country B on income which he put into a retirement account in Country B before arriving in the U.S.[13] A's failure to report income and file FBARs in the U.S. was willful and B's failure was not. The maximum civil penalty for willful FBAR violations is the greater of $100,000 or 50 percent of the account value per year, but the maximum for non-willful violations is $10,000 and no penalty applies to those who qualify for the reasonable cause exception.[14] Moreover, given the way in which the IRS has historically administered the statute outside of the OVDP, B might have received a warning letter for failing to file FBARs.[15] Thus, the 20 percent offshore penalty is a great deal for A but not for B. B would have paid less outside the OVDP.

The IRS announced, however, in OVDP FAQ #35 that:

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[10] IRM 4.26.16.4(5) (July 1, 2008); 31 U.S.C. § 5321(a)(5)(C) (willful FBAR penalty); 31 U.S.C. § 5321(b)(1) (indicating a six-year period of limitations applies to FBAR violations).

[11] *See* IRS, *Voluntary Disclosure: Questions and Answers*, http://www.irs.gov/newsroom/article/0,,id=210027,00.html (Feb. 9, 2011) (first posted May 6, 2009) (hereinafter OVDP "FAQ"). According to the IRS, "[t]axpayers are strongly encouraged to come forward under the Voluntary Disclosure Practice.… Those taxpayers making "quiet" disclosures should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years.… The IRS will be closely reviewing these returns to determine whether enforcement action is appropriate." OVDP FAQ #10. The IRS affirmatively advised "…the voluntary disclosure process is appropriate for most taxpayers who have underreported their income with respect to offshore accounts…" OVDP FAQ #50.

[12] OVDP FAQ #12. This discussion focuses on the civil FBAR penalty because it is often the largest penalty for which the offshore penalty is a substitute. *See* 31 USC § 5321.

[13] Another common "non-willful" situation involves a U.S. resident who maintains an account in another country as a convenient way to send funds to relatives. Alternatively, a U.S. citizen may be living and paying taxes in a foreign jurisdiction, yet oblivious to U.S. filing and reporting obligations.

[14] *See* 31 U.S.C. § 5321(a).

[15] IRM 4.26.16.4.7(3) (July 1, 2008).

> **Voluntary disclosure examiners** do not have discretion to settle cases for amounts less than what is properly due and owing. These examiners **will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer. Under no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes**.[16]

As noted above, "existing statutes" applicable to FBAR violations provide for a reasonable cause exception, apply a lower maximum penalty to non-willful violations, and place the burden of proving willfulness upon the IRS.[17] The IRS's implementation of existing statutes also requires that it apply significantly less than the statutory maximum penalty amounts to certain taxpayers with relatively low account balances under "mitigation" guidelines.[18] Thus, taxpayers who would not have been subject to significant penalties because their violations were not willful, because they had relatively low account balances, or because they qualified for the "reasonable cause" exception believed the statement "[u]nder no circumstances will a taxpayer be required to pay a penalty greater than what he would otherwise be liable for under existing statutes" applied to them.

It seemed reasonable for taxpayers to believe the IRS would adhere to the publicly-announced terms of the program and make this comparison as part of the 2009 OVDP because it did so under the Last Chance Compliance Initiative (LCCI), the predecessor of the OVDP.[19] Under the LCCI, examiners were

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[16] OVDP FAQ #35 (Emphasis added.). The FAQ discussion of "discretion" could reasonably be interpreted as clarifying that examiners would not have the authority traditionally delegated to Appeals officers to settle cases based on the "hazards of litigation." *See, e.g.*, Policy Statement 8-47, IRM 1.2.17.1.6 (Aug. 28, 2007).

[17] *See* 31 U.S.C. § 5321(a)(5). *See also Ratzlaf v. United States*, 510 U.S. 135, 141 (1994); *U.S. v. Williams*, 2010-2 USTC ¶ 50,623 (E.D. VA. 2010); CCA 200603026 (Sept. 1, 2005) (noting "there is no willfulness if the account holder has no knowledge of the duty to file the FBAR," that "the criteria for assertion of the civil FBAR penalty are the same as the burden of proof that the Service has when asserting the civil fraud penalty under IRC section 6663…[that the IRS will have to show] 'clear and convincing evidence,' [of willfulness]," and that "the presumption of correctness with respect to tax assessments would not apply to an FBAR penalty assessment for a willful violation"); IRM 4.26.16.4.5.3(1)-(3) (July 1, 2008) ("(1) The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty. (2) A finding of willfulness under the BSA must be supported by evidence of willfulness. (3) The burden of establishing willfulness is on the Service.").

[18] *See generally* IRM 4.26.16 (July 1, 2008).

[19] *See e.g.*, CCA 200603026 (Sept. 1, 2005) (noting that [the LCCI letter] "says, 'Also, civil penalties for violations involving [FBARs] will be imposed for only one year and we may resolve the FBAR penalty for less than the statutory amount based on the facts and circumstances of your case.' The instructions to agents contained in the Guidelines for Mitigation of the FBAR Civil Penalty for LCCI Cases provide: 'The examiner may determine that the facts and circumstances of a particular case may warrant that a penalty under these guidelines is not appropriate or that a lesser amount than the guidelines would otherwise provide is appropriate.' If agents follow these

expressly directed to apply FBAR mitigation guidelines to avoid inappropriately high FBAR penalties.[20]

What procedures are causing a problem?

On March 1, 2011, more than a year after the 2009 OVDP ended, after learning that examiners were spending the time to compare the 20 percent penalty to what would be due under existing statutes, the IRS "clarified" its seemingly unambiguous statement in FAQ #35.[21] The March 1 memo directed examiners to stop accepting less than the 20 percent offshore penalty under the 2009 OVDP regardless of whether a taxpayer would pay less under existing statutes, except in narrow circumstances. Even in those few cases where the IRS was supposedly still applying FAQ #35, it generally did not consider reasonable cause and assumed the violation was subject to the maximum penalty for willful violations unless the taxpayer could prove that the violation was not willful.[22] Thus, in the absence of evidence, taxpayers who would be subject to the lower penalty for non-willful violations (or given a warning letter or overlooked) outside of the program would be subject to the 20 percent penalty inside the program. Moreover, the IRS did not provide any guidance to taxpayers regarding what evidence they could use to establish non-willfulness or reasonable cause.

What is the problem?

The IRS materially changed the terms of the 2009 OVDP after taxpayers applied to it in reliance on the original terms, treating similarly situated taxpayers differently.

Some taxpayers applied to the OVDP with the reasonable expectation, based on FAQ #35, that they could do no worse inside the program than they would fare in an audit. For those whose applications the IRS processed before March 1, this belief was mostly true.[23] For those whose applications the IRS processed after March 1, it was not. In other words, among similarly situated taxpayers who timely entered the 2009 OVDP, those whose cases were processed before

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guidelines we need not be imposing the FBAR penalty arbitrarily in cases in which it clearly does not apply.").

[20] *See, e.g.*, IRM Exhibit 4.26.16-4 (July 1, 2008) (LCCI penalty mitigation guidelines).

[21] Memorandum from Director, SB/SE Examination, and Director, International Individual Compliance, for all OVDI Examiners, *Use of Discretion on 2009 OVDP Cases* (Mar. 1, 2011).

[22] IRS response to TAS information request (Aug. 4, 2011) ("In most cases, reasonable cause was not considered since examiners could not make that decision during a certification. Since OVDP cases were certifications and not examinations, it was up to the taxpayer to provide information to substantiate a lower penalty. In cases where clear and convincing documentation was provided by the taxpayer penalties at less than the maximum may have been considered at the discretion of the field subject to concurrence of a Technical Advisor …. Without adequate substantiation, maximum penalties were used for the comparison to the offshore penalty.").

[23] We understand that at least in some cases, the IRS did not shift the burden of proof until after March 1.

March 1 could get a better deal than those whose cases were, through no fault of their own, processed after March 1. Such inconsistent treatment is simply unfair and arbitrary.

Those unlucky taxpayers who believed they should pay less under existing statutes and whose applications the IRS had not processed by March 1 had two options. They could either agree to pay more than they thought they owed or "opt out" of the 2009 OVDP and face the possibility of excessive civil penalties and criminal prosecution. Both options were problematic.

Opting out would leave a taxpayer worse off than if he or she had not entered the OVDP. The taxpayer's return was much more likely to be audited than if he or she had made a "quiet" correction.[24] Even taxpayers who made quiet corrections and were audited would be better off because they would not have wasted the resources necessary to apply to the OVDP and any audit would likely cover fewer years.[25] Encouraging taxpayers to opt out would also waste all of the resources already expended on the 2009 OVDP application by the IRS, as it plans to examine them anyway. In any future examination, the IRS is likely to request and review the items that were before the examiner processing the 2009 OVDP submission.[26]

The other option available to these unlucky taxpayers whose applications were not processed by March 1, *i.e.*, to remain in the program and pay more than they believed they owed under "existing statutes" – was even worse. Even inadvertently applying pressure to taxpayers who would otherwise pay less under existing statutes to pay more than they owe violates IRS policy along with most conceptions of fairness and due process. According to IRS policy:

> An exaction by the United States Government, which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the United States Constitution. Accordingly, a Service representative in his/her conclusions of fact or application of the law, shall hew to the law and the recognized standards of legal construction. It shall be

[24] IRS guidance indicates that it "will" examine anyone who withdraws from the 2009 OVDP or 2011 OVDI, though the scope of the examination and identity of the examiner will depend upon what an IRS committee decides. *See* Memorandum for Commissioner, LB&I Division and Commissioner, SB/SE Division, from Deputy Commissioner for Services and Enforcement, *Guidance for Opt Out and Removal of Taxpayers from the Civil Settlement Structure of the 2009 OVDP and the 2011 OVDI* (June 1, 2011).
[25] Audits of those making quiet corrections would be likely to cover fewer years because, unlike those who applied to the OVDP, those making quiet corrections are less likely to have been asked to agree to extend the statutory period of limitations with respect to old years.
[26] This contradicted the portion of 2009 OVDP FAQ #35, which stated "[T]hese examiners [the OVDP examiners] will compare the 20 percent offshore penalty to the total penalties that would otherwise apply to a particular taxpayer."

> his/her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers.[27]

The IRS's reversal could be subject to legal challenge.

If a court determines that a taxpayer has reasonably relied on FAQ #35 to his or her detriment, it might require the IRS to follow FAQ #35. It could base this decision on the so-called "Accardi" doctrine or similar legal theories based on the "duty of consistency" or "equality of treatment."[28] Courts often acknowledge that taxpayers generally may not rely on the IRM or similar types of guidance.[29] Particularly where taxpayers have reasonably relied on IRS procedures, however, courts have required the IRS to follow its procedures to avoid inconsistent results.[30] For example, after the IRS issued press releases announcing changes to procedures in the IRM that would require its special agents to give partial Miranda warnings that were not constitutionally required, some courts relied on the Accardi doctrine to suppress evidence obtained by agents who failed to comply with the new procedures.[31] The Accardi doctrine

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[27] Policy Statement 4-7, IRM 1.2.13.1.5 (Feb. 23, 1960). Moreover, the IRS mission is to "provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with *integrity and fairness to all*." IRM 1.1.1.1 (Mar. 1, 2006) (emphasis added).

[28] The Accardi doctrine was originally based on an agency's failure to follow its regulations. *See, e.g., Shaughnessy v. United States ex rel Accardi*, 349 U.S. 280, 281 (1955); *Vitarelli v. Seaton,* 359 U.S. 535 (1959). As noted below, however, it has been extended to other guidance and procedures.

[29] *See, e.g., Avers v. Comm'r*, T.C. Memo. 1988-176.

[30] For further discussion of the Accardi doctrine and related legal theories, *see, e.g.,* Thomas W. Merrill, *The Accardi Principle*, 74 Geo. Wash. L. Rev. 569 (2005-2006); Joshua I. Schwartz, *The Irresistible Force Meets the Immovable Object: Estoppel Remedies for an Agency's Violation of Its Own Regulations or Other Misconduct,* 44 Admin. L. Rev. 653 (1992); Christopher M. Pietruszkiewicz, *Does the Internal Revenue Service have a Duty to Treat Similarly Situated Taxpayers Similarly?* 74 U. Cin. L. Rev. 531, 532-534 (2005). Even in the absence of written procedures, the IRS may have a duty of "equality of treatment" and "consistency," but these theories may require the taxpayer to prove competitive disadvantage or invidious discrimination. *See, e.g., Int'l Bus. Machines Corp. v. U.S.*, 343 F.2d 914 (Ct. Cl. 1965), *cert. denied*, 382 U.S. 1028 (1966) (IRS abused discretion in prospectively (not retroactively) revoking beneficial private ruling given to taxpayer's competitor while denying the taxpayer a similar ruling in the interim). *Compare Avers v. Comm'r*, TC Memo 1988-176 (tax shelter investor not entitled to settlement on terms offered to other shelter investors because the offers were in error and the taxpayer failed to prove discriminatory purpose); *with Sirbo Holdings, Inc. v. Comm'r*, 476 F.2d 981 (2nd Cir. 1973) (reasoning the IRS could not settle with one taxpayer while refusing to settle on the same terms with another similarly situated taxpayer without explanation).

[31] *See, e.g., United States v. Heffner*, 420 F2d 809 (4th Cir. 1969) ("An agency of the government must scrupulously observe rules, regulations, or procedures which it has established. When it fails to do so, its action cannot stand and courts will strike it down…. It is of no significance that the procedures or instructions which the IRS has established are more generous than the Constitution requires…. Nor does it matter that these IRS instructions to Special Agents were not promulgated in something formally labeled a 'Regulation' or adopted with strict regard to the Administrative Procedure Act; the Accardi doctrine has a broader sweep…. The arbitrary

was later limited to situations where taxpayers had detrimentally relied on the government's procedures.[32] As noted above, however, it appears that some taxpayers may, in fact, have detrimentally relied on FAQ #35, for example, by incurring significant fees to participate in the OVDP and agreeing to extend the period of limitations.

The IRS did not publish the March 1 memo as required by law.

The Freedom of Information Act (FOIA) requires the IRS to make available to the public all "administrative staff manuals and instructions to staff that affect a member of the public," unless an exemption applies.[33] Thus, the IRS's failure to make its March 1 memo available to the public appears to have violated the FOIA. Moreover, if an item is not properly published and the taxpayer is not otherwise given "timely" notice of it, it may not be "relied on, used, or cited" by the IRS against a taxpayer.[34] While giving taxpayers notice of the March 1 memo might address this problem, it may be difficult to argue that such notice is timely. Accordingly, the IRS's use of and reliance on the March 1 memo may constitute a second FOIA violation.

The IRS reversal has damaged its credibility with practitioners and may reduce voluntary compliance along with participation in any future initiatives.

People voluntarily comply with tax laws for a variety of reasons other than economic deterrence.[35] According to one study, research "clearly shows that financial incentive, as well as the risk of detection and punishment, is less important than the influence of norms and moral values."[36] For example, a

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character of such a departure is in no way ameliorated by the fact that the ignored procedure was enunciated as an instruction in a 'News Release.'") (internal citations omitted); *United States v. Leahey,* 434 F.2d 7 (1st. Cir. 1970) (explaining its suppression of evidence obtained without following IRM procedures: "we have the two factors intersecting: (1) a general guideline, deliberately devised, aiming at accomplishing uniform conduct of officials which affects the post-offense conduct of citizens involved in a criminal investigation; and (2) an equally deliberate public announcement, made in response to inquiries, on which many taxpayers and their advisors could reasonably and expectably rely. Under these circumstances we hold that the agency had a duty to conform to its procedure, that citizens have a right to rely on conformance, and that the courts must enforce both the right and duty.").

[32] *United States v. Caceres*, 440 U.S. 741, 752-53 (1979).

[33] *See* 5 U.S.C. § 552(a)(2)(C). No exemptions appear to apply in this case.

[34] 5 U.S.C. § 552(a)(2) (flush). To invalidate the agency's action, however, a taxpayer would need to establish that he or she was adversely affected by a lack of publication or would have been able to pursue an alternative course of conduct. *See Zaharakis v. Heckler*, 7744 F.2d 711, 714 (9th Cir. 1984).

[35] *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138-50 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) (summarizing existing literature); IRS Oversight Board, 2009 Taxpayer Attitudes Survey (Feb. 2010) (finding 92 percent of survey respondents indicated that personal integrity influences their tax compliance behavior whereas only 63 percent cited the fear of an audit.).

[36] *See, e.g.*, Swedish Tax Agency, *Right from the Start: Research and Strategies* 6 (2005).

taxpayer who values integrity, honesty, and the benefits of government may feel guilty if he or she violates the rules. The strength of these motives may depend on whether the taxpayer perceives that the government or the IRS is acting with respect for basic elements of procedural justice such as impartiality, honesty, fairness, politeness, and respect for taxpayer rights.[37] The IRS generally acknowledges that such perceptions drive compliance.[38] Thus, the perception that the IRS is acting unfairly by treating similarly situated taxpayers differently and changing the terms of the OVDP after taxpayers have acted in reliance on them is likely to reduce respect for the IRS as well as voluntary compliance.

Perhaps even more importantly, many respected tax practitioners who undoubtedly play a significant role in facilitating tax compliance (or noncompliance) by their clients[39] have lost faith in the fairness and integrity of the IRS because of its reversal.[40] As a result, the IRS is likely to have more

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[37] *See, e.g.*, Michael Doran, *Tax Penalties and Tax Compliance*, 46 Harv. J. on Legis. 111, 113 (Winter 2009) (summarizing norms theories).

[38] According to the IRS policy statement, "[p]enalties are used to enhance voluntary compliance.… the Service will design, administer, and evaluate penalty programs based on how those programs can most efficiently encourage voluntary compliance." Policy Statement 20-1 (June 29, 2004). As the "penalty handbook" explains, "[p]enalties best aid voluntary compliance if they support belief in the fairness and effectiveness of the tax system." IRM 20.1.1.2(10) (Dec. 11, 2009). It acknowledges that disproportionately large or seemingly unfair penalties may discourage voluntary compliance. IRM 4.26.16.4 (July 1, 2008) (noting that the penalties for failure to file the required Report of Foreign Bank and Financial Accounts (FBAR) "should be asserted only to promote compliance with the FBAR…. examiners should consider whether the issuance of a warning letter and the securing of delinquent FBARS, rather than the assertion of a penalty, will achieve the desired result of improving compliance in the future…. Discretion is necessary because the total amount of penalties that can be applied under the statute can greatly exceed an amount that would be appropriate in view of the violation."); IRM 20.1.1.1.3 (Dec. 11, 2009) ("[a] wrong [penalty] decision, even though eventually corrected, has a negative impact on voluntary compliance.").

[39] For a discussion of the role of preparers and their potential impact on tax compliance, see National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 44 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

[40] *See, e.g.*, CCH Federal Taxes Weekly, *Practitioners' Corner: Bar to Arguing Non-Willfulness Under Offshore Disclosure Programs Creates Concerns*, 2011 No. 13., 153, 155 (Mar. 31, 2011) (quoting Baker Hostetler tax partner, James Mastracchio, as saying: "We were able to make FAQ 35 submissions requesting a review of the willfulness issue all along until February 8 of this year … [the IRS] seems to be changing the rules of the game halfway through…. It is clear that the IRS has been faced with a shortfall in administrative resources to review FAQ 35 submissions … the troubling thing is that closing the program to willfulness consideration under FAQ 35 now, based on a resource issue, when some persons have been granted relief, treats similarly situated taxpayers differently."); Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010) (stating "from the viewpoint of the practitioner community perhaps more important, the FAQ 35 process now appears to be a classic ''bait and switch.'' Practitioners advised clients that FAQ 35 would offer a chance at penalty mitigation, but now our experience is that the language in that guidance is essentially an empty promise."); Pedram Ben-Cohen, *IRS's Offshore Bait and Switch: The Case for FAQ 35*, 46 DTR J-1 (Mar. 9, 2011).

difficulty gaining participation in any future settlement initiatives.[41] The IRS's reversal could also make taxpayers and practitioners generally less willing to trust and cooperate with the IRS in other situations.

III. CONCLUSION

The 2009 OVDP was a great deal for people involved in criminal tax evasion. They were not affected by the IRS's "clarification" that it would not consider non-willfulness, reasonable cause, or the mitigation guidelines in applying the offshore penalty because their violations were willful. However, the IRS is perceived as having reneged on the terms of the 2009 OVDP that would benefit taxpayers whose violations were not willful. Many felt the IRS treated them unfairly as compared to similarly situated taxpayers. It placed them in the unacceptable position of having to agree to pay amounts they do not owe under "existing statutes" or face the prospect that the IRS would assert excessive civil and criminal penalties.

The IRS's perceived reversal burdened taxpayers, wasted resources, violated longstanding IRS policy, opened the IRS to potential legal challenges, and was not properly disclosed as required by FOIA. It also damaged the IRS's credibility with taxpayers as well as the practitioner community. As a result, the IRS is likely to have more difficulty gaining participation in any future settlement initiatives. This erosion in trust for the IRS among taxpayers and practitioners is also likely to have a negative impact on IRS's mission and voluntary tax compliance more generally.

Attachment

> National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 23-24 (*IRS's Inconsistency and Failure to Follow Its Published Guidance Damaged Its Credibility with Practitioners involved in the Voluntary Disclosure Program*).

cc:

Steven T. Miller, Deputy Commissioner, Services and Enforcement
Douglas Shulman, Commissioner of Internal Revenue

[41] According to the IRS, all of the 3,000 applications to the 2011 OVDI came in after the 2009 OVDP deadline and before the IRS's announcement of the 2011 OVDI on March 1, 2011. IRS response to TAS information request (July 13, 2011). Thus, it appears that the 2011 OVDI may not have received any significant number submissions after the IRS's reversal became known.