The Good, the Bad and the Ugly of Opting Out of the OVDI

By Michael J. DeBlis III

Michael J. DeBlis examines the Offshore Voluntary Disclosure Initiative and provides an overview of the FBAR fundamentals.

Since 2009, many U.S. persons with foreign accounts and income have sought shelter from the IRS onslaught by entering the IRS voluntary disclosure program. For eligible taxpayers who ventured through the front door, the OVDI provided the certainty of no criminal prosecution and civil penalty relief. The program required taxpayers to amend their income tax returns to report all previously unreported income. In so doing, taxpayers are required to pay back-taxes, interest and a 20-percent accuracy-related penalty or 25-percent delinquency penalty on their delinquent taxes. As far as those aspects of the program are concerned, there is no doubt that the tradeoff of a penalty for a sound night's sleep is reasonable.

However, the penalties do not end there. Indeed, those mentioned thus far are just the tip of the iceberg. The IRS also imposes what is likely the highest penalty in the history of IRS initiatives—a single "FBAR-related" offshore penalty. The offshore penalty is equivalent to 27.5 percent of the *highest* aggregate value of each undisclosed financial account at any time during the look-back period. In limited situations, the offshore penalty can be reduced from 27.5 percent to 12.5 percent or five percent of the account value.[1]

Before delving any deeper into the OVDI abyss, this would be a good time for a slight digression into some FBAR fundamentals. First and foremost, what is the purpose of the FBAR penalty? Stated otherwise, what conduct is the penalty meant to punish? Two distinct acts. The first, and by far the most common, is the failure to file a foreign bank account report. And the second is the failure to maintain required records and to make them available upon request.

Second, when must an FBAR be filed? An FBAR must be filed when: (1) the filer is a U.S. person; (2) the U.S. person (a) has a foreign financial account, or (b) the U.S. person has a financial interest in the account or signature or other authority over the foreign financial account; *and* (3) the aggregate amount(s) in all foreign account(s) valued in U.S. dollars exceeds $10,000 at any time during the calendar year.[2]

Virtually every term is a legal term with a precise meaning. Therefore, it is necessary to define each one. A "U.S. person" includes a citizen or resident of the United States. Citizenship is generally determined by a U.S. birth certificate or naturalization papers. For non-U.S. citizens, the residency determination may be somewhat problematic.[3]

A person living in and doing business in the United States is not just limited to individuals. It also includes business entities, trusts and estates. A certificate of incorporation from a U.S. state establishes that a corporation is a U.S. person.

The term, "financial account" is quite broad. It includes bank, savings and checking accounts; time deposits; securities accounts; mutual funds, brokerage and securities derivatives accounts; any other account maintained in a foreign financial institution or with a person doing business as a financial institution; and a foreign insurance policy having a cash surrender value.[4] The term does not include individual bonds, notes or stock certifications in the physical possession of the U.S. person.[5]

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An account is "foreign" if located outside all geographical areas of the United States. The term "financial interest" includes accounts for which the U.S. person is the owner of record or has legal title, regardless of whether the account is maintained for his or her own benefit or for the benefit of others, including those who are *not* U.S. persons.[6]

A U.S. person has account "signature authority" if he has the ability to control the disposition of money or other property in the account by delivering a document containing his signature to the bank or other person with whom the account is maintained.[7]

FBARs are required for each calendar year during which the aggregate amount(s) in the account(s) exceeded $10,000 valued in U.S. dollars at any time during the calendar year. For example, if the statement closing balance is $9,000, but at any time during the year there is a balance of $15,000, the maximum value is $15,000.[8] Foreign currency is converted by using the official exchange rate in effect at the end of the year in question or converting foreign currency into U.S. dollars.

Each person for whom the FBAR filing requirement applies must maintain records. Those records include the following: (1) the name in which the account is maintained; (2) the number or other designation of the account; (3) the name and address of the foreign bank or other person with whom the account is maintained; (4) the type of account; and (5) the maximum value of each account during the reporting period.[9]

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To say that the offshore penalty *can* be financially burdensome on taxpayers is as gross an understatement as saying that one *might* feel sore the morning after running the NYC Marathon. This "take it or leave it" penalty is imposed on *all* taxpayers, regardless of their underlying conduct. That means that it applies even if the taxpayer did *not* know about the requirement to report the foreign account in the first place. And that is what has taxpayers up in arms.

Those taxpayers who find the offshore penalty unacceptable have begun to rise up and challenge the fairness of a "one size fits all" penalty that applies equally to both willful and non-willful taxpayers. Their frustration can best be expressed by a phrase made popular in the movie "Network": "I'm mad as hell and I'm not going to take this anymore."

And it's hard to blame them. Indeed, the overwhelming majority of American taxpayers with unreported assets overseas are *not* criminals, yet OVDI treats all taxpayers as if they were Al Capone.

Let's be honest and recognize a simple truth: the tax system in this country is overwhelmingly complicated. A day doesn't go by that there isn't talk about overhauling the Tax Code. There are as many different specialties within the realm of tax law—from state and local taxation to international taxation and everything in between—as there are specialties within medicine. To that end, mistakes, errors and accidents happen. But that doesn't mean that a taxpayer who has failed to report a foreign bank account on account of a technicality should be treated the same as a taxpayer who *intentionally* failed to report foreign assets. Indeed, many a taxpayer would sooner be condemned to a life of eternal damnation than be treated like a 19th century gangster.

This begs the question, how can the IRS assess a "one size fits all" penalty that applies *equally* to both willful and non-willful taxpayers without having to prove that the taxpayer acted willfully? After all, in the criminal setting, the government carries the heavy burden of proving beyond a reasonable doubt that a taxpayer acted willfully. If that is true, shouldn't the government carry *some* burden of proof for willfulness in the civil setting? Yes. And thankfully it does. However, because willfulness, as it is used in this context, applies to a civil penalty and not to a tax crime, the government's burden of proof is *not* "beyond a reasonable doubt." Instead, it is "by clear and convincing evidence."

The simple answer to the rhetorical question, "how can the IRS assess a one size fits all penalty?" is that OVDI makes an end run around willfulness. How so? By assuming that it exists in every case, regardless of how innocent the facts. In other words, the program automatically assumes that because the taxpayer had unreported assets overseas, that the taxpayer *must* have known that he had a duty to report those accounts and to file an FBAR.

Why does the IRS assume willfulness? For two reasons. The first is efficiency. Very simply, the IRS does not have unlimited resources to devote to individually reviewing thousands of taxpayer disclosures. Indeed, finding the "smoking gun," if it even exists, is no different than trying to find a needle in a haystack.

Why, you might ask, is it even necessary to dig through thousands of taxpayer disclosures in the first place? To understand why, it is necessary to understand what methods of proof the government uses to prove willfulness, in the context of an FBAR violation. As a preliminary matter, willfulness is a state of mind. Seldom are there any witnesses and only in a rare case

would a taxpayer admit the required state of mind. As such, it can rarely be proven by direct evidence.

That begs the question, "how does the government prove willfulness?" Willfulness is proven through circumstantial evidence—by conduct or acts from which a person's state of mind can be inferred.

What types of facts might give rise to such an inference? One such fact might be records revealing that income related to funds in a foreign bank account was *not*reported. Another might be a copy of the taxpayer's signed income tax return with Schedule B attached showing that the box pertaining to foreign accounts was unchecked. A third might be copies of statements for the foreign financial account. A fourth might be correspondence with the account holder's tax preparer disclosing the FBAR filing requirement. And a fifth might be copies of previously filed FBARs.

The second reason that the IRS assumes willfulness is, not surprisingly, money. This is the very essence of the program. Indeed, the primary objective of the OVDI is to bring offshore money back into the U.S. tax system. A comparison of the maximum non-willful FBAR penalty with the maximum willful FBAR penalty reveals how the presumption of willfulness works much like a carrot and a stick. If a taxpayer was unaware of his obligation to file an FBAR and fails to file it, the maximum penalty that can be imposed for a *non-willful* failure to file is $10,000 per year.

On the other hand, if a taxpayer *willfully* fails to file an FBAR, the maximum penalty that can be imposed is 50 percent of the account balance per year. By assuming willfulness and by threatening taxpayers with as draconian a penalty as the *maximum* willful FBAR penalty, the IRS has created the appearance that the OVDI is the deal of the century. With the maximum FBAR penalty hanging over the heads of taxpayers like the sword of Damocles, nary a taxpayer who finds himself in the position of having failed to file an FBAR would be bold enough to take such a risk.

If you are evaluating the current 27.5-percent offshore penalty and cringing about how much it will hurt, what about opting out? What does it mean to opt-out in the first place? It's an election made by a taxpayer to have his or her case handled under the standard audit process. There are many factors that must be considered before making this decision. That's because the opt-out election is irrevocable, meaning that if the taxpayer wakes up the next morning with buyer's remorse, it's too late.

Because opting out comes at a hefty price, the issue in every opt-out is whether the potential risks of opting out outweigh the potential rewards. The biggest risk of opting out is the possibility that the IRS might refer the case to the Department of Justice for prosecution. To that end, the first question that must be answered before a taxpayer even thinks about opting out is whether he is at material risk of criminal prosecution. Those who watch the criminal tax enforcement system know that DOJ Tax prosecutes only cases of *material* misconduct.

As used in this context, the term "material" is vague and ambiguous. A taxpayer *not* at material risk for prosecution is not the same as a taxpayer at "no risk" of prosecution. This implies that taxpayers for whom this question is even relevant must be willing to assume some risk. And that leads to an important point: opting out is *not* for the faint of heart, the risk-averse or for anyone without some tolerance for risk

To the extent that the taxpayer is at material risk of prosecution, OVDI is the easy choice and probably the only rational choice other than the ostrich approach of burying one's head in the sand and hoping that the government does not discover past problems.

But what about taxpayers who are *not* at material risk of criminal prosecution? Does the corollary to the previously stated rule—*i.e.,* that rule being that OVDI is the *right* choice—apply? In other words, should such taxpayers storm the exit doors of the opt-out oligarchy and never look back? The answer to that question is "not necessarily."

Even assuming that there is no material risk of prosecution, there are other risks that loom for those who wish to opt out. For example, taxpayers take the chance of a full audit and penalties in excess of what is being offered in OVDI. In addition, civil fraud can trump the statute of limitations, resulting in an examination that goes back farther than the OVDI's eight-year disclosure period.

Before panicking, taxpayers contemplating an "opt out" can take comfort in the fact that the decision to opt out is not as capricious as rolling the dice at the craps table. Thankfully, a framework exists for eliminating much of the risk and uncertainty that is inherent in opting out. While simple in theory, like anything in tax, it can be tedious in application. Nonetheless, it is practical and sensible.

In applying this framework, the best place to start is by comparing the amount due *under* the offshore initiative to the tax, interest, and applicable penalties for all open years that the taxpayer would owe *outside* of the OVDI regime.[10] If the amount due under the offshore initiative is *greater* than the tax, interest

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and applicable penalties that a taxpayer would owe outside of the OVDI regime, then opting out would appear to be the *obvious* choice. In other words, if the results under the voluntary disclosure program are more severe than the results outside of the voluntary disclosure program, opting out is the way to go.

On the other hand, if the amount due under the offshore initiative is *less* than the tax, interest and applicable penalties that a taxpayer would owe outside of the OVDI regime, then opting out would appear to be the *wrong* choice. In other words, if the results under the voluntary disclosure program are more advantageous than the results outside of the voluntary disclosure program, it is best to stay in the program.

While at first blush this might appear to be relatively simple, the devil is in the details. Indeed, before such a comparison can even be made, a fundamental issue must be resolved. While that issue might appear trivial or insignificant, it isn't. Indeed, it can adversely affect the end result in the same way that applying the wrong "useful life" metric can affect a depreciation calculation. The issue is whether civil penalties *outside* of the OVDI regime should be calculated at their maximum levels when it comes to making this comparison? In other words, should civil penalties *outside* of the OVDI regime be calculated without regard to other circumstances that may reduce liability, such as reasonable cause?

Before answering this question, knowledge of what civil penalties await a taxpayer *outside* of the OVDI regime is critical. While there are several, the most serious, by far, is the FBAR penalty.

There are two types of FBAR penalties—non-willful and willful. The maximum non-willful FBAR penalty is $10,000 for each negligent violation of the FBAR filing or recordkeeping requirements.[11] For willful violations, the maximum FBAR penalty is the *greater* of (1) $100,000 or (2) 50 percent of the total balance of the foreign account per violation.[12] Therefore, FBAR civil penalties have varying upper limits, but no floor.

When it comes to deciding whether the FBAR penalty should be calculated at its *maximum* level or at an *adjusted* level that takes into account circumstances that might reduce liability, there are two schools of thought. The first is grounded in a conservative approach. That approach takes the position that the FBAR penalty should *always* be calculated at its maximum level and without regard to other circumstances that may reduce liability, such as reasonable cause. In other words, no matter how strong the taxpayer's reasonable cause defense, it will be ignored. The second approach is more liberal, taking into consideration the taxpayer's individual circumstances.

The latter has the effect of adjusting the FBAR penalty to a level that is proportionate with the taxpayer's underlying conduct. The former, on the other hand, drives the calculation into the FBAR penalty stratosphere. How so? By assuming the worst—*i.e.,* that the IRS will be able to prove that the taxpayer willfully violated the FBAR filing requirements.

This author endorses the liberal approach for the simple reason that it more accurately predicts the true FBAR penalty outside of the OVDI framework. This is especially true if the FBAR-related mitigation guidelines somehow benefit the taxpayer. A simple comparison of the maximum and minimum FBAR penalties for non-willful violations illustrates this point. For example, the difference between $10,000—the maximum non-willful FBAR penalty,[13] on the one hand, and $500—the non-willful FBAR penalty for a foreign account with a maximum balance that never exceeded $50,000[14]—on the other hand, is $9,500. This disparity is simply too great to assume the worst—*i.e.,* the *maximum* non-willful FBAR penalty.

It should come as no surprise that assuming the maximum penalty—when willfulness clearly does not exist—can adversely impact the decision to opt out. For example, a non-willful taxpayer contemplating an opt-out will be much less likely to do so if confronted with an FBAR penalty that has been grossly inflated to its maximum level. And the biggest travesty in this is that the only justification for calculating the FBAR penalty at its maximum level is an illusory risk that the IRS will somehow assert the maximum penalty when, in reality, the taxpayer has as good a chance of being slapped with the maximum penalty as he has of being struck by lightning.

As illustrated above, the FBAR-related mitigation guidelines are critical to the decision of whether to opt out. If the taxpayer contemplating an opt out is compared to a boat that is trying to navigate its way to shore in a stormy and turbulent sea, the FBAR-related mitigation guidelines would be the equivalent of the lighthouse that guides it in. To that end, tax practitioners should never dispense with a thorough analysis of the FBAR-related mitigation guidelines before advising a client on the pros and cons of opting out. Indeed, the question that must always be asked is whether the FBAR-related mitigation guidelines might benefit the taxpayer *outside* of the OVDI framework.

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While mentioned briefly above, now is as good a time as any to delve deeper into the FBAR mitigation guidelines. If the FBAR mitigation guidelines conjure up the same fear as abstract formulas from algebra and geometry that prevented you from getting a wink of sleep the night before an exam, you can breathe a sigh of relief. That's because they are nothing more than a way to assist examiners in determining an appropriate penalty amount. As discussed above, FBAR civil penalties do *not* have a set amount—only a cap. The mitigation guidelines may lessen the severity of the FBAR penalty "knockout punch" by providing for a penalty that is *below* the maximum, depending on the account balances.

Some basic principles must be understood before applying the FBAR mitigation guidelines. As a preliminary matter, the mitigation guidelines apply not only to non-willful FBAR penalties, but also to willful FBAR penalties.

Second, the mitigation guidelines are only intended as an informal aid for IRS examiners. Examiners are expected to "exercise discretion," taking into account the facts and circumstances of each case, " in determining whether penalties should be asserted and, [if so], the total amount of penalties to be asserted."[15] The idea that the guidelines should never trump an examiner's discretion can—and often times *do*—inure to the benefit of a taxpayer. Indeed, the IRM explicitly states that in exercising their discretion, "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."[16]

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For example, suppose the taxpayer fails to report five small foreign accounts with a combined balance of $20,000. However, the taxpayer properly reports the income from each account and makes no effort to conceal the existence of the account. Under these circumstances, it may be more appropriate to issue a warning letter rather than assert penalties under the mitigation guidelines.[17]

For non-willful FBAR penalties, the guidelines for penalties range from $500 for each violation (if the maximum balance for all accounts to which the violations relate did not exceed $50,000 at any time during the year) up to $10,000, the statutory maximum.[18] And for willful FBAR penalties, the guidelines for penalties range from the greater of $1,000 per violation or five percent of the maximum balance of the account to which the violations relate (for each violation) up to the statutory maximum.[19] Therefore, overlooking the mitigation guidelines could create a margin of error as wide as the Grand Canyon.

Four threshold conditions must be satisfied before the mitigation guidelines apply.[20] First, the taxpayer must have no history of criminal tax or BSA convictions for the preceding 10 years as well as no history of past FBAR penalty assessments. Second, no money passing through any of the foreign accounts associated with the taxpayer must have been from an illegal source or used to further a criminal purpose. Third, the taxpayer must have cooperated during the examination (*i.e.,* the IRS did not have to resort to a summons to obtain nonprivileged information; the taxpayer responded to reasonable requests for documents; or the taxpayer back-filed correct reports). And fourth, the taxpayer must not have sustained a civil fraud penalty for an underpayment (for the year in question) due to the failure to report income related to any amount in a foreign account.

As important as the FBAR mitigation guidelines are to calculating the appropriate FBAR penalty, there is something even more important. And that is determining whether the FBAR penalty is willful or non-willful. Indeed, to the extent that the FBAR mitigation guidelines can somehow benefit the taxpayer outside of the OVDI framework, it is first necessary to determine whether the violation was willful or non-willful. The seminal issue is, "Can the government prove, by clear and convincing evidence, that the taxpayer willfully violated the FBAR filing requirements?" That issue turns on how courts interpret willfulness.

Willfulness is the cornerstone to a willful FBAR penalty. It is defined by courts as a voluntary, *intentional* violation of a known legal duty. If that sounds familiar, that's because the definition of willfulness—in the context of a civil FBAR penalty—is identical to the definition of willfulness in the context of a criminal violation of the anti-structuring statute.[21]

How does the government interpret the definition of willfulness for purposes of an FBAR penalty? Stated otherwise, what showing must the government make in order to prove a voluntary, intentional violation of a known legal duty? According to the IRS, not much. It must prove no more than knowledge on the part of the taxpayer that he had a duty to file an FBAR. Why? Because "knowledge of the duty to file an FBAR would entail knowledge that it is illegal to *not* file the FBAR."

Does the corollary to this principle apply? In other words, that there is no willfulness if the taxpayer had

no knowledge of the duty to file the FBAR? While that might appear logical, it is not always true. Under the theory of willful blindness, willfulness may be attributed to a person who has made a conscious effort to *avoid* learning about the FBAR reporting and recordkeeping requirements.[22] The IRM provides an example in which a person admits knowledge of but fails to answer the question concerning signature authority at foreign banks on Schedule B of his income tax return.[23]

The reasoning is that because Schedule B refers taxpayers to the FBAR instructions, the taxpayer could have learned of the FBAR filing and recordkeeping requirements merely by reading the instructions. The failure to learn of the filing requirements coupled with other factors—such as efforts taken to conceal the existence of the accounts and the amounts involved—may lead the government to conclude that the violation was due to willful blindness.

Thankfully, the IRM specifically states that the mere fact that a taxpayer failed to check the box on Schedule B is *not* sufficient, by itself, to establish that the FBAR violation was due to willful blindness.[24] While that might allow taxpayers to breathe a sigh of relief, it comes with a caveat. A recently decided federal court of appeals case comes very close to establishing a "strict liability standard" for incorrectly answering the same question on Schedule B of a U.S. tax return.

The issue in *Williams*[25] was whether the government could recover civil FBAR penalties from the taxpayer. In holding that it could not, the U.S. District Court for the Eastern District of Virginia reasoned that the government failed to prove that Mr. Williams willfully violated his obligation to file an FBAR. In a split-decision opinion, the Fourth Circuit Court of Appeals reversed the decision of the district court. In so doing, the court held that a taxpayer who signs a tax return after checking "No" in response to the Schedule B question pertaining to foreign bank accounts is deemed to have "known the contents of the return." Therefore, he had knowledge of the FBAR filing requirement.

Admittedly, the facts did not weigh heavily in the Mr. Williams' favor. In 2000, he had an interest in two Swiss bank accounts that were held through a foreign entity. He failed to report the income earned from these accounts on his 2000 federal tax return. Specifically, he checked the "No" box in response to the Schedule B question pertaining to whether he had an interest in any foreign financial accounts. The icing on the cake was that Mr. Williams then failed to file the required FBAR, reporting his interest in the accounts.

In 2002, Mr. Williams disclosed both accounts to the IRS. But not before the IRS caught wind of it. As a result, he was indicted on charges of criminal tax evasion and conspiracy to defraud the IRS. He subsequently pleaded guilty to both charges. During his plea allocution, Mr. Williams admitted all of the essential elements of the charged crimes, including that he willfully evaded taxes by filing false and fraudulent tax returns on which he failed to disclose his interest in two accounts.

The Fourth Circuit Court of Appeals zeroed in on the fact that Mr. Williams had signed his 2000 federal tax returns. They viewed that as *prima facie* evidence that he knew the contents of his return and that, at a minimum, the questions contained in Schedule B and its directions "put Williams on inquiry notice of the FBAR filing requirement." The majority treated Mr. Williams' testimony that he was ignorant of the question and directions in Schedule B because he never read the question or paid attention to the directions, as evidence of willful blindness to the FBAR requirements. To that end, the court reasoned that Mr. Williams made a "conscious effort to avoid learning about reporting requirements."

While the majority could have rested there and concluded that the record established willful blindness and reversed the district court's holding on that basis alone, they decided to go one step further. That one step has created a firestorm of opposition amongst critics. Why? Because the court concluded that they were "convinced that, at a minimum, Williams's undisputed actions *establish[ed] reckless conduct*," thus satisfying "the proof requirement under [the FBAR Penalty Provision]." (Emphasis supplied.) In support of their conclusion, the majority reasoned that "in cases where willfulness is a statutory condition of civil liability, [courts] have generally taken [willfulness] to cover not only knowing violations of a standard, but *reckless ones* as well." (Emphasis supplied.)

The practical effect of this reasoning is nothing short of mind blowing. First, and most important, the court unilaterally eviscerated the willfulness standard by diluting its definition from an intentional violation of a known legal duty to a reckless disregard of a statutory duty. In so doing, the court applied a standard of willfulness *contrary* to the government's own interpretation, and judicial precedence, under Title 31. In addition, the holding established judicial precedent for future courts to scrutinize and to view

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with a healthy dose of skepticism those with considerable assets who fail to inquire about their obligations when it comes to reporting foreign bank accounts.

While *Williams* might strike fear in the hearts of even the bravest taxpayers, if there is any consolation, it's that *Williams* is an unpublished opinion. Therefore, it is not binding precedent on federal courts in the fourth circuit, much less any of its sister circuits.

The ease with which willful blindness can be proven is a stark reminder to taxpayers of the risks inherent in opting out. It is the flashing neon sign in the store window. And if that sign could speak, it would say: "Opting out is not an exercise for the faint of heart, the risk-averse, or for anyone without some tolerance for risk." The only guaranteed result is to get in OVDI and stay in it. To put it bluntly, the risk-averse should seek shelter in the OVDI bunker and be done with it—perhaps with the thought of opting out later if circumstances change.

While the FBAR penalty tends to be the most severe penalty outside of the OVDI framework, it is by no means the only penalty. The following other penalties may apply:

- **Failure-to-file a tax return**—Code Sec. 6651(a)(1): Generally, taxpayers must file income tax returns. If a taxpayer fails to do so, a penalty of five percent of the balance due, plus an additional five percent for each month or fraction thereof during which the failure continues may be imposed. The penalty shall not exceed 25 percent.
- **Failure-to-pay the tax shown on the return**—Code Sec. 6651(a)(2): If a taxpayer fails to pay the amount of tax shown on the return, he or she may be liable for a penalty of 0.5 percent of the amount of tax shown on the return, plus an additional 0.5 percent for each additional month or fraction thereof that the amount remains unpaid, not exceeding 25 percent.
- **Accuracy-related penalty on underpayments of tax—** Code Sec. 6662: Depending upon which component of the accuracy-related penalty is applicable, a taxpayer may be liable for a 20-percent or 40-percent penalty.

As if that wasn't bad enough, there is also the civil fraud penalty,[26] which is the 800 pound gorilla. Indeed, it has the potential of being the worst penalty of them all. The civil fraud penalty amounts to 75 percent of the unpaid tax. A taxpayer is liable for the civil fraud penalty when an underpayment of tax, or a failure to file a tax return, is due to fraud. Unbeknownst to most taxpayers, civil fraud can trump the statute of limitations. This means that if the taxpayer opts out, the IRS could conceivably even examine tax years *prior* to the OVDI's eight-year disclosure period.

Up to this point, there has been little to no discussion on the statute of limitations or on interest as it pertains to the FBAR penalty. By no means does that suggest that either one of these is insignificant or so trivial that it can be overlooked. When it comes to interest, it is just as likely to rear its ugly head and bite the taxpayer in the butt when he least expects it as the information return penalty is.

As a preliminary matter, interest does not accrue on FBAR penalties *prior* to assessment. In other words, only the penalty amount is owed if (1) full payment is made in a pre-assessment case, or (2) payment is made within 30 days after the date a notice of the penalty amount due is first mailed to the filer.

Interest only begins to accrue on the date the FBAR notice of penalty assessment is mailed. But no interest is owed on payments received within 30 days from the date a notice of the penalty amount due is first mailed to the filer. In addition to interest, a six-percent delinquency penalty applies to amounts remaining unpaid 90 days from the date a notice of the penalty amount due is first mailed to the filer.

As far as the statute of limitations for assessing an FBAR civil penalty is concerned, generally it is six years, even if the FBAR has not been timely filed.[27] Once assessed, the government must bring an action in court to recover the assessed FBAR penalty within two years from the date of assessment.[28] The state of limitations for criminal FBAR violations is five years.[29]

Finally, to the extent that information is discovered during a full-scope examination that was *not* previously disclosed by the taxpayer during the OVDI period—or, worse yet, was *inconsistent* with information supplied by the taxpayer during the OVDI period—the IRS may refer the matter to Criminal Investigation (CI). Therefore, representations that were made to the IRS during the OVDI period ought not be overlooked before making the decision to opt out.

Below is an example of a disclosure made during the voluntary disclosure period that was subsequently determined to be false during a full-scope examination. The fate that befell this taxpayer is a powerful lesson for those who might be tempted to opt out after misrepresenting critical information during the voluntary disclosure period. You can use your imagination to guess what happened to Jason, this poor, unfortunate—yet not too smart—taxpayer.

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Jason is a U.S. citizen who worked overseas. While living abroad, he opened up a foreign bank account. The highest aggregate balance in the account was $1 million. The account earned a total of $350,000 over an eight-year period, beginning in 2003 and ending in 2010. None of this interest was reported on his tax returns.

Fearing the worst, Jason entered the 2011 OVDI. On his voluntary disclosure application, Jason declared that he had been working overseas as a consultant from 1989 to 1999. However, he had to return to the United States permanently after a medical condition prevented him from continuing to work.

The IRS asserted a $250,000 offshore penalty (25 percent of $1 million). Overwhelmed by the offshore penalty and believing it was too harsh, Jason decided to opt out. Pete, the assigned examiner, placed tax years 2003 through 2010 under regular examination. The examination revealed that the income Jason reported from 2003 through 2010 was much *less* than his expenses during the same period. Specifically, Jason spent approximately $750,000 over the eight-year period, roughly $50,000 per year *more* than what he earned during the *same* period.

When Pete asked Jason how he was able to support himself, Jason said that because he was unable to work due to his medical condition, he received gifts from family members and friends. However, Jason could not provide any proof of the gifts or even recall the names of the people who gave him the gifts.

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Ultimately, Pete tracked down Nick, the owner of a business that Jason performed consulting services for. Nick disclosed, albeit reluctantly, that he paid Jason approximately $50,000 a year "under the table."

How will things end up for Jason? Put simply, Jason should not leave his house without packing a toothbrush and an extra pair of boxers. Here, the pattern of significant amounts of unreported income over an eight-year period coupled with the false statements Jason made on his voluntary disclosure application and to Pete directly, leads to only one conclusion—one that Jason could live without. Jason's case is a prime candidate for referral to Criminal Investigation for possible prosecution. At the very least, Jason faces a stiff civil fraud penalty that will make him wish that he never opted out.

Against this backdrop of parade of horribles lurking deep within the bowels of the OVDI regime should be compared the potential benefits of opting out. What are the potential benefits of opting out? As discussed above, one such benefit might be a maximum penalty (which takes into account other circumstances that may reduce liability, such as the penalty mitigation guidelines and all applicable defenses) outside the OVDI regime that is substantially *less* than the maximum penalty inside the OVDI regime.

Second is the ability to assert a defense to the draconian FBAR penalty. Indeed, that is what motivates many taxpayers to opt out. And for good reason. A successful defense could unilaterally eviscerate the FBAR penalty completely (for both willful and non-willful penalties) or lower it to a level that is substantially *less* than the 27.5-percent offshore penalty. One such defense is "reasonable cause."

The authority for the "reasonable cause" exception is found in the IRS Manual.[30] The IRM approves of the "reasonable cause" guidance provided under 26 C.F.R. §1.6664, *Reasonable Cause and Good Faith Exception to the § 6662 penalties*. Therefore, even though the words "full audit" may strike fear in the hearts of taxpayers, those are chances worth taking when the taxpayer has a reasonable cause defense.

Whether a failure to file or failure to pay was due to "reasonable cause" is based on a consideration of the facts and circumstances. Factors that weigh *in favor* of a determination that an FBAR violation was due to reasonable cause include the following:

- The sophistication and education of the taxpayer
- Whether there were recent changes to the tax forms or to the law that the taxpayer could *not* reasonably be expected to know
- The level of complexity of the tax or compliance issue
- Reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account
- Evidence that the unreported foreign account was established for a legitimate purpose and that no effort was made to intentionally conceal the reporting of income or assets
- That there was no tax deficiency related to the unreported foreign account (or, if there was a tax deficiency, it was *de minimis*)

Other factors, in addition to those listed here, might weigh in favor of a determination that the failure to file was due to reasonable cause. No single factor is determinative. It is a "facts and circumstances" test.

Factors that might weigh *against* a determination that an FBAR violation was due to reasonable cause include the following:

- Whether the taxpayer's background and education indicate that he should have known of the FBAR reporting requirements

- The taxpayer's compliance history (*i.e.,* whether the taxpayer had been penalized before)
- Evidence that the unreported foreign account was established for an illegitimate purpose (*i.e.,* sheltering money from the U.S. government)
- That the taxpayer failed to disclose the existence of the account to his tax preparer
- That there was a tax deficiency related to the unreported foreign account

As with factors that weigh in favor of a determination that an FBAR violation was due to reasonable cause, there may be other factors that weigh against a determination that a violation was due to reasonable cause.

For those who think that the meaning of "reasonable cause" is as clear and precise a term as a household appliance, think again. Reasonable cause is a legal term of art that has been substantially litigated. As such, there is strong case law that provides precedent for the term. For this reason, it is recommended that justification for reasonable cause be accompanied by a legal memorandum to accompany the FBAR report.

Below are two examples where the reasonable cause defense was successful. Both examples are simple and easy to follow.

Example 1. John is a U.S. citizen who has a checking account in Country A. The highest balance in that account exceeded $10,000. John failed to file an FBAR to report his financial interest in that account. After reading recent press releases and learning of his FBAR filing obligations, John filed an accurate, albeit late, FBAR. The FBAR was accompanied by a written statement explaining why John believed that the failure to file the FBAR was due to reasonable cause.

What is the result? The IRS will review all of the facts and circumstances to determine whether the violation was due to reasonable cause. John's explanation for why he failed to timely file an FBAR will be deemed reasonable. Because the IRS determined that the FBAR violation as due to reasonable cause, no FBAR penalty will be asserted.

Example 2. Jane is a U.S. citizen who lives and works in Country B. She is a computer programmer. Jane has checking and savings accounts with ABC Bank, a bank that is located in the city where she lives. The aggregate balance of the checking and savings accounts is $50,000 during the tax year.

Jane complied with Country B's tax laws and properly reported all of her income on Country B tax returns. However, she failed to file U.S. federal income tax returns and failed to file FBARs to report her financial interest in the checking and savings accounts.

After reading recent press releases and learning of her federal income tax return and FBAR reporting obligations, Jane filed delinquent FBARs, reporting both foreign accounts, and attached statements to the FBARs explaining that she was previously unaware of her obligation to report the accounts on an FBAR. Jane also filed U.S. federal income tax returns properly reporting all income. No tax was due.

What is the result? As in Example 1, the IRS will review all of the facts and circumstances to determine whether the FBAR violation was due to reasonable cause. Here, Jane had a legitimate purpose for maintaining the foreign accounts. Moreover, there was no indication that she made any effort to intentionally conceal the reporting of income or assets. Finally, no tax was due. Jane's explanation for why she failed to timely file an FBAR will be deemed reasonable in light of the facts and circumstances. Since the IRS determined that the FBAR violation was due to reasonable cause, no FBAR penalty will be asserted.

After carefully considering the pros and cons of opting out, let's assume that the taxpayer decides to opt out. What are the procedures for doing so? There are several. However, this recitation highlights only the most significant procedures. First, the taxpayer must submit a letter to the IRS notifying them of his intention to "opt out" of the OVDI. At that point, the examiner and manager will consider the facts of the case and how the audit process will proceed.

In referring the case for examination, the examiner and manager will decide whether to refer the case for a normal examination or to a Special Enforcement Program agent. In considering the facts of the case and referring the case for examination, the examiner and manager will consult with technical advisors. All relevant years and issues will then be subject to a complete examination.

At the conclusion of the examination, "all applicable penalties will be imposed."[31] As discussed above, those penalties could be substantially greater than the 27.5-percent offshore penalty. If the case is disputed, the taxpayer will have recourse to Appeals.

A subtle but critical point that has far-reaching consequences is the realization that even after opting out, the taxpayer remains within Criminal Investigation's Voluntary Disclosure Practice. This means that the taxpayer must still cooperate fully with the agent by providing all requested information and records. In addition, the taxpayer must pay the tax, interest, and penalties that are ultimately determined to be due. If the taxpayer does not cooperate or make payment arrangements, the case may be referred back to Criminal Investigation.[32]

To summarize, OVDI avoids exposure to additional potential penalties associated with the income tax returns and required foreign information reports. It may avoid an examination which might include an interview of the taxpayer and his return preparer. It limits the number of tax years at issue while also providing certainty with respect to the avoidance of a referral to the U.S. Department of Justice for criminal tax prosecution.

The bottom line is that while the OVDI can be economically oppressive given the penalty structure, it is predictable. Opting out is much less so.

When a client calls me with questions about opting out, what echoes through my mind are two lines from the poem, "Do not go gentle into that good night," by Dylan Thomas. They offer inspiration for the weary taxpayer who is courageous enough to stand up to Uncle Sam but who is now confronted with the harsh reality of what awaits him outside of the OVDI framework:

Do not go gentle into that good night.

Rage, rage against the dying of the light.

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Rescued from the Brink of Insanity: Practical and Sound Advice for Making the Decision to Opt Out of the OVDI

While the above steps provide a solid framework for analyzing the pros and cons of opting out, they are nothing more than tools. As such, they are utterly useless if the tax professional does not know how to *apply* them to the facts of a case. It's like having a needle and yarn but not having a clue how to knit.

While *reading* can aid in learning, there is no substitute for *doing*. Reading about what steps to take to solve a tax problem is no different than reading about how to ride a bicycle. In the same way that the only way to learn how to ride a bicycle is by experiencing it firsthand—*i.e.,* by physically getting on it (and perhaps falling off it more than once)—the only way to become proficient at solving tax problems is by trudging through a multitude of hypotheticals. Therefore, my motto is, "Learning by doing."

So why not test your problem solving skills out on a few true-to-life hypotheticals? Below are some hypotheticals designed to assist the reader in recognizing when it would be advantageous for a taxpayer to opt out as well as when it would be detrimental for a taxpayer to opt out. As previously mentioned, opting out is not for the faint of heart, the risk-averse or for anyone without some tolerance for risk.

Nor is this an activity that should be undertaken by anyone without a background in tax. Because OVDI is relatively new, there is still much uncertainty surrounding opts out. If OVDI is compared to a long desert road with countless forks, decisions have to be made at every fork. And while Yogi Berra's quotes have an uncanny way of being prophetic, the quote, "When you come to a fork in the road, take it," will not solve your opt out problems. For better or for worse, these decisions often come down to judgment calls.

And these judgment calls are not trivial. Instead, they have the potential to impact not only a person's financial well-being but their very freedom. To that end, I recommend consulting with an experienced tax professional who has the knowledge and expertise to assist in navigating the minefields of an OVDI opt out. Therefore, if you remember nothing else from this article, remember this: "Don't go it alone."

Opting Out: The Solution for the Non-willful OVDI Taxpayer

Hypotheticals Demonstrating When Opting Out Is in the Best Interests of the Taxpayer

Under what circumstances might opting out of the OVDI be *advantageous* for the taxpayer? The following examples illustrate the effect of a taxpayer opting out of the OVDI. The facts of each example were chosen to illustrate particular issues and do not represent a full analysis of a taxpayer's particular situation. Consequently, they should not be relied upon in dealing with an actual case. For all of the following examples, assume a 35-percent rate on unreported income.

Example 1: Unreported Income but No Tax Deficiency

Trevor is a U.S. citizen who works and lives in Country A. He has a brokerage account in Country A that he opened in 1999. The account had a high balance of $2 million and generated income of $150,000 each year. Trevor did not report any of the income on his U.S. tax return because he mistakenly assumed that he only had to report it on a Country A tax return.

Trevor's amended Form 1040 returns show that, after applying the foreign tax credit for taxes paid to Country A, there was no tax deficiency with respect to the unreported income. Trevor entered the 2011 OVDI. He is now having second thoughts and is considering opting out.

The analysis is as follows. For ease in following, the analytical framework has been broken down into steps. As you go through these steps, you will see a pattern emerge. For those who like to see the "big picture," this framework is nothing more than an aid in analyzing the facts to determine whether Trevor should remain in the OVDI or opt out. To that end, the framework compares the potential risks of opting out against the potential rewards.

Step one is to determine whether Trevor is at material risk of criminal prosecution. As discussed above, this issue should be decided with an eye toward the government's criminal tax enforcement objectives. Assuming that Trevor is at material risk of criminal prosecution, remaining in OVDI is a "no brainer." Based on these facts, he is *not* at material risk of prosecution. Therefore, he can breathe a sigh of relief.

Step two compares the amount due *under* the offshore initiative to the tax, interest and applicable penalties for all open years that Trevor would owe *outside* of the OVDI regime. If the former is *greater* than the latter, then *opting out* would appear to be the obvious choice. But if the former is *less* than the latter, then *remaining in the program* would appear to be the *obvious* choice.

What is the amount due *under* the offshore initiative? Let's start with the offshore penalty. The offshore penalty is equivalent to 25 percent of the highest aggregate value of each undisclosed financial account at any time during the OVDI look-back period (remember this is the 2011 OVDI).[33] In order to calculate the offshore penalty, it's necessary to determine what the highest value of Trevor's foreign brokerage account was during the eight-year look-back period. Here, it was $2 million.

Therefore, the offshore penalty under 2011 OVDI is a whopping $500,000 (*i.e.,* 25 percent of $2 million)! If this penalty strikes you as being severe enough to shock the conscience, you would be justified in feeling that way. After all, Trevor owed no tax to the U.S. government and there was no indication of any wrongdoing.

Against this backdrop of parade of horribles lurking deep within the bowels of the OVDI regime should be compared the potential benefits of opting out. How much must Trevor pay in tax, interest, and penalties *outside* of the OVDI regime? As a preliminary matter, there is no tax deficiency.

Let's turn to the FBAR penalty. If, upon examination, the IRS determines that the FBAR violation was *not* willful, Trevor would be subject to a non-willful FBAR penalty of up to $10,000 per year, the maximum statutory penalty for non-willful violations.

Can the government prove that Trevor's failure to file the FBAR was willful? Because Trevor *mistakenly* assumed that he only had to report the income generated from his foreign account on a Country A tax return, the likelihood that the IRS would find his FBAR violation to be *willful* is slim to none.

However, if you thought that $10,000 was the *total* FBAR penalty, you'd have made the very same mistake that many tax preparers make. On the contrary, $10,000 is merely the penalty for *one* year.

Recall that the statute of limitations for assessing an FBAR civil penalty is *six*years. Here, this includes FBARs that should have been filed to report the foreign brokerage account during calendar years 2004 through 2009.[34] Therefore, the maximum *total* penalty is $60,000 ($10,000/year x 6 years).

As discussed above, the maximum FBAR penalty should not always be relied upon as an accurate indication of what the FBAR penalty would be outside of the OVDI regime. The question that must always be answered is whether the FBAR-related mitigation guidelines might benefit Trevor *outside* of the OVDI framework. The mitigation guidelines may lessen the severity of the FBAR penalty by providing for a penalty that is *below* the maximum. The amounts proscribed under the mitigation guidelines are based on the account balance.

Unfortunately for Trevor, the FBAR-related mitigation guidelines offer no relief. In fact, they might even *hurt* Trevor in the sense that they validate the *maximum* total FBAR penalty in the same way that the "Good Housekeeping" stamp of approval guarantees the quality of everyday household products. The reason why is

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because the brokerage account's $2 million high balance qualifies Trevor for the Level III non-willful FBAR penalty.[35] And the Level III penalty is $10,000, which just so happens to be the maximum statutory penalty for a non-willful FBAR violation under these facts.

But just when things appear bleak for Trevor, a ray of light shines at the end of the tunnel. And that ray of light might help Trevor dodge a $60,000 FBAR bullet. How so? By convincing the IRS that the violation was due to *reasonable cause*. Reasonable cause is a defense to the assertion of a penalty. It can either eliminate a penalty completely, or lessen its impact.

Here, Trevor might argue that he reasonably relied on the written advice of an accountant after disclosing the facts to him. If successful, he would get out from paying any FBAR penalty.

Even if Trevor is not successful in asserting a reasonable cause defense, opting out is still a win-fall for him. Indeed, as Chart 1 illustrates, opting out saves him almost half a million dollars. Therefore, the obvious choice is for Trevor to opt out. *See* Chart 1.

Example 2: Unreported Income and Failure to File FBAR

Joan is a U.S. citizen who lived abroad for three years from 2007 to 2009. While living abroad, Joan opened an account in 2007 with a bank located in Country X. Assume that the highest balance in that account during the three years (2007, 2008 and 2009) was $200,000.

Joan filed U.S. income tax returns for all three years. However, she only filed an FBAR for 2008 and 2009, *not* for 2007. Joan was unaware of her FBAR filing obligation until 2008, when she hired an accountant to prepare her return. Joan failed to report approximately $2,000 of interest income from the account. Therefore, she is unable to simply file a delinquent FBAR for 2007. The tax deficiency was $700.

Joan entered the 2011 OVDI. She is now having second thoughts and is considering opting out. Step one is to determine whether Joan is at material risk of criminal prosecution. Based on these facts, she is not.

Step two compares the amount due *under* the offshore initiative to the tax, interest and applicable penalties for all open years that Joan would owe *outside* of the OVDI regime. If the former is *greater* than the latter, then *opting out*would appear to be the obvious choice. But if the former is *less* than the latter, then *remaining in the program* would appear to be the *obvious* choice.

What is the amount due *under* the offshore initiative? Let's start with the offshore penalty. The offshore penalty is equivalent to 25 percent of the highest aggregate value of each undisclosed financial account at any time during the OVDI look-back period (remember that this is the 2011 OVDI).[36] In order to calculate the offshore penalty, it's necessary to determine what the highest value of Joan's foreign account was between 2007 and 2009. Here, it was $200,000. Therefore, the offshore penalty under 2011 OVDI is $50,000 (*i.e.,* 25 percent of $200,000).

What else is Joan liable for under OVDI? For starters, she must pay the tax deficiency for each year (here, $700). Second, she must pay interest on the deficiency. And finally, she must pay the accuracy-related penalty. Generally, the accuracy-related penalty is 20 percent of the deficiency. Because the tax deficiency is $700, the accuracy-related penalty is $140 (20 percent of $700).

If you're keeping track, Joan's total liability under OVDI is $50,840:

- Income Tax Due: $700
- Offshore Penalty: $50,000
- Accuracy-Related Penalty: $140

Against this backdrop of parade of horribles lurking deep within the bowels of the OVDI regime should again be compared the potential benefits of opting out. How much must Joan pay in tax, interest and penalties *outside* of the OVDI regime? Let's begin with the tax deficiency. Here, Joan would be liable for a $700 tax deficiency for each year. Of course, she would also owe interest with respect to that deficiency.

Let's turn to penalties. First, the FBAR penalty. If, upon examination, the IRS determines that Joan's failure to file an FBAR was *not* willful, she would be subject to a non-willful FBAR penalty of no more than

Chart 1.	Civil Settlement Structure Within OVDI	Opt Out and Six Years Nonwillful FBAR Penalty
Income Tax Due (not including interest)	$0	$0
20% Accuracy-Related Penalty	$0	$0
25% Offshore Penalty	$500,000 (25% of $2 million)	$0
FBAR Penalty	$0	$60,000 ($10,000/year x 6 years)
Total	**$ 500,000**	**$60,000**

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$10,000. That violation would relate to her failure to file an FBAR in 2007.

Can the government prove that Joan's failure to file a 2007 FBAR was willful? Because Joan was *unaware* of the FBAR filing obligation until 2008, the likelihood that the IRS would find her failure to file a 2007 FBAR to be willful is slim to none.

As discussed above, the maximum FBAR penalty should not always be relied upon as an accurate indication of what the FBAR penalty would be outside of the OVDI regime. This is especially true under facts such as these where the highest aggregate value of the foreign account is only $200,000. The question that must be answered is whether the FBAR-related mitigation guidelines might benefit Joan *outside* of the OVDI framework. Indeed, the mitigation guidelines may lessen the severity of the FBAR penalty by providing for a penalty that is *below* the maximum. Here, the answer is a resounding, "yes!"

Why? The account's $200,000 high balance qualifies Joan for the Level II non-willful penalty.[37] And that penalty is $5,000, not to exceed 10 percent of the maximum balance in the account during the year. Unlike the Level III maximum penalty that Trevor had the misfortune of qualifying for in example one, the Level II penalty here is 50 percent *less* than the statutory maximum.

What does this mean for Joan? Two things. First and foremost, the maximum non-willful FBAR penalty that Joan could be subjected to outside of the OVDI regime is *not* $10,000, but instead $5,000. And second, the FBAR-related mitigation guidelines have indeed benefited Joan. Indeed, $5,000 is a far more accurate estimate of Joan's maximum non-willful FBAR penalty outside of the OVDI regime than $10,000 is. The lesson to be learned here is never to overlook the mitigation guidelines and how they can benefit the taxpayer.

Those who think that Joan has "beaten the house" and that $5,000 is as low an FBAR penalty as she will ever see should think twice. There is always the possibility—however remote—that Joan might not have to pay *any* FBAR penalty. That's because $5,000 is not the *actual* FBAR penalty that will be asserted. On the contrary, it's the *maximum* penalty.

While the maximum penalty can easily turn into the actual penalty, that is not an excuse for overlooking defenses. Indeed, a successful defense can either eliminate the penalty completely, or lessen its impact. For example, if the IRS determines that Joan's failure to file an FBAR was due to reasonable cause, it might choose not to impose *any* penalty.

What other penalties might Joan be subject to outside of the OVDI regime? First, she will very likely have to pay an accuracy-related penalty. Generally, the accuracy-related penalty is 20 percent of the deficiency. Because the tax deficiency is $700, the accuracy-related penalty is $140 (20 percent of $700).

In the worst-case scenario, the IRS might assert the civil fraud penalty. The civil fraud penalty applies when an underpayment of tax, or a failure to file a tax return, is due to fraud. Generally, the taxpayer is liable for 75 percent of the deficiency or the amount attributable to fraud. While this doomsday scenario might turn Joan's luck upside down, it would certainly not be the Apocalypse that she was dreading. Indeed, the civil fraud penalty would only be $525 (75 percent of $700).

If you're keeping track, Joan's total maximum penalties *outside* of the OVDI regime are $5,525:

- FBAR Penalty: $5,000
- Civil Fraud Penalty: $525

Of course, this does not include the $700 tax liability, which raises the total maximum amount of tax, interest and penalties due and owing from $5,525 to $6,225. This is still a pittance when compared to $50,840, Joan's maximum liability within the OVDI regime. Under these circumstances, the obvious choice is for Joan to opt out. *See* Chart 2.

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Chart 2.	Civil Settlement Structure Within OVDI	Opt-Out and One-Year Nonwillful FBAR Penalty	Opt Out and Assume the Civil Fraud Penalty Applies
Income Tax Due (Not Including Interest)	$700	$700	$700
20% Accuracy-Related Penalty	$140 (20% of $700)	$140 (20% of $700)	$0
25% Offshore Penalty	$50,000 (25% of $200,000)	$0	$0
Civil Fraud Penalty	$0	$0	$525 (75% of $700)
FBAR Penalty	$0	$5,000	$5,000
Total	**$50,840**	**$5,840**	**$6,225**

Hypotheticals Demonstrating When Opting Out Is Detrimental to the Taxpayer

Under what circumstances might opting out of the OVDI be detrimental for the taxpayer? Below are two examples.

Example 3: Large Unreported Gain

Kevin is a U.S. citizen. In 2008, he opened a checking account in Country A with funds upon which U.S. taxes were previously paid. Kevin owned an apartment building in Country A that he sold in 2008. However, Kevin failed to report the gain from the sale of that building on his tax return.

The fair market value of the apartment building was $10 million. And Kevin's unreported gain from the sale was $6 million. The related tax deficiency was $2,100,000.

Kevin deposited the entire $10 million from the sale into his foreign checking account. $10 million represented the *highest* balance in the foreign checking account during the year. It was also the balance in the account as of June 30 of the following year, the date when an FBAR was due.

The apartment building was held in a foreign grantor trust, with Kevin as the grantor. Kevin established the trust in 2008, shortly before selling the apartment building. He then transferred the building into the trust. Kevin never filed a Form 3520 to report the creation of the trust or to transfer the building into the trust.

Kevin entered the 2011 OVDI. He is now having second thoughts and is considering opting out. Because there are no criminal overtones, let's skip right to step two.

Step two compares the amount due *under* the offshore initiative to the tax, interest and applicable penalties for all open years that Kevin would owe *outside* of the OVDI regime. If the former is *greater* than the latter, then *opting out* would appear to be the obvious choice. But if the former is *less* than the latter, then *remaining in the program* would appear to be the *obvious* choice.

What is the amount due *under* the offshore initiative? Let's start with the offshore penalty. The offshore penalty is equivalent to 25 percent of the highest aggregate value of each undisclosed financial account at any time during the OVDI look-back period (remember that this is the 2011 OVDI).[38] In order to calculate the offshore penalty, it's necessary to determine what the highest value of Kevin's foreign checking account was in 2008. Here, it was $10 million, which was comprised of the proceeds from the sale of the apartment building. Therefore, the offshore penalty under the 2011 OVDI is $2.5 million (*i.e.,* 25% of $10 million).

What else is Kevin liable for under OVDI? For starters, he must pay tax on $6 million, the unreported gain from the sale of the apartment building. At a rate of 35 percent, the related tax deficiency is $2,100,000. Second, Kevin must pay interest on the deficiency. And finally, he must pay the accuracy-related penalty. Generally, the accuracy-related penalty is 20 percent of the deficiency.[39] Because the tax deficiency is $2,100,00, the accuracy-related penalty is $420,000 (20 percent of $2,100,000).

If you're keeping track, Kevin's total liability under OVDI is $5,020,000, calculated as follows:

- Income Tax Due: $2,100,000
- Offshore Penalty: $2,500,000
- Accuracy-related Penalty: $420,000

Against this backdrop of parade of horribles should again be compared the potential benefits of opting out. How much must Kevin pay in tax, interest and penalties *outside* of the OVDI regime? Let's begin with the tax deficiency. Kevin's tax deficiency is $2,100,000. Of course, Kevin would owe tax and interest with respect to that $2,100,000 deficiency.

Let's turn to the penalties. First, the FBAR penalty. If, upon examination, the IRS determines that Kevin's failure to file an FBAR in 2008 was *willful*, he could face a maximum FBAR penalty of $5 million. Holy cow! If that penalty strikes you as being severe, recall that for willful FBAR penalties the maximum FBAR penalty is the *greater* of (1) $100,000, or (2) 50 percent of the closing balance in the account as of June 30, the last day for filing the FBAR.

Here, there is no question that (2) is greater than (1). Ten million dollars was the closing balance in Kevin's account as of June 30, 2008. And 50 percent of $10 million is $5 million. Because $5 million is greater than $100,000, $5 million is the maximum willful FBAR penalty. Therefore, the maximum willful FBAR penalty is 50 percent of the closing balance in the account, and *not* $100,000.

Before the government can assert a $5 million FBAR penalty against Kevin, it must prove that Kevin's failure to file an FBAR was *willful*. Can the government carry its burden? Before answering this question, we need to know exactly what burden of proof the government carries. Because willfulness, as it is used in this context, applies to a civil penalty and not to a tax crime, the government's burden of proof is *not* beyond a reasonable doubt. Instead, it is by clear and convincing evidence. Therefore, the issue should be framed as follows: Can

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the government prove, by *clear and convincing evidence*, that Kevin intentionally violated a known legal duty, specifically the duty to file an FBAR?

Here, arguments can be made both for and against willfulness. How it will turn out is anyone's guess. Therefore, whether Kevin's failure to file an FBAR was or was not willful is a story better left for another day.

What impact does the statute of limitations have on Kevin's FBAR liability? The statute of limitations for assessing FBAR penalties is six years. This means that Kevin will also be liable for FBAR penalties for all other open years, assuming of course that the balance in his checking account never fell below $10,000.01 at *any* given point during any one of those years.

As discussed above, the maximum FBAR penalty is not always an accurate indication of what the FBAR penalty would be outside of the OVDI regime. The question that must be answered is whether the FBAR-related mitigation guidelines might benefit Kevin *outside* of the OVDI framework. The mitigation guidelines may lessen the severity of the FBAR penalty by providing for a penalty that is *below* the maximum. The amounts proscribed under the mitigation guidelines are based on the account balance.

Unfortunately for Kevin, the FBAR-related mitigation guidelines offer no relief. In fact, they might even *hurt* Kevin in the sense that they validate the *maximum* FBAR penalty in the same way that the "Good Housekeeping" stamp of approval guarantees the quality of everyday household products. The reason why is because the account's $10 million high balance qualifies Kevin for the Level IV willful FBAR penalty.[40] And the Level IV penalty is $5 million, or 50 percent of the closing balance in the account as of June 30, which just so happens to be the *maximum* statutory penalty for a willful FBAR violation under these facts.

What other penalties might Kevin be subject to outside of the OVDI regime? There are two. First, if the IRS finds that Kevin's failure to report the gain from the sale of the apartment building was due to fraud, he faces a civil fraud penalty. The civil fraud penalty applies when an underpayment of tax, or a failure to file a tax return, is due to fraud. Generally, the taxpayer is liable for 75 percent of the deficiency or the amount attributable to fraud. Because the unreported gain from the sale of the building resulted in a deficiency of $2,100,000, that represents the amount attributable to fraud. As such, the civil fraud penalty is a staggering $1,575,000 (75 percent of $2,100,000).

The second penalty is a penalty for failing to file an information return, here Form 3520.[41] As if the willful FBAR penalty and the civil fraud penalty were not bad enough, this penalty can unilaterally cause Kevin's penalty liability to soar into the penalty stratosphere. The penalty is $3.5 million (35 percent of $10 million).

The final issue is whether any defenses exist to any of the aforementioned penalties. A successful defense can either eliminate the penalty completely, or lessen its impact. For example, if the IRS determines that a taxpayer's failure to file an FBAR was due to *reasonable cause*, the IRS might not even assert the penalty. Therefore, defenses must never be overlooked. Here, there are no defenses.

If you're keeping track, the penalties alone are staggering:

- FBAR Penalty: $5,000,000
- Civil Fraud Penalty: $1,575,000
- Code Sec. 6677 Penalty: $3,500,000

Kevin's total maximum penalties outside of the OVDI regime are $10,075,000. Of course, this does not include the $2.1 million tax liability, which raises the total maximum amount of tax, interest and penalties due and owing from $10,075,000 to

Chart 3.	Civil Settlement Structure Within OVDI	Opt-Out and One-Year Willful FBAR Penalty	Opt Out and Assume the Civil Fraud Penalty Applies
Income Tax Due (not including interest)	$2,100,000	$2,100,000	$2,100,000
20% Accuracy-Related Penalty	$420,000 (20% of $2.1 million)	$420,000 (20% of $2.1 million)	$0
25% Offshore Penalty	$2,500,000 (25% of $10 million)	$0	$0
Civil Fraud Penalty	$0	$0	$1,575,000 (75% of $2,100,000)
Code Sec. 6677 Penalty	$0	$3,500,000 (35% of $10 million)	$3,500,000 (35% of $10 million)
FBAR Penalty	$0	$5,000,000 (50% of closing account balance on June 30, the date that the FBAR was due)	$5,000,000 (50% of closing account balance on June 30, the date that the FBAR was due)
Total	**$5,020,000**	**$11,020,000**	**$12,175,000**

$12,175,000. By comparison, Kevin's maximum liability within the OVDI regime is $5,020,000.

The choice is clear. While $5,020,000 is by no means "chump change," it is less than one-half of what Kevin faces outside of the OVDI regime. Even if Kevin is able to avoid the civil fraud penalty, his liability outside of the OVDI regime is still twice that of what it is inside the OVDI. That might make the pain of paying a $5,020,000 tax liability just a little easier to swallow. Under these circumstances, the obvious choice is for Kevin to remain in the 2011 OVDI. *See* Chart 3.

Example 4: Possible Referral to Criminal Investigation for Investigation or to DOJ for Prosecution

Sam is a U.S. citizen. He owns a building located in Country X. In 2002, he sold the building for $400,000 short term capital gain. Sam intentionally failed to report the gain on his 2002 Form 1040. Assume that Sam's basis in the building was zero.

Sam deposited the proceeds from the sale of the building in an offshore bank account located in Country Y. The account in Country Y is in the name of a trust. Sam established the trust in Country Z in 2000. The account earned $12,000 in interest each year from 2003 through 2010.

Sam closed the account in Country Y and repatriated the funds back to the United States, disguising them as a loan from an allegedly unrelated entity. The highest balance in the foreign account was $496,000.

Sam entered the 2011 OVDI. He is now having second thoughts and is considering opting out.

Step one is to determine whether Sam is at material risk of criminal prosecution. Indeed, this fact pattern gives rise to *at least* two potential tax crimes. However, this problem focuses on just one: tax evasion. Tax evasion is the capstone of traditional tax crimes. As it applies to these facts, it is the attempt by a taxpayer to prevent the IRS from knowing that additional tax is due and owing (*i.e.,* otherwise known as evasion of assessment).

The government must prove three elements beyond a reasonable doubt. First, that the taxpayer owed substantially more tax than what was reported on the income tax return. Second, that the taxpayer knew that he owed substantially more tax than what he reported on the return. And, third, that the taxpayer's purpose was to evade or defeat the payment of taxes. An affirmative attempt to evade or defeat the tax due and owing is sufficient.

One small word is all that distinguishes civil tax liability from criminal tax liability. What is that pestilent word? It is willfulness. That very word strikes fear in the hearts of taxpayers. Why? Because it means the difference between whether the taxpayer will be subject to nothing more than a penalty or whether the taxpayer will become a guest of "Club Fed." And despite the jokes about Club Fed, spending several years—if not longer—confined to a cold, dank cell is no laughing matter. To add insult to injury, as harsh a sentence as prison can be, it does not absolve a taxpayer of paying hefty fines and penalties upon release.

While only a small percentage of cases are referred to the DOJ for prosecution, those that are have a devastating impact on the taxpayer. For example, while easy to overlook, the collateral consequences of having a felony conviction can be even more serious than incarceration itself. By far, one of the most serious collateral consequences is stigmatization. Indeed, that alone can bring personal, social, and financial ruin. For those with families to support, the loss of a professional license may mean the loss of their livelihood, and thus the ability to provide for their family. This is why those who find themselves ensnared in the criminal justice system view the collateral consequences of having a felony conviction to be far more severe than serving a lengthy prison sentence.

Willfulness is the cornerstone to any criminal tax matter. It is defined by courts as an *intentional* violation of a known legal duty. In the criminal setting, the government carries the heavy burden of proving—beyond a reasonable doubt—that a taxpayer acted willfully. The definition of willfulness can be bifurcated into two parts. As explained in the IRM: "Willfulness is demonstrated by the [taxpayer's] knowledge of the reporting requirements and the [taxpayer's] conscious choice not to comply with the requirements."[42]

Willfulness is a state of mind. Seldom are there any witnesses and only in a rare case would a defendant admit the required state of mind. The question thus becomes, how does the government prove willfulness? State of mind is proved through *circumstantial* evidence—*i.e.,* by conduct or acts from which a person's state of mind can be inferred. The landmark case is *Spies.*[43] In *Spies,* the Supreme Court of the United States held that an affirmative willful attempt may be inferred from the following conduct:

> (1) keeping a double set of books, (2) making false entries or alterations, or false invoices or

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documents, (3) destruction of books or records, (4) concealment of assets or covering up sources of income, (5) handling of one's affairs to avoid making the records usual in transactions of the kind, and (6) any conduct, the likely effect of which would be to mislead or to conceal.[44]

These are known as the "badges of fraud."

Unfortunately for taxpayers, in *Williams,* the Fourth Circuit Court of Appeals diluted the definition of willfulness to a *reckless* disregard of a statutory duty. The practical effect of that ruling was to make it easier for the government to prove willfulness. Fortunately, if the IRM is any indication, it appears that the official position of the IRS is to interpret the meaning of willfulness in accordance with the heightened definition (*i.e.,* an intentional violation of a known legal duty), as opposed to the diluted definition.

Viewing these facts in a light most favorable to Sam, let's assume that the heightened definition of willfulness applies. Unfortunately for Sam, even under the heightened definition, the government will be able to prove willfulness. Indeed, Sam *knew* that he had to report the gain from the sale of the building on Form 1040. However, he failed to do so. That failure was not due to an oversight or a mistake. Instead, it was born of a choice—a conscious choice—made by Sam to prevent the IRS from knowing that he owed additional tax. In that way, Sam avoided having to pay any tax on the $400,000. Therefore, Sam's failure to report the gain from the sale of the building was *intentional*.

Similarly, the government will be able to prove an affirmative act. To do so, they need do nothing more than show that the $400,000 gain from the sale of the building was *never* reported on the return. After all, the most common affirmative act is the filing of an *inaccurate* tax return.

Based on these facts, Sam is at material risk of prosecution. Therefore, the only rational choice is for Sam to remain in OVDI. However, for purposes of a complete analysis, let's work through the remaining steps.

Step two compares the amount due *under* the offshore initiative to the tax, interest, and applicable penalties for all open years that Sam would owe *outside* of the OVDI regime. If the former is *greater* than the latter, then *opting out*would appear to be the obvious choice. But if the former is *less* than the latter, then *remaining in the program* would appear to be the *obvious* choice.

What is the amount due *under* the offshore initiative? Let's start with the offshore penalty. The offshore penalty is equivalent to 25 percent of the highest aggregate value of each undisclosed financial account at any time during the OVDI look-back period (remember that this is the 2011 OVDI).[45] In order to calculate the offshore penalty, it's necessary to determine what the highest value of Sam's foreign account was. Here, it was $496,000. Therefore, the offshore penalty under the 2011 OVDI is $124,000 (*i.e.,* 25 percent of $496,000).

What else is Sam liable for under OVDI? For starters, he must pay tax on $96,000, the unreported interest income for the tax years 2003 through 2010 ($12,000 interest/year x 8 years). At a rate of 35 percent, the related tax deficiency is $33,600. Second, Sam must pay interest on the deficiency. And finally, he must pay the accuracy-related penalty.[46] Generally, the accuracy-related penalty is 20 percent of the deficiency. Because the tax deficiency is $33,600, the accuracy-related penalty is $6,720 (20 percent of $33,600).

If you're keeping track, Sam's total liability under OVDI is $164,320, calculated as follows:

- Income Tax Due: $33,600
- Offshore penalty: $124,000
- Accuracy-related Penalty: $6,720

Against this backdrop of parade of horribles again should be compared the potential benefits of opting out. How much must Sam pay in tax, interest and penalties *outside* of the OVDI regime? Let's begin with the tax deficiency. Sam's *total* tax deficiency for the years 2002 through 2010 is $173,600 (*see* Chart 4). Of course, Sam would also owe interest with respect to that $173,600 deficiency.

Let's turn to penalties. First, the FBAR penalty. If, upon examination, the IRS determines that Sam's failure to file an FBAR was *willful*, he could face a maximum FBAR penalty of $1,362,000. Holy cow! If that penalty strikes you as being severe, recall two things. First, for willful FBAR penalties, the maximum FBAR penalty is the *greater* of (1) $100,000, or (2) 50 percent of the closing balance in the account as of June 30, the last day for filing the FBAR. And second, for purposes of assessing FBAR penalties, the statute of limitations is six years, not one.

Before a $1,362,000 FBAR penalty can be asserted, the government must prove that Sam's failure to file an FBAR was *willful*. Can the government carry its burden? Before answering this question, we need to know exactly what burden of proof the government carries. Because willfulness, as it is used in this context, applies to a civil penalty and not to a tax crime,

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the government's burden of proof is *not* beyond a reasonable doubt. Instead, it is by clear and convincing evidence. Therefore, the issue should be framed as follows: Can the government prove, by *clear and convincing evidence*, that Sam intentionally violated a known legal duty, specifically the duty to file an FBAR?

This is as good an example as any of a taxpayer who acted willfully. Indeed, the facts explicitly state that Sam *intentionally* failed to file an FBAR. Therefore, the assessment of a willful FBAR penalty is warranted.

What impact does the statute of limitations have on Sam's FBAR liability? Because the statute of limitations for assessing FBAR penalties is six years, Sam will be subject to FBAR penalties for all open years assuming, of course, that the aggregate balance in Sam's account exceeded $10,000 each year.

Here, the threshold condition is satisfied. The balance in Sam's account never fell below $10,000.01 at any given point during any one of the open years. Therefore, the statute of limitations for assessing FBAR penalties will be open for the 2004 through 2009 calendar years.

Chart 4.

Year	Unreported Gain	Source	Tax Rate	Tax Deficiency
2002	$400,000	Sale of building	35%	$140,000
2003	$12,000	Interest	35%	$4,200
2004	$12,000	Interest	35%	$4,200
2005	$12,000	Interest	35%	$4,200
2006	$12,000	Interest	35%	$4,200
2007	$12,000	Interest	35%	$4,200
2008	$12,000	Interest	35%	$4,200
2009	$12,000	Interest	35%	$4,200
2010	$12,000	Interest	35%	$4,200
Total	**$496,000**		**35%**	**$173,600**

Chart 5.

Year	Account Balance	FBAR Penalty
2004	$424,000[1]	$212,000
2005	$436,000	$218,000
2006	$448,000	$224,000
2007	$460,000	$230,000
2008	$472,000	$236,000
2009	$484,000	$242,000
Total	**$2,724,000**	**$1,362,000**

[1] In 2003, the balance in the account was $400,000, representing the proceeds from the sale of the building. Beginning in 2003, the account generated interest at the rate of $12,000 per year. Therefore, as of June 2003, the last day for filing an FBAR, the account had a high balance of $412,000. And as of June 2004, the account had a high balance of $424,000.

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What is the *total* maximum willful FBAR penalty that can be asserted for all open years? It is $1,362,000, or 50 percent of the closing balance in the account as of June 30 for each calendar year for all open years.[47] As discussed above, the open years span from 2004 to 2009. The calculation consists of two parts. Step one consists of calculating the FBAR penalty for each individual calendar year beginning with 2004 and ending with 2009. And step two consists of tallying up all of the FBAR penalties from all of the open years. That sum is the *total* maximum FBAR penalty. The FBAR penalties for each year are shown in Chart 5.

As discussed above, the total maximum FBAR penalty is not always an accurate prediction of what the FBAR penalty would be outside of the OVDI regime. The question that must be answered is whether the FBAR-related mitigation guidelines might benefit Sam *outside* of the OVDI framework. The mitigation guidelines may lessen the severity of the FBAR penalty by providing for a penalty that is *below* the maximum. The amounts proscribed under the mitigation guidelines are based on the account balance.

Unfortunately for Sam, the FBAR-related mitigation guidelines offer no relief. The account's $496,000 high balance qualifies Sam for the Level III willful FBAR penalty.[48] While at first blush, it might appear as though this classification benefits Sam—since Level III is one level *below* Level IV, the level that triggers the *maximum* statutory penalty—looks can be deceiving. Therefore, a word of caution is in order: "When it comes to tax, don't assume anything." So read on.

Unlike the expression, "the lesser of two evils," the Level III penalty is the *greater* of two evils, those being: (1) 10 percent of the maximum balance during the calendar year for each Level III account, or (2) 50 percent of the closing balance in the account as of June 30, the last day for filing the FBAR.

Based on the closing balances in the account spanning *all* of the open years, (2) is greater than (1). Indeed, on June 30 of each open year, 50 percent of the closing balance in the account consistently *exceeded* 10 percent of the maximum balance in the account.

Therefore, the *total* Level III willful penalty is 50 percent of the closing balance in Sam's foreign account for all of the open years. If that phrase sounds familiar,

that's because it's identical to the *maximum* total willful FBAR penalty that Sam is subject to: $1,362,000.

Although Sam may have qualified for a lower level under the mitigation guidelines, that did absolutely nothing to reduce his willful FBAR penalty liability. Indeed, Sam is still subject to a total maximum willful FBAR penalty of $1,362,000. Put simply, the penalty mitigation guidelines are utterly useless for Sam.

What other penalties might Sam be subject to outside of the OVDI regime? There are three. First, if the IRS finds that Sam's failure to report the gain from the sale of the building was due to fraud, he faces a civil fraud penalty. The civil fraud penalty applies when an underpayment of tax, or a failure to file a tax return, is due to fraud. Generally, the taxpayer is liable for 75 percent of the deficiency or the amount attributable to fraud. Because the unreported gain from the sale of the building resulted in a deficiency of $173,600, that represents the amount attributable to fraud. As such, the civil fraud penalty is $130,200 (75 percent of $173,600).

The last two penalties are asserted under Code Sec. 6677. As if the maximum willful FBAR penalty and the civil fraud penalty were not bad enough, these penalties can unilaterally cause Sam's liability to soar into the penalty stratosphere.

The first penalty is for failing to file Form 3520 to report the $400,000 transfer to the account. That penalty is $140,000 (35 percent of $400,000). And the second penalty is for failing to file Forms 3520-A. That penalty amounts to $201,600. It is calculated as follows: five percent of $400,000, the short-term capital gain + the interest income added each year, from 2002 to 2010. The penalties for failing to file Forms 3520-A are shown in Chart 6.

Chart 6.

Year	Unreported Gain	Penalty Rate	Penalty for Failing to File Forms 3520-A
2002	$400,000	5%	$20,000
2003	$412,000	5%	$20,600
2004	$424,000	5%	$21,200
2005	$436,000	5%	$21,800
2006	$448,000	5%	$22,400
2007	$460,000	5%	$23,000
2008	$472,000	5%	$23,600
2009	$484,000	5%	$24,200
2010	$496,000	5%	$24,800
Total			**$201,600**

Therefore, the total Code Sec. 6677 penalty is $341,600 ($140,000 + $201,600). The final issue is whether there are any defenses to any of the aforementioned penalties. A successful defense can either eliminate the penalty completely, or lessen its impact. For example, if the IRS determines that a taxpayer's failure to file an FBAR was due to *reasonable cause*, the IRS might not even assert the penalty. Therefore, defenses must never be overlooked. Here, there are no defenses.

If you're keeping track, the penalties alone are staggering:

- FBAR Penalty: $1,362,000
- Civil Fraud Penalty: $130,200
- Code Sec. 6677 Penalty: $341,600

Sam's total maximum penalties outside of the OVDI regime are $1,833,800. Of course, this does not include the $173,600 tax liability, which raises the total maximum amount of tax, interest and penalties due and owing from $1,833,800 to $2,007,400. By comparison, Sam's maximum liability within the OVDI regime is just $164,320.

The choice is clear. In fact, it is a "no brainer." While $164,320 is by no means "chump change," it is less than 10 percent of what Sam faces outside of the OVDI regime. Moreover, it is a small price to pay to avoid what is very likely to be a referral to the Department of Justice for prosecution, not to mention the peace of mind of not having to worry about how Sam will provide for his family in his absence (*i.e.,* assuming that he is convicted and sentenced to a lengthy prison term). Therefore, Sam should remain in the 2011 OVDI. *See* Chart 7.

Chart 7.	Civil Settlement Structure Within OVDI	Opt Out and Eight Years Code Sec. 6677 Penalty and Six Years FBAR Penalty
Income Tax Due (not including interest)	$33,600	$173,600
75% Civil Fraud Penalty	$0	$130,200 (75% of $173,600)
20% Accuracy-Related Penalty	$6,720 (20% of $33,600)	$0
25% Offshore Penalty	$124,000 (25% of $496,000)	$0
Code Sec. 6677 Penalty	$0	$341,600
FBAR Penalty	$0	$1,362,000
Total	**$164,320**	**$2,007,400**

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ENDNOTES

1 Eligible taxpayers qualify for a reduced five-percent offshore penalty if they (1) are foreign residents who were unaware they were U.S. citizens, or (2) meet four specific conditions. Examiners have no authority to negotiate a different offshore penalty percentage. To qualify for the reduced 12.5-percent offshore penalty, the highest aggregate account balance in each of the years covered by the OVDI must be *less* than $75,000. Examiners have no authority to negotiate a different offshore penalty percentage.
2 31 U.S.C. § 5314.
3 *See* IRM 4.26.16.3.1.1 (July 1, 2008).
4 IRM 4.26.16.3.2 (July 1, 2008).
5 *Id.*
6 IRM 4.26.16.3.4 (July 1, 2008).
7 IRM 4.26.16.3.5 (July 1, 2008).
8 IRM 4.26.16.3.6 (July 1, 2008).
9 31 C.F.R. 103.32; IRM 4.26.16.3.8 (July 1, 2008).
10 IRS 2011 OVDI FAQ and Answers, Questions No. 50, available online at *www.irs.gov/Businesses/International-Businesses/2011-Offshore-Voluntary-Disclosure-Initiative-Frequently-Asked-Questions-and-Answers.*
11 31 U.S.C. § 5321(a)(5)(B).
12 31 U.S.C. § 5321(a)(5)(C). *See also* IRM 4.26.16.5.5 (July 1, 2008).
13 The maximum non-willful FBAR penalty is $10,000.
14 The non-willful FBAR penalty for an account with a maximum balance that never exceeded $50,000 at any time during the year is $500 for each violation, not to exceed an aggregate penalty of $5,000 for all violations.
15 IRM 4.26.16.4.6 (July 1, 2008). *www.irs.gov/irm/part4/irm_04-026-016.html.*
16 *Id.*
17 *Id.*
18 Exhibit 4.26.16-2 (July 1, 2008), Normal FBAR Penalty Mitigation Guidelines for Violations Occurring After October 22, 2004.
19 *Id.*
20 IRM 4.26.16.4.6.1 (July 1, 2008).
21 *See* IRS CCA 200603026 (Sept. 1, 2005) (the IRS stated that the FBAR provisions providing for civil penalties and criminal penalties contained a similar willfulness requirement, and concluded that the phrase "willful violation" had the same definition and interpretation. The IRS cited the Supreme Court in *W. Ratzlaf,* SCt, 94-1 USTC ¶50,015, 510 US 135, 114 SCt 655, which addressed the standard for willfulness in the context of a criminal violation of the anti-structuring statute. In *Ratzlaf*, the Supreme Court held that willfulness was a voluntary, intentional violation of a known legal duty. In other words, in order for the government to prove that a defendant willfully violated the anti-structuring statute, it must prove that the defendant acted with knowledge that his conduct was unlawful).
22 IRM 4.26.16.5.3 (July 1, 2008).
23 *Id.*
24 *Id.*
25 *J.B. Williams,* CA-4, 2012-2 USTC ¶50,475, 489FedAppx 655.
26 Code Sec. 6651(f) or 6663.
27 31 U.S.C. § 5321(b)(1).
28 The FBAR penalty is not like other IRS penalties. As a non-Title 26 penalty, the IRS can do nothing more than assess the FBAR penalty. It cannot collect it under the Code with liens and levies and other IRS collection tools. Instead, the IRS is treated just like any other creditor. To collect the FBAR penalty, the IRS must make a referral to DOJ's Tax Division, which then must seek a judgment in a U.S. district court against the taxpayer.
29 18 U.S.C. § 3282. This section says that except as otherwise expressly provided by law, no person shall be prosecuted, tried, or punished for any noncapital offense, unless the indictment is found or the information is instituted within five years next after such offense shall have been committed.
30 IRM 4.26.16.4.3.1 (July 1, 2008).
31 FAQ 51 of the 2009 OVDP.
32 FAQ 69 of the 2011 OVDI.
33 This is the offshore penalty for 2011 OVDI.
34 Based on these facts, the first non-willful failure to file an FBAR would have occurred on June 30, 2005, the date on which the 2004 FBAR was due.
35 The guidelines for a Level III non-willful FBAR penalty are as follows: If the maximum aggregate balance for all accounts to which the violations relate at any time during the calendar year exceeds $250,000, the Level III penalty is $10,000 for each Level III account violation, the statutory maximum for non-willful violations.
36 This is the offshore penalty for 2011 OVDI.
37 The guidelines for a Level II non-willful FBAR penalty are as follows: If the maximum aggregate balance for all accounts to which the violations relate does not exceed $250,000 at any time during the year, the Level II penalty is $5,000 for each violation, not to exceed 10 percent of the maximum balance in the account during the year. Here, the maximum aggregate balance of Joan's account was only $200,000.
38 This is the offshore penalty for 2011 OVDI.
39 Code Sec. 6662.
40 The guidelines for a Level IV willful FBAR penalty are as follows: If the maximum aggregate balance for all accounts to which the violations relate at any time during the calendar year exceeds $1 million, the Level IV penalty is the *greater* of: (1) $100,000, or (2) 50 percent of the closing balance in the account as of the last day for filing the FBAR.
41 Code Sec. 6677.
42 IRM 4.26.16.5.3 (July 1, 2008).
43 *M.R.Spies,* SCt, 43-1 USTC ¶9243, 317 US 492, 63 SCt 364.
44 *Id.*, 317 US, at 499.
45 This is the offshore penalty for 2011 OVDI.
46 Code Sec. 6662.
47 For each calendar year, the maximum willful FBAR penalty is 50 percent of the closing balance in the account as of June 30, and *not* $100,000. Why? The maximum willful FBAR penalty is the *greater* of (1) $100,000, or (2) 50 percent of the closing balance in the account as of the last day for filing the FBAR. Here, of all the calendar years involved, there was never a year where 50 percent of the closing balance in the account (as of June 30) fell below $100,000. On the contrary, it consistently exceeded $100,000 by more than twice the amount. Therefore, for purposes of determining the maximum willful FBAR penalty, the $100,000 penalty was preempted by 50 percent of the closing balance in the account as of June 30.
48 The guidelines for a Level III willful FBAR penalty are as follows: If the maximum aggregate balance for all accounts to which the violations relate at any time during the calendar year exceeded $250,000 but did *not* exceed $1 million, the Level III penalty is the *greater* of: (1) 10 percent of the maximum balance during the calendar year for each Level III account, or (2) 50 percent of the closing balance in the account as of the last day for filing the FBAR.

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