

Contact:
info@rowbotham.com

Website:
www.rowbotham.com

San Francisco Office:
tel: (415) 433-1177
fax: (415) 433-1653

Santa Clara Office:
tel: (408) 850-7295
fax: (415) 433-1653

Recommended Changes to the IRS Voluntary Disclosure Program

July 24, 2009

The IRS has had a voluntary disclosure program in place for many years. The objective of this program is to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities into compliance with United States tax laws. However, taxpayers have been reluctant to come forward because of uncertainty about potential criminal and civil penalties. In order to insure that taxpayers are treated consistently and predictably, the Service issued a Memorandum on March 23, 2009 that clarifies the potential penalties for failure to disclose and report income from offshore accounts.

We are concerned about how the Service will deal with the potential 20% penalty for failure to report foreign accounts. We have previously written to the Service about issues related to income earned in passive foreign investment companies (PFICs), as most of these foreign accounts qualify as PFICs. In general, unless a taxpayer has filed an election in a prior year return to report income currently from foreign funds, the PFIC tax is payable in the year the fund is liquidated. Thus, where taxpayers have liquidated their accounts in 2009, assuming an election was not previously made, their tax on income earned in the fund in past years is not delinquent. It is due with the 2009 return under PFIC tax rules. As a result of these uncertainties, many taxpayers that wish to become compliant are unable to determine the amount of tax and potential penalties that will be assessed and are reluctant to process through the Voluntary Disclosure program.

In our letter to the IRS below, we have explained these concerns and made specific recommendations for changes.

The March 23, 2009 IRS Memorandum can be viewed at irs.gov.

Comments Forwarded to the IRS

July 16, 2009

Charlie Judge
Internal Revenue Service
11501 Roosevelt Blvd.
Offshore Unit, DP S611
South building, Room 2002
Philadelphia PA 19154

Dear Mr. Judge:

Voluntary Disclosure Program

We previously discussed our concerns about the Voluntary Disclosure Program procedures with your San Francisco and Philadelphia offices and wish to bring these matters to your attention. We hope our comments are helpful and that appropriate action is taken to minimize the concerns of many taxpayers.

Suggested Changes to Procedures:

1. Allow retroactive QEF elections where taxpayers have invested in passive foreign investment companies (PFICs).
2. Consider alternatives to the 20% penalty where taxpayers are passive account owners.
3. Provide a mechanism for passive taxpayers to bypass the CI process and allow them to advance directly to the civil exam review.

Our Detailed Comments Follow.

1. PFIC Problems and Retroactive QEF Elections

If taxpayers are invested in PFICs, they may not be delinquent with prior years' taxes. If investors close their accounts in 2009, the tax due under PFIC rules would be payable with their 2009 returns.

Taxpayers and their advisors frequently overlook PFIC tax rules. Our own experience is that noncompliant taxpayers are frequently invested in PFICs. Currently, taxpayers cannot get comfort from their advisors about their prior years' taxes if they choose to file amended returns and process through the Voluntary Disclosure program since their amended returns may not be accepted by the civil exam group if the retroactive QEF election is disallowed.

A retroactive election can be accomplished in two different ways: (1) protective regime and (2) consent regime. The protective regime is difficult for most taxpayers to satisfy as it requires alleging various facts that usually don't exist for taxpayers in the Voluntary Disclosure program. The consent regime requires a ruling from the IRS. Treas. Reg. 1.1295-3(f).

Recommendation: If taxpayers choose to amend their prior years' returns and process through the Voluntary Disclosure program, the IRS should consider accepting the amended returns with a retroactive QEF election. The taxpayer, by processing through the program, is doing so "with the consent" of the Commissioner, and thus should not need to file a ruling request as noted above. This would significantly increase the number of taxpayers willing to take advantage of the program.

2. Penalty concerns

The 20% penalty on the foreign account balance (March 23, 2009 Memorandum) will discourage many taxpayers from going through the Voluntary Disclosure program or filing returns with the Service. In one case we are advising the family of a taxpayer in her 80s that is suffering with Alzheimer's disease and is no longer competent. Several years ago, she transferred her funds to a new account with her daughter as a joint owner due to her declining health. She would not qualify for the reduced penalty of 5%. The wording of the recent IRS memo, with respect to the 5% penalty, is overly restrictive and appears to make the penalty nonnegotiable. In such cases where the account activity is substantially passive, taxpayers will continue to remain noncompliant which is contrary to the objectives of the Service.

Recommendation: While taxpayers may not meet normal reasonable cause exceptions for penalties, some thought should be given to providing for a broader qualification for the 5% penalty. If the hurdle to qualify for reduced penalties is limited to only "tax saints", the number of participants in the program will be de minimis.

3. Alternative Procedure for Processing Passive Investors

Prior to the issuance of the IRS March 23 Memorandum, taxpayers could consider a "quiet" filing that would qualify for voluntary disclosure treatment. Both CPAs and attorneys could advise clients about amending their returns and forwarding them to the respective

service centers. However, the memorandum eliminated the quiet filing option for taxpayers, and in so doing, removed the accounting profession from the advisory role. All taxpayers, passive or otherwise, are now forced to retain legal counsel and process through CI if they wish to obtain closure. This will discourage a vast number of passive taxpayers from participating in the program and create administrative problems: (1) CPAs will no longer have the ability to represent clients where quiet filings might have been appropriate; (2) processing all Voluntary Disclosure applicants through CI will hugely overburden the system, especially since many of the taxpayers are passive in nature, and are not the focus of the CI group; and (3) substantial numbers of taxpayers will be reluctant to deal with the CI process due to the costs and the criminal implications even for minor tax deficiencies and for even the most passive types of situations.

Recommendation: Given the scope of the program and the objective of getting the maximum number of taxpayers compliant with respect to their offshore accounts, the Service should consider procedures that will allow taxpayers in the passive category to bypass CI and go straight to the civil exam process. This would eliminate the problems noted above and would vastly increase the number of taxpayers willing to take advantage of the program.

Thank you for your time and consideration of our concerns and comments.

Very truly yours,
Rowbotham & Company LLP

Brian Rowbotham
br@rowbotham.com
(415) 433-1177

Peter Trieu
ptrieu@rowbotham.com
(415) 433-1177

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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
Washington, D.C. 20224

Small Business/Self-Employed Division
Large and Mid-Size Business Division
Criminal Investigation Division

March 23, 2009

MEMORANDUM FOR SBSE EXAMINATION AREA DIRECTORS
LMSB INDUSTRY DIRECTORS
CI DIRECTORS OF FIELD OPERATIONS

FROM:

Faris R. Fink *Faris R. Fink*
Deputy Commissioner, SBSE

Barry B. Shott *Barry B. Shott*
Deputy Commissioner, LMSB International

Victor Song *Victor Song*
Deputy Chief, Criminal Investigation

SUBJECT: Routing of Voluntary Disclosure Cases

The purpose of this memorandum is to alert you to a change in the processing of voluntary disclosure requests containing offshore issues. All voluntary disclosure requests are mandatory work.

All incoming voluntary disclosure requests will continue to initially be screened by Criminal Investigation (CI) to determine if the taxpayer is eligible to make a voluntary disclosure. Refer to IRM 9.5.11.9 for questions pertaining to taxpayer eligibility. For voluntary disclosure requests containing only domestic issues, where CI has preliminarily determined taxpayer eligibility, CI will continue to forward those requests to the appropriate Area/Industry PSP for civil processing.

Effective as of the date of this memorandum, voluntary disclosure requests containing offshore issues, where CI has preliminarily determined taxpayer eligibility, will now be forwarded by CI to the Philadelphia Offshore Identification Unit (POIU) for civil processing. Additionally, any voluntary disclosures with offshore issues that are currently in Area/Industry case inventories (whether or not there has been prior taxpayer contact by SBSE or LMSB) should also be forwarded to the POIU.

The address for the POIU follows:

Internal Revenue Service
11501 Roosevelt Blvd.
South Bldg., Room 2002
Philadelphia, PA 19154
Attn: Charlie Judge, Offshore Unit, DP S-611