The IRS Approach to Retroactive Relief for VDP Taxpayers

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Based on a flawed legal analysis, the IRS is implementing a policy of denying section 9100 late-election relief for all taxpayers in the voluntary disclosure programs.

Introduction

On February 8 the IRS announced a new special offshore voluntary disclosure initiative (2011 OVDI) for taxpayers with offshore assets.[1] That initiative follows the six-month offshore voluntary disclosure program that began in March 2009 (2009 OVDP). The terms of the 2011 OVDI are similar in many ways to those of the 2009 OVDP. However, there are several differences. The new initiative increases the offshore account penalty for most taxpayers from 20 to 25 percent, but it creates a second lower penalty tier of 12.5 percent and further clarifies the application of the 5 percent penalty tier for some limited classes of taxpayers considered less culpable. The 2011 OVDI announcement and frequently asked questions also address issues of great taxpayer interest such as the pre-clearance process, the consequences of ''opting out'' of the initiative if the civil settlement result is not satisfactory to the taxpayer, the inclusion of those taxpayers who missed the 2009 OVDP deadline, and the specific procedures and timing to be followed on the civil side.[2]

The language of the 2011 announcement is somewhat stronger than that of the announcement of the 2009 OVDP, in which taxpayers were invited to voluntarily disclose offshore accounts and activities, and were promised a ''predictable set of outcomes . . . and a fair settlement.'' However, the 2011 OVDI announcement did not disclaim those goals. Approximately 15,000 taxpayers, most encouraged by practitioners, accepted the invitation to enter the 2009 OVDP.

The 2009 OVDP promised, and in most cases delivered, quick routing through the IRS criminal tax function with only limited investigation. However, the IRS's civil examination side was clearly unprepared to handle the large amount of disclosures. Taxpayers who had submitted their disclosures relatively early in the process were issued a form information document request due on or before January 15, 2010. Practitioners were told that the IRS would use that information to develop policies and practices regarding the processing of the submissions on the civil side. With the exception of a simplified mark-to-market procedure for evaluating passive foreign investment company-related income (made public on September 13, 2010), however, it is not clear that the IRS developed comprehensive civil policies and procedures in advance of the 2009 OVDP, or even 15 months into the program. It is commendable that the IRS is attempting to smooth out the process in the 2011 OVDI. However, there are still several unresolved issues, including the issue to which this article is addressed, which is the IRS approach to granting, or, more accurately, not granting, relief to taxpayers in a voluntary disclosure program (VDP) to make late regulatory elections under reg. section 301.9100-1 through -3 (section 9100 relief).

In light of the statements of IRS officials regarding fairness and predictability, the void in the area of civil guidance left participants with the reasonable impression that with the exception of the special rules for penalties, the general tax statutes and regulations — including several rules governing IRS procedures — would continue to apply by their terms.

The 2009 OVDP attracted a variety of taxpayer types. Some taxpayers had been purposefully hiding assets in offshore accounts. However, the publicity surrounding the program also increased awareness for those taxpayers who were not purposefully hiding assets but were simply not aware of their U.S. tax obligations. Therefore, many immigrants or accidental citizens, some with little understanding of the English language, let alone U.S. tax law, first learned when consulting with practitioners that they were taxable in the United States on foreign income. While factual circumstances and taxpayer sophistication vary significantly from taxpayer to taxpayer, most practitioners assumed that after the disclosure was reviewed by the IRS Criminal Investigation division, taxpayers would receive the promised fair and predictable treatment on the civil side of the IRS.

While some aspects of the VDP are commendable, other aspects of the 2009 OVDP have received

[1] IR-2011-14, *Doc 2011-2718*, *2011 TNT 27-10*.

[2] Along with the news release, the IRS released a new set of frequently asked questions, *Doc 2011-2719*, *2011 TNT 27-19*.

significant criticism.[3] Many practitioners have complained about the rigidity of the program: The lack of flexibility may leave little room for consideration of individual taxpayers' facts and circumstances. While the 2011 OVDI guidance addressed many practitioner concerns from the 2009 OVDP, it still lacks flexibility.

The IRS has suggested, in connection with the 2009 OVDP, that it will deny any section 9100 relief for late elections for VDP taxpayers when the election involves assets being disclosed as part of the VDP. That policy is an example of the rigidity and variance from expected rules that have not yet been publicly addressed, to our knowledge. If the IRS follows through with that proposal, VDP taxpayers who have requested (or anticipate requesting) section 9100 relief will be denied relief, regardless of the taxpayers' facts and circumstances. In fact, it has become clear that taxpayers otherwise entitled to section 9100 relief would be denied relief solely because of being in the VDP. Moreover, the IRS did not inform taxpayers that section 9100 relief would be denied, either in any of the information provided in connection with the 2009 OVDP or in any of the guidance released February 8 concerning the 2011 OVDI. We question whether that is good tax policy, or for that matter good government policy, as it appears to contravene both the section 9100 regulations and the IRS's representations in 2009 concerning predictability and fairness.

There are several reasons why a VDP taxpayer may seek section 9100 relief to make a late election. For example, a taxpayer who did not understand the U.S. federal tax consequences of entity classification on a transaction may seek to make a late entity classification election.[4] Section 9100 relief is administrative permission to make a late election and is governed by the rules of reg. section 301.9100-1, -2, and -3, with most requests governed by reg. section 301.9100-3. Under the general rule of reg. section 301.9100-3(a), requests for relief will be granted when the taxpayer provides the evidence to establish that the taxpayer acted reasonably and in good faith and when the grant of relief will not prejudice the interests of the government. Reg. section 301.9100-3(b)(1) provides more specific rules under which a person is deemed to have acted reasonably and in good faith. Reg. section 301.9100-3(b)(3) provides exceptions to (b)(1). Notwithstanding the structure and language of reg. section 301.9100-3, the IRS generally does not consider the plain language of paragraph (a), even though that paragraph may apply to many taxpayers, and considers only paragraph (b) regarding ''acting reasonably and in good faith.'' Also, in proposing a result adverse to VDP taxpayers who, were they not in the VDP, would qualify for section 9100 relief, we believe that the IRS has distorted the language and purpose of reg. section 301.9100-3(b)(3)(i) and (iii). The following discussion focuses on what we believe to be the IRS's ill-conceived logic and policy regarding that.

No Relief Under Reg. Section 301.9100-3(b)(3)(i)

The 2009 OVDP was set out in three internal IRS memorandums dated March 23, 2009. The IRS did not issue a revenue procedure or any other traditional guidance such as regulations, announcements, or notices. Therefore, no attempt was made by the IRS to suggest that it was making new law or interpreting existing law.[5] It was merely announcing a settlement initiative to encourage compliance and explaining the IRS internal procedure to taxpayers.

The memorandums included a statement that accuracy-related or delinquency penalties would be imposed without allowing a reasonable cause exception. The IRS has suggested that this internal IRS instruction to the field means that VDP taxpayers have accepted the imposition of accuracy-related penalties under section 6662 for some unreported income during the 2003 through 2008 tax years, and that seeking section 9100 relief is an attempt to ''alter a return position for which an accuracy-related penalty has been or could be imposed'' within the meaning of reg. section 301.9100-3(b)(3)(i), thus triggering the (b)(3)(i) exception to (b)(1).

A VDP taxpayer, however, may not have taken any return position at all, including, for instance, in the area of entity classification. For example, a

[3]*See, e.g.*, Mark E. Matthews and Scott D. Michel, ''IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year,'' *BNA Insights*, Sept. 21, 2010.

[4]While there may be other elections that would have been beneficial to a taxpayer had the election been timely made, we believe that most VDP taxpayers requesting section 9100 relief would be requesting permission to make late entity classification elections.

[5]The IRS often maintains that it must follow the clearly stated applicable law and has no authority to settle matters on terms in variance of the law applicable to a particular case (although it may settle on the basis of hazards of litigation or uncertainty of application of law). That may explain the IRS's reluctance to issue more traditional forms of guidance in connection with VDPs. *See, e.g.*, *United States v. Simon*, 106 AFTR 2d 2010-6739 (D. In. Oct. 8, 2010), *Doc 2010-22264, 2010 TNT 198-16* (administrative relief was denied to a taxpayer that had criminal liability under the foreign bank account report statute when the IRS had extended the reporting deadline through a notice, because criminal liability under a statute cannot be absolved by an administrative notice).

taxpayer who owns an interest in a foreign entity with a default classification as a corporation could be required to file a Form 5471 on acquisition. A VDP taxpayer, however, may not have made that filing, possibly because the taxpayer was not aware of a filing obligation. That same taxpayer, however, likely would not have included income earned by the foreign entity on Form 1040, which would be required if the intended treatment of the foreign entity was as a partnership or disregarded entity. Thus, a common scenario among 2009 OVDP taxpayers was that no return position was taken at all.[6]

In the process of making such a broad policy decision, the IRS may have assumed that all VDP taxpayers intended to hide their holdings by not taking a return position in their failure to report or disclose some foreign income. While that may be true in the case of some of the VDP taxpayers, there is no evidence that it is true of all VDP taxpayers. That assumption seems unfair and arbitrarily prejudicial to the many VDP taxpayers who did not report some earnings or activities (and did not consciously take a ''return position'') because of their lack of understanding.

Reg. section 301.9100-3(b)(3)(i) also provides that qualified amended returns should be taken into account when determining whether a taxpayer is seeking to alter a return position. Reg. section 1.6664-2(c)(3) generally defines a qualified amended return as an amended return filed after the due date of the return for the tax year and before the date of contact by the IRS concerning an examination. The general function of a qualified amended return is to identify whether the taxpayer voluntarily reported income before audit.

To be accepted into a VDP, a taxpayer must have voluntarily disclosed previously unreported foreign income and other relevant facts related to that person's taxes in the initial disclosure and throughout the voluntary disclosure process. As part of the program, VDP taxpayers have agreed to file amended returns fully disclosing previously unreported income. To be accepted in a VDP, that initial disclosure is required to be made before any contact from the IRS. Therefore, the amended return or initial disclosure provided in connection with a voluntary disclosure is — or should at least be treated as — a qualified amended return for this purpose. The actual return forms must be consistent with any requested section 9100 relief, as well as the initial disclosure. It is unfair to interpret reg. section 301.9100-3(b)(3)(i) in a rigid manner that excludes VDP taxpayers for merely doing what the IRS encouraged them to do.

Finally, a common complaint among practitioners advising taxpayers in the 2009 OVDP is the lack of consideration given to taxpayers that have acted with reasonable cause and good faith that would otherwise meet exceptions to accuracy-related penalties under section 6662.[7] Assuming that VDP taxpayers have taken a return position within the meaning of reg. section 301.9100-3(b)(3)(i), many taxpayers did not take a position for which an accuracy-related penalty ''has been or could be imposed under section 6662.'' In the case of many VDP taxpayers, no penalty could technically be imposed under section 6662 if they meet the ''reasonable cause and good faith'' exception of section 6664(c)(1). That reasonable cause and good faith is not eliminated merely because the taxpayer will, in the future, agree to waive the defense as part of a settlement with the IRS. The settlement position is not, in and of itself, the law nor an interpretation of the law, and should not change the application of section 9100 relief to the taxpayer under the regulation. By its terms, reg. section 301.9100-3(b)(3)(i) incorporates the reasonable cause and good faith exception and there is no qualification in reg. section 301.9100-3(b)(3)(i) that would allow importation of an IRS settlement position contrary to sections 6662 and 6664(c)(1). In short, VDP taxpayers agreed to accuracy-related penalties, not to the elimination of the possibility of section 9100 relief or other relief that may depend on the taxpayers' reasonable cause and good faith.

Taxpayer and practitioner confidence in the fairness of the tax system would be seriously shaken if the IRS could alter the interpretation of a regulation by adopting a settlement position. Therefore, the interpretation of reg. section 301.9100-3(b)(3)(i) should not turn on a settlement position or upon the issuance of an internal directive to the field. The IRS rationale appears to be an attempt to bootstrap into a harsh result for those VDP taxpayers who, without fault, have made mistakes and are trying to rectify them.[8]

[6]For that matter, we question whether a taxpayer who files no return at all has taken a return position within the meaning of reg. section 301.9100-3(b)(3)(i), and in any event, accuracy-related penalties would not apply to a nonfiler. While the IRS clearly has an interest in staking out a broad interpretation of the term ''return position,'' it appears to be unreasonable and arbitrary to assume the term ''return position'' includes in all cases purported positions that never actually were taken or intended to be taken on a return.

[7]The 2011 OVDI similarly will not allow taxpayers to assert a reasonable cause defense against penalties.

[8]Taking each taxpayer's case individually on its merits according to the policies underlying section 9100 relief would provide assurance that taxpayers who are not acting with reasonable cause and good faith would not obtain relief.

No Relief Under Reg. Section 301.9100-3(b)(3)(iii)

Reg. section 301.9100-3(b)(3)(iii) states: ''If specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In that case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.''

The IRS has suggested that merely entering into a VDP is a change in a specific fact that makes a retroactive election advantageous and, therefore, is the ''use of hindsight'' under reg. section 301.9100-3(b)(3)(iii). That is incorrect for a number of reasons. First, the event that makes an election advantageous often occurs before the due date for the election. The individual facts and circumstances of a VDP taxpayer should be examined to see whether that is the case. However, that would be precluded under the IRS's rationale.

What does ''hindsight'' mean? In *Vines v. Commissioner*,[9] the issue was whether the taxpayer's request for section 9100 relief should have been granted concerning a section 475(f) election. In that case, the taxpayer requested relief after not being aware of the ability to make an election. The IRS argued that to allow the late election would give the taxpayer the benefit of hindsight because the section 475(f) election could have allowed the taxpayer to elect the most favorable treatment for some securities trades. The Tax Court rejected that argument, saying that the relevant inquiry under a plain reading of reg. section 301.9100-3(b)(3)(iii) ''is whether allowing a late election gives the taxpayer some advantage that was not available on the due date.'' Entering into the VDP is not a ''changed fact'' within the meaning of reg. section 301.9100-3(b)(3)(iii). There is no ''wait and see if I get caught and then I'll request the election.''

In fact, the opposite is the case. A voluntary disclosure does not make an election advantageous, but rather materializes the risk of personal taxation of income from foreign transactions. It is, instead, the specific facts of a taxpayer's case that could make an election more favorable. The argument made by the IRS has the effect of punishing people who have made voluntary disclosure, and it is hard to escape the notion that punishment is what is intended. It is arbitrary because it affects VDP taxpayers in different ways unrelated to specific facts leading to the disclosure, and it is contrary to the facts and circumstances approach of reg. section 301.9100-3.

[9]126 T.C. 279 (2006), *Doc 2006-24089, 2006 TNT 231-14.*

Also, the IRS cannot and should not deny section 9100 relief when a taxpayer has provided ''strong proof that the taxpayer's decision to seek relief did not involve hindsight.'' For example, a taxpayer who has no knowledge of the workings of the U.S. tax system or of the particular taxation of transactions involving foreign entities and assets would have insufficient information to evaluate whether an election is appropriate. In that situation, a taxpayer is merely seeking what he would have been entitled to in the first place, rather than suffering the consequences of income flowing from a transaction or structure that was unintended and unplanned from a U.S. tax perspective.

The IRS Reads Out Reg. Section 301.9100-3(a)

A broader issue is brought to light by the denial of section 9100 relief based on what we believe is an incorrect interpretation of reg. section 301.9100-3(b). Reg. section 301.9100-3(a) states the controlling legal standard applicable to such ruling requests:

> Requests for *relief* subject to this section *will be granted when the taxpayer provides the evidence* (including affidavits described in paragraph (e) of this section) *to establish* to the satisfaction of the Commissioner *that the taxpayer acted reasonably and in good faith*, and the grant of relief will not prejudice the interests of the Government. [Emphasis added.]

Reg. section 301.9100-3(b)(1) lists five favorable factual scenarios after the statement: ''Except as provided in paragraphs (b)(3)(i) through (iii) of this section, a taxpayer is *deemed* to have acted reasonably and in good faith if the taxpayer . . . '' (emphasis added). Meeting any one of those is sufficient under (b)(1) to ''deem'' the taxpayer to have acted reasonably and in good faith. The regulatory structure of (b) as a ''deeming'' regarding (a) should be contrasted with reg. section 301.9100-3(c), which provides that ''this paragraph (c) provides the standards the Commissioner will use to determine when the interests of the Government are prejudiced'' (within the meaning of paragraph (a)).

When considering section 9100 relief in general, however, the IRS references the specified facts and standards in reg. section 301.9100-3(b) and ignores reg. section 301.9100-3(a). In effect, that assumes that the phrase ''acted reasonably and in good faith'' carries no meaning other than provided in paragraph (b) and that the legal standard for purposes of reg. section 301.9100-3 is independent of the natural and ordinary interpretation of that phrase. However, reg. section 301.9100-3(b)(1) does not list an exclusive set of facts or standards under which a taxpayer may be determined to have acted reasonably and in good faith. It merely states five factual scenarios under which it is deemed that the

taxpayer acted reasonably and in good faith. The purpose of reg. section 301.9100-3(b)(1) appears to be the simplification of the administrative processing of applications for relief for a large portion of applications.

Nevertheless, the possible existence of a general administrative practice does not render nugatory, or alter, the general legal standard stated in paragraph (a), either in cases in which the facts presented in reg. section 301.9100-3(b)(1) exist or in those cases in which those facts do not exist. Although that is an issue applicable to all taxpayers and not only those in the VDP, the fact that the IRS would rely only on reg. section 301.9100-3(b)(3)(i) and (iii) in broadly denying section relief to VDP taxpayers highlights that the IRS ignores reg. section 301.9100-3(a) in processing section 9100 relief requests. The IRS should not ignore the provisions of reg. section 301.9100-3(a) simply as a matter of administrative convenience.

Also, the exceptions in (b)(3) apply, by their terms, ''for purposes of this paragraph (b)'' and, accordingly, only negate a positive determination under (b)(1). Therefore, the exceptions in (b)(3) do not negate the positive determination required under (a) if the conditions under (a) are met.

Policy Implications

As noted above, the unfairness of implementing a strict policy is inconsistent with the promises of a ''predictable set of outcomes . . . and a fair settlement'' made by the IRS when inviting noncompliant taxpayers to enter the 2009 OVDP. Denying section 9100 relief to taxpayers who would otherwise qualify for relief and who have otherwise acted reasonably and in good faith simply because they have accepted the government's offer of ''fair'' treatment by stepping forward and voluntarily becoming compliant taxpayers will not lead to a fair settlement in many cases. There is nothing fair nor predictable about the IRS denying section 9100 relief to taxpayers who would otherwise be entitled to relief.

The circumstances of the taxpayers who have already stepped forward and acknowledged their prior noncompliance vary widely, and those taxpayers should not all be painted with the same brush. They knew the penalty structure offered by the IRS but did not expect that they would be punished with higher *taxes* than would otherwise be the case because of their voluntary disclosure. For some taxpayers, opting out of the 2009 OVDP may be the only way to get fair and reasonable relief, despite the potential risks that course of action might entail.

The policy implications for that type of decision regarding the 2011 OVDI should be obvious: If potential invitees to the new program do not believe that they will be treated fairly and predictably — based on how taxpayers were treated in the 2009 OVDP — many will not apply for the 2011 OVDI but will perhaps seek alternatives that are less desirable from the government's perspective. Also, the government will run the risk that only those taxpayers who are likely to be discovered and criminally prosecuted will voluntarily step forward next time.

The proposed IRS approach could also damage the section 9100 relief process in general by distorting the applicable rules in a manner that may prove difficult to limit to voluntary disclosures, and could ultimately negatively affect the compliance benefits derived by the government from the 2009 OVDP and the 2011 OVDI. Taking each taxpayer's case individually on its merits according to the policies and rules underlying section 9100 relief would provide assurance that taxpayers who are not acting reasonably and in good faith would not obtain relief. There are not so many taxpayers in a VDP requesting section 9100 relief that their individual facts and circumstances cannot be addressed on the merits.