Brigham Young University International Law & Management Review

Volume 10 | Issue 1 Article 3

5-1-2014

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Steven Ferraro

EFFECT OF UNITED STATES V. WILLIAMS ON THE OFFSHORE VOLUNTARY DISCLOSURE PROGRAM

Steven Ferraro[*]

I. INTRODUCTION

The Offshore Voluntary Disclosure Program (OVDP) allows taxpayers who are delinquent in the filing of Reports of Foreign Bank and Financial Accounts (FBAR) and corresponding unreported taxable income the opportunity to be compliant. An FBAR is a disclosure form that requires taxpayers holding foreign accounts aggregating over $10,000 to submit financial information to the Internal Revenue Service (IRS) annually. After joining the OVDP, taxpayers file eight years of back tax returns and FBARs. By doing so, taxpayers become responsible for paying the back tax liability, plus interest, and related accuracy penalties.[1] In consideration for voluntary compliance, the IRS alleviates all generally asserted penalties surrounding delinquent FBARs (FBAR Penalties), and replaces them with a single 27.5% penalty on the highest aggregate amount in the foreign financial accounts over the past eight years (Offshore Penalty).[2] Additionally, the IRS agrees not to recommend taxpayer disclosure to the Department of Justice for criminal prosecution.[3]

The success of the OVDP is widely accepted. As of November 2012, the IRS collected $5 billion through the current OVDP and its previous iterations, funds which otherwise would evade taxation in the United States.[4] Additionally, by bringing over 34,500 taxpayers into compliance, the IRS saves future taxable dollars from escaping collection.[5] Most significantly, the IRS collects valuable information on previously undisclosed foreign accounts aiding international tax enforcement efforts.[6] In exchange for these benefits, the IRS merely replaces the potentially high FBAR penalties for the generally lower 27.5% Offshore Penalty. Without the OVDP, the IRS would likely not know which delinquent accounts to charge the FBAR Penalties.

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[*] Associate, Herzfeld & Rubin, P.C., (Admitted in New Jersey). The author appreciates the valuable comments on earlier drafts of this Article provided by Professor Steven Dean.

[1] IRS, *Offshore Voluntary Disclosure Program: Frequently Asked Questions and Answers*, http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers (last visited June 26, 2012) [hereinafter *FAQ*].

[2] *Id.* at 7.

[3] *Id.* at 3.

[4] IRS NEWS RELEASE IR-2012-64 (JUNE 26, 2012).

[5] *Id.*

[6] *FAQ*, *supra* note 1, at 1.

Initial critics of the OVDP pointed to its one size fits all approach toward delinquent taxpayers.[7] Under the OVDP's guidelines, all taxpayers are charged a 27.5% Offshore Penalty, regardless of how willful or fraudulent they were in neglecting to file their FBAR. This is unlike FBAR Penalties, which vary by the level of willfulness. Incidentally, in certain situations where a taxpayer nonwillfully violates the FBAR reporting requirement, that taxpayer would pay a lower penalty if caught outside the OVDP than if she entered the OVDP, and paid the 27.5% Offshore Penalty. Given the likelihood of escaping an audit, the OVDP incentivized nonwillful taxpayers to avoid the program.

To alleviate this problem the IRS devised an opt out feature that allows nonwillful taxpayers to enter the OVDP and come into compliance without facing steep penalties. Rather than accepting the 27.5% Offshore Penalty, taxpayers face a full examination and are subject to FBAR penalties. One factor in determining the size of the FBAR penalty is the willfulness of the FBAR Reporting Requirement violation. The penalty for a willful violation of the FBAR Reporting Requirement is significantly more draconian than the penalty for a nonwillful violation. Thus, the standard for determining whether a violation is willful, the Civil Willfulness Standard, is a factor for a taxpayer to consider when determining whether to voluntarily disclose, because it determines both the expected liability of opting out and the expected liability of the FBAR penalties if caught outside the OVDP.

Tax practitioners are beginning to reexamine the Civil Willfulness Standard after the recent Fourth Circuit case *United States v. Williams*.[8] In *Williams*, the court broke away from its more lenient interpretation of the Civil Willfulness Standard, and moved toward a stricter liability standard.[9] Although the court declined to offer a bright line rule, it devoted almost all of its opinion to whether or not a taxpayer checked "No" on Question 7 of Schedule B, Part III of the taxpayer's Form 1040 (Question 7a).[10] Question 7a asks whether a taxpayer held a foreign account, and guides the taxpayer to check the FBAR instructions. Based on that evidence (nearly exclusively), the court found Mr. Williams in willful violation through willful blindness.[11]

Williams may have significant impact on certain taxpayers in relation to the OVDP. With the IRS potentially finding more delinquent taxpayers willful, and thus subject to a higher FBAR Penalty, it becomes more expensive to stay out of the OVDP. If taxpayers do enter the OVDP, the opt out procedure may be less appealing. For a relatively blameless taxpayer who, pre-*Williams,* would have likely been found nonwillful, there is a possibility that the best decision for that taxpayer is to enter the OVDP, and not opt out. These changes have two effects.

[7] *See* Thomas Zehnle, *Rethinking the Approach to Voluntary Disclosures*, TAX NOTES TODAY, Jan. 31, 2012 at 577, *available at* 2012 TNT 20-3.
[8] United States v. Williams, 489 F. App'x 655 (4th Cir. 2012).
[9] *Id.*
[10] *Id.*
[11] *Id.*

First, as previously explained, it can dramatically affect a delinquent taxpayer's decisions to enter the OVDP. Second, these changes also affect the equity of the OVDP by practically removing the opt out for many taxpayers, thus reviving the one size fits all approach of initial concern.

This paper proposes a new solution for the OVDP in the wake of *Williams*. The IRS should keep the incentives provided for taxpayers to enter the OVDP, but also provide for equitable justice. This article bases its structure on a proposal by the National Taxpayer Advocate, Nina Olson, and features an incorporated version of the opt out system, which codifies three distinct penalty tracks for taxpayers. This solution maintains administrative ease, encourages disclosure, and promotes equity in treatment.

Part II will review the success of the OVDP. First, it will provide an overview of the OVDP, including its history, and significant features. Secondly, the Part will analyze what features gave the OVDP success. Part III will analyze the changing civil willfulness standard. First, it will analyze the status of the civil willfulness standard, and how it was potentially changed by the Fourth Circuit's decision in *Williams*. Second, the Part will consider how the changing willfulness standard might affect the OVDP. Finally, Part IV will detail the solution to amend the OVDP in light of *Williams*.

II. SUCCESS OF THE OVDP

A. Overview of the OVDP

The need for the OVDP arose from a growing concern about undisclosed wealth held by U.S. citizens in foreign countries. The Tax Justice Network estimates that wealth to be between $21 trillion and $32 trillion, which equates to between $190 billion and $280 billion of lost annual tax revenue.[12] With the U.S. Federal Budget deficit approaching $1.1 trillion for fiscal year 2012, the tax revenue currently escaping the IRS would reduce the deficit by approximately 25%.[13] Considering the looming actions Congress may take to cut entitlements, and raise revenue from compliant taxpayers, policymakers must address this concern.

In addition to the historic budget shortfall, income inequality is near an all time high.[14] Pressure is mounting to encourage the government to stand up for low, and middle income taxpayers, who use foreign undisclosed accounts less frequently, by cracking down on wealthy individuals who continue to obtain unfair tax advantages by hiding

[12] *Revealed: global super-rich has at least $21 trillion hidden in secret tax havens*, TAX JUSTICE NETWORK (July 22, 2012), http://www.taxjustice.net/cms/upload/pdf/The_Price_of_Offshore_Revisited_Presser_120722.pdf.

[13] CONG. BUDGET OFFICE, AN UPDATE TO THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022 (2012).

[14] LINDA LEVINE, CONG. RESEARCH SERV., THE US INCOME DISTRIBUTION AND MOBILITY: TRENDS AND INTERNATIONAL COMPARISONS, R42400 (2012).

wealth overseas. Compelling disclosure of foreign held assets while preserving administrative resources would aid our country's fiscal health, and begin to mend income inequality.[15]

Based on the dual concerns of raising revenue and protecting fairness, the IRS formally established a special voluntary disclosure program in 2009 (Program), similar to the current OVDP.[16] This new Program, considered alongside the IRS's pursuit of John Doe Summons on foreign UBS clients,[17] increased examinations of FBAR fillings, and is part of a concentrated effort to solve the issue of undisclosed foreign wealth.[18] The Program allowed the IRS to assess an Offshore Penalty of 20% after receiving full disclosure from the delinquent taxpayer.[19] The 20% Offshore Penalty was often substantially lower than the FBAR Penalties assessed by the IRS outside the Program. The Program was successful. It accepted 18,000 applications and, as of January 2012, the IRS collected \$3.4 billion with 5% of its claims still pending.[20]

Because delinquent taxpayers showed interest in making further disclosures,[21] the IRS announced a follow up Program in 2011, the Offshore Voluntary Disclosure Initiative (OVDI).[22] The most significant difference from the previous Program was an increase in the Offshore Penalty, from 20% to 25%.[23] The OVDI was also successful as it brought in an additional 12,000 submissions.[24]

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[15] Even Congress has noted the need for a formal program. In 2008, just months before the establishment of the OVDP, Senator Baucus noted that "[I]t's clear from today's testimony that we have an opportunity—indeed a duty—to find legislative solutions to pressure the IRS and better enable them to collect on the nearly \$345 billion annually of legally-owed but unpaid taxes." Sen. Max Baucus, *Baucus Says Congress Has a 'Duty' to Ameliorate Offshore Tax Evasion*, TAX NOTES TODAY, July 25, 2008, *available at* 2008 TNT 144-29.

[16] The IRS has had a long-standing practice of voluntary disclosure, but has never established a formal policy, except for a brief period in 2003. See *FAQ, supra* note 1, at 3.

[17] In August 2009, the IRS, the Swiss government, and UBS came to an agreement that sent United States client data from almost all the sources sought in the John Doe summonses to the IRS. The purpose of this agreement was to reveal identities of taxpayers with foreign accounts to the United States government. On November 17, 2009, the IRS estimated that the agreement would produce 4,450 foreign accounts subject to an IRS investigation. Between 2001 and 2008, only bank accounts worth more than \$989,000 were subject to disclosure. David D. Stewart, *IRS Releases UBS Agreement Criteria, Results of Voluntary Disclosure Initiative*, TAX NOTES TODAY, Nov. 18, 2009, *available at* 125 Tax Notes 832.

[18] Between 2004 and 2009, the Treasury Inspector General for Tax Administration found penalties from examinations of FBARs increased 388% to \$20,500,000, and penalties collected increased from \$1,800,000 to \$9,800,000. *Increases in Examinations, Penalties Commensurate with Rise in FBAR Reporting, TIGTA Says*, TAX NOTES TODAY, Sept. 29, 2010, *available at* 2010 TNT 227-4. Furthermore, the IRS increased staffing, doubling the overseas offices of the Criminal Investigations in 2010. The IRS now has offices in Beijing, Hong Kong, and Panama. Amy S. Elliott, *IRS Increases Staffing For Next Round of Offshore Enforcement*, TAX NOTES TODAY, Nov. 15, 2010, *available at* 129 Tax Notes 775.

[19] Steven T. Miller, Memorandum from Deputy Comm'r for Serv. and Enforcement, *Opt Out and Removal Guide for 2009 OVDP and 2011 OVDI* (June 1, 2011), *available at* http://www.irs.gov/pub/newsroom/2011_ovdi_opt_out_and_removal_guide_and_memo_june_1_2011.pdf at 18.

[20] IRS News Release IR 2012-5 (Jan. 9, 2012) [hereinafter *\$4.4 billion*]; IRS News Release IR 2010-122 (Dec. 9, 2010) [hereinafter *Prepared Remarks*].

[21] IRS News Release IR 2011-14 (Feb. 8, 2011).

[22] *Id.*

[23] *Id.*

[24] IRS News Release IR 2011-94 (Sept. 15, 2011).

In 2012, the IRS established the OVDP, which unlike the first two editions would remain active indefinitely.[25] The IRS cited the "continued strong interest from taxpayers and tax practitioners" for continuing this Program.[26] The Offshore Penalty increased once again from 25% to 27.5%.27 As of June 2012, the Program brought an additional 1,500 voluntary disclosures.[28] The combined efforts of the three Programs surpassed $5 billion in penalties, and back taxes. [29]

To participate in the OVDP [30] the delinquent taxpayer must disclose all of her foreign held assets which aggregate over $10,000 and were not previously reported on FBARs.[31] Additionally, taxpayers must file all delinquent FBARs for the previous eight years,[32] and complete an "Offshore Letter," which requires procedural information regarding the taxpayer's foreign account.[33] For any account with an aggregate value above $500,000 the taxpayer must provide bank statements to substantiate the financial information.[34]

In addition to disclosure, taxpayers must also pay and calculate all past due tax liability on income earned, and not reported from the undisclosed accounts.[35] Thus, taxpayers must submit their original U.S. tax returns, along with their new amended U.S. tax returns, for all years covered by the Offshore Voluntary Disclosure.[36] The taxpayer must pay all applicable interest, and a 20% accuracy related penalty.[37]

In return for agreeing to voluntarily disclose accounts, and pay back taxes and interest, the IRS allows the delinquent taxpayer to pay an

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[25] *$4.4 billion*, *supra* note 20.

[26] *Id.*

[27] *FAQ*, *supra* note 1, at 7.

[28] IRS News Release IR 2012-64 (June 26, 2012).

[29] *Id.*

[30] The taxpayer's process: to ensure that the taxpayer is eligible for the OVDP, the taxpayer may submit her name, social security number, and other vital information to the IRS for pre-clearance. The goal of pre-clearance is to ensure that only eligible taxpayers send information to the IRS. Upon passage from the pre-clearance department, the taxpayer must send an offshore letter to the criminal investigations department. The criminal division will issue a preliminary acceptance to the OVDP. Within ninety days of acceptance, the taxpayer must furnish the remaining required information for a civil examination, including past due tax liabilities. There is no thorough examination in this process. The civil examiner will ensure the completeness and correctness of the submission, and accompanying paperwork, but will not follow an audit-like procedure. The IRS will issue a Form 906 "Closing Agreement" which outlines the proposed Offshore Penalty. If the taxpayer wishes to pay, she signs the closing agreement, and sends in the final Offshore Payment. *See FAQ*, *supra* note 1, at 7.

[31] The OVDP is specifically for taxpayers who have unreported tax liability income. The OVDP is not for those who forgot to report assets that did not produce income. Additionally, the OVDP is specifically for those people currently not under investigation by the IRS. *See FAQ, supra* note 1, at 17.

[32] *Id.* at 7. For calendar year taxpayers the voluntary disclosure period is the most recent eight tax years for which the due date has already passed. The eight-year period does not include current years for which there has not yet been noncompliance. The IRS is allowed to look back for eight years if the taxpayer signs the relevant forms (the regular statute of limitations is only three years). To facilitate the extended inquiry, the IRS requires signed forms to enter the OVDP.

[33] Some of the information requested includes the estimated amount in each account, estimated income from the accounts, financial institution, and contact information of the financial institution.

[34] *Id.* at 25.

[35] *Id.* at 7.

[36] *Id.*

[37] 26 U.S.C. § 6662(a).

Offshore Penalty in lieu of all FBAR Penalties. For many taxpayers the Offshore Penalty is much less than the FBAR Penalties; for others, however, it is not. The IRS lacks any authority to alter the Offshore Penalty.[38] Furthermore, there is no appeals process after completion of the OVDP.[39]

B. Why the OVDP Worked

The OVDP has been extremely successful. To understand, or criticize, the effect of the OVDP, the four goals of the Program must be considered: raising revenue, bringing individual disclosing taxpayers into compliance, assisting in further prosecutions, and reducing administrative costs.

The first goal of the OVDP is to raise revenue. As indicated, the budget deficit and U.S. government debt is growing unsustainably large and may cause fiscal problems that threaten the United States in the not so distant future. Given the staggering amount of wealth remaining abroad, the IRS may combat the deficit by raising revenue through this program. In this light, the collection of $5.5 billion, which otherwise would still be abroad, is a great success. On the other hand, $5.5 billion is only a fraction of potential tax revenue that could be collected from the approximate $32 trillion held abroad by U.S. citizens.[40] The Program has failed to bring in a majority of foreign undisclosed wealth. However, without this program, $5.5 billion would remain abroad.

The second goal of the OVDP is to bring individual taxpayers who disclose permanently into compliance.[41] The IRS accomplishes this goal by requiring taxpayers in the Program to disclose account information by filing delinquent FBARs and an Offshore Letter. The benefit to the IRS, as explained by former IRS Commissioner Doug Schulman (Schulman), is that these taxpayers will now "properly report and pay their taxes for years to come."[42] The OVDP encourages all taxpayers to "come in through the front door," and hopefully continue to be compliant and pay taxes in the future.[43] The IRS seems to have accomplished this goal, as 38,000 taxpayers have entered compliance. However, others might disagree, as that reflects only a small handful of delinquent taxpayers. Nevertheless, because of this Program 38,000 taxpayers are now compliant.

The third goal of the OVDP is to assist in further prosecutions. Each voluntary disclosure submission contains information on the foreign

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[38] *FAQ*, *supra* note 1, at 50.

[39] *Id.* at 49.

[40] David Leigh, *Leaks reveal secrets of the rich who hide cash offshore*, THE GUARDIAN (Apr. 3, 2013) http://www.theguardian.com/uk/2013/apr/03/offshore-secrets-offshore-tax-haven.

[41] The IRS describes the OVDP's primary goal as "to bring taxpayers that have used undisclosed foreign accounts, and undisclosed foreign entities to avoid or evade tax into compliance with United States tax laws." *Id.* at 2.

[42] *Prepared Remarks*, *supra* note 20.

[43] Marie Sapirie, *Consistency is Focus of OVDI, Official Says*, TAX NOTES TODAY, Mar. 21, 2011, *available at* 2011 TNT 54-4.

account and financial institution. The IRS has been mining existing information to identify the actors and institutions assisting U.S. taxpayers in hiding offshore accounts. The IRS plans to use this information to prosecute delinquent taxpayers in accordance with their power to issue John Doe Summons, and it relies on the threat of further summonses to encourage other taxpayers to disclose. In furtherance of this goal, Schulman said, "With both preparers and the IRS stepping up their efforts in the area, a 'hide-in-the-sand' approach to reporting offshore accounts and income has become a much riskier calculus for US taxpayers holding assets anywhere around the world."[44] This goal is the most difficult to assess. Disclosure has decreased each year, an indication that this Program may be losing momentum. It is possible that delinquent taxpayers who value compliance with U.S. tax law have already disclosed. The threat of foreign tax enforcement is growing, however, as are the number of prosecutions. It may be best to revisit this goal after the IRS has had the chance to develop their use of the information.

The final goal of the OVDP is to keep administrative costs low. The IRS chose to take a one size fits all approach, greatly reducing the amount of administrative resources needed for each disclosure. The OVDP enables the IRS to centralize the criminal and civil processing of voluntary disclosures and to resolve a large number of the cases without formal (and costly) examination.[45] This goal has been a success.

Underlying each of the four main policy goals is the OVDP's ability to incentivize taxpayers to voluntarily disclose. If it fails to bring in taxpayers, the IRS would not achieve any of its goals. Therefore, before discussing any changes to the OVDP, it is important to understand why taxpayers would want to enter the OVDP. The five factors taxpayers consider whether to enter the OVDP are: potential of being caught outside the OVDP, penalty framework inside the OVDP, personal utility placed on compliance with the U.S. tax law, certainty of timing and amount of taxation; and criminal FBAR avoidance.

The first factor influencing the taxpayer's decision is the greater risk of being caught violating the FBAR Reporting Requirement outside the OVDP. During the last four years, the IRS has engaged in a variety of enforcement programs to find delinquent taxpayers hiding offshore accounts. These programs include tax treaties, whistleblower laws, and the Foreign Account Tax Compliance Act (FATCA).[46] Nondisclosing taxpayers are now much less confident that their identity will remain unknown to the IRS. Although the IRS is still less likely to catch taxpayers outside the OVDP, the tide is changing and taxpayers have more incentive than ever before to enter into compliance.

The role of audits is very important in evaluating this factor. Although the overall audit rate is about 3% for individual taxpayers, that

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[44] *Shulman Discusses Progress on IRS's International Tax Agenda, Multiyear Tax Compliance Strategy*, TAX NOTES TODAY, Dec. 10, 2009, *available at* 2009 TNT 236-15.
[45] *FAQ*, *supra* note 1, at 1.
[46] *Id.* at 4.

does not paint the appropriate picture. The percentage of audits in which the IRS agent found an error was approximately 30% among individuals. Therefore, taxpayers should not feel comforted by the 3% audit figure.

The second factor encouraging taxpayers to enter the OVDP is the special penalty framework. Taxpayers place varying degrees of importance on this factor depending on the size and amount of their accounts, and whether they violated the FBAR Reporting Requirement "willfully" or "nonwillfully." A taxpayer who violates the FBAR Reporting Requirement willfully will likely face a lower overall penalty by entering the OVDP as opposed to opting out. However, for taxpayers who violate the FBAR Reporting Requirement nonwillfully, the offshore penalty is less beneficial than being caught outside the OVDP. For those taxpayers, the opt out is essentially neutralized, as they will pay the same penalty being caught outside of the OVDP as by entering it and opting out.

Third, potentially the most significant factor for some taxpayers is the utility they derive from being compliant with the U.S. tax laws.[47] When analyzing a taxpayer's decision to enter the OVDP, it would be easy to consider only quantitative factors. However, some taxpayers who discover that they have been violating the FBAR Reporting Requirement may want to enter the OVDP to be compliant. This may be true even if "quantitatively" they would be better off not entering the OVDP. Many honest taxpayers likely find a high level of utility by following the law. However, taxpayers who intentionally violate the FBAR Reporting Requirements likely find less utility in compliance with tax law than other taxpayers.

The fourth factor is the value taxpayers place on the certainty the OVDP provides. The OVDP allows taxpayers to obtain certainty in two areas: the timing of the penalty, and the amount of the penalty. The certainty of the amount of the penalty is important because it allows taxpayers to plan for the loss they will face. Taxpayers who live and rely on the undisclosed money will be more sensitive to this factor. The certainty of timing factor is important because it allows taxpayers to prepare to make their payments. Taxpayers who opt out do not get either benefit. As one tax practitioner asks, "What is the cost of being able to sleep at night?"[48]

The concept of risk aversion explains this factor. Risk aversion is the behavioral economic concept whereby, given two equal levels of expected tax liabilities, the taxpayer would prefer the option with the least amount of variability. This happens because taxpayers value certainty. Economic literature has indicated that people are more risk averse when the losses are potentially high. Alternatively, people tend to favor risk more when it involves a potentially high gain. Therefore, as

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[47] Utility is a concept in economics that encompasses an individual's preferences. For example, someone who enjoys baseball would likely derive a high level of utility from watching a no-hitter. This would be more powerful with a citation.

[48] Lee Sheppard, *New Analysis: How Do United States Holders of Swiss Accounts Come Clean?*, TAX NOTES TODAY, Sept. 25, 2008, *available at* 2008 TNT 188-5.

the IRS pursues more aggressive enforcement policies that have the effect of increasing the expected tax liability facing delinquent taxpayers, the taxpayer becomes more risk averse and, therefore, more likely to enter the OVDP because it provides certainty.

Finally, an additional incentive the OVDP offers is avoidance of criminal charges. Taxpayers who acted willfully in their violation of the FBAR Reporting Requirement, may be subject to criminal penalties.[49] Entering the OVDP will shield this delinquent taxpayer, as the IRS will not recommend the taxpayer to the criminal division. However, if a taxpayer opts out, the IRS may pursue criminal prosecution.[50] Taxpayers who are not in danger of criminal prosecution will not consider this a significant factor.

Even if the OVDP meets all of its goals, the IRS should not view it as a success unless it treats all taxpayers equitably.[51] Initially, a major problem with the OVDP was that it treated all taxpayers the same, regardless of the reason they failed to disclose their foreign accounts. For example, some practitioners complained that there existed a major difference between those taxpayers who inherited accounts from their parents and never withdrew money to the United States, and those taxpayers that deliberately set up foreign accounts to dodge domestic taxation.[52] To address the issue of equity, the IRS added programs that lowered the Offshore Penalty to 5% or 12.5%, based on certain taxpayer qualifications. [53] However, those programs only deal with a limited number of taxpayers and do not address the problem at large.

The most important provision addressing equity concerns is the opt out. This provision allows taxpayers to enter the OVDP instead of taking the 27.5% Offshore Penalty and face an examination and argue that they acted nonwillfully. Taxpayers will only use the opt out provision if they would face a lower expected penalty under an examination than through the Offshore Penalty. Thus, taxpayers who violated the FBAR requirement willfully can pay the 27.5% Offshore Penalty, but those who acted without willful intent can opt out, and pay the smaller FBAR penalties.

The penalty framework is just one factor that influences taxpayers. Taxpayers also consider the expected probability of the IRS catching them outside the Program. In addition, many taxpayers who are nonwillful value compliance with the U.S. law. Finally, some taxpayers

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[49] *E.g.*, 26 U.S.C. 7201 (2013) (tax evasion); 26 U.S.C. § 7206(1) (2013) (filing a false return); 26 U.S.C. § 7203 (2013) (failure to file an income tax return); 31 U.S.C. § 5322 (2013) (willfully failing to file an FBAR); 31 U.S.C. § 5322 (2013) (willfully filling a false FBAR). Note that when the case is clearly nonwillful, there is no chance for a criminal violation. Thus, in those situations, this factor is not as important.

[50] *FAQ*, *supra* note 1, at 51.

[51] It is important to note that this paper does not consider the horizontal equity between taxpayers who violate different law. If the IRS pursues an OVDP for offshore evaders, is it equitable to not give a similar program to those who are evading domestic corporate tax who want to enter compliance? It seems that if this program is successful, others might follow in its steps.

[52] Randall Jackson, *Audit Might Be Best Choice For United States Taxpayers in Voluntary Disclosure Program*, TAX NOTES TODAY, Apr. 8, 2010, *available at* 2010 TNT 68-1.

[53] *FAQ*, *supra* note 1, at 53.

prefer the certainty of knowing when they will have to make the payment. Thus, even though some taxpayers may not be better off quantitatively, other taxpayers will find it advantageous to enter the OVDP, and then opt out.

Consider an example of two fictional taxpayers' and their decision to enter the OVDP. Ms. Francis Bar (Ms. Bar) inherited four foreign accounts from wealthy overseas relatives, and used them for storing money in Europe to pay for travel expenses; the monies never left the foreign country and she does not live off the funds. The accounts earn very little income, as Ms. Bar held them in basic low interest and low risk savings accounts. She pays all foreign tax in a tax heavy jurisdiction. When she speaks to her domestic accountant annually, Ms. Bar does not disclose these accounts (nor does she report them or the corresponding foreign tax credits), as she is not aware that foreign accounts are relevant for U.S. income tax. Ms. Bar signed her Form 1040 and checked, "No" on Question 7a. Based on this information, if examined, there is a 5% chance that the IRS will find that she violated the FBAR regulation willfully.

Mr. William Full (Mr. Full) opened four foreign accounts to deposit money from his purely domestic self-owned business. He does not have family in the foreign jurisdiction, or any other reason to visit. Mr. Full works on a monthly basis with his accountant, but never mentions the foreign money. Mr. Full tells his lawyers that he deposits his money internationally because he believes in the diversification of asset location. He lives predominantly off the foreign earnings and moves most of the income back to the United States. Mr. Full signed his Form 1040 and checked "No" on Question 7a. Based on this information, and given that the IRS agent would be viewing only circumstantial evidence, there is a 50% chance that the IRS will find that he violated the FBAR regulation willfully, if the IRS examines him.

Each taxpayer, Ms. Bar and Mr. Full, has an aggregate account balance of $12,445,000, spread over four offshore accounts ($35,000; $80,000; $330,000; and $12,000,000 respectively). The 27.5% Offshore Penalty for both Ms. Bar and Mr. Full would be $3,422,375.[54]

When Mr. Full considers whether to enter the OVDP, he must know his expected penalty if examined outside of the OVDP. If the IRS finds Mr. Full to have willfully violated the FBAR Reporting Requirement, his FBAR Penalty would be $37,068,000.[55] However, if the IRS finds him to have violated the FBAR Reporting Requirement nonwillfully, his penalty would be $171,000.[56] Given that Mr. Full would be found willful 50% of

[54] $12,445,000 (aggregate account balance) × 0.275 (offshore penalty percentage) = $3,422,375 (offshore penalty).

[55] $37,068,000 (willful penalty) = $5,000 (first account) + $8,000 (second account) + $165,000 (third account) + $6,000,000 (fourth account) × 6 (for each year).

[56] $171,000 (nonwillful penalty) = $3,500 (first account) + $5,000 (second account) + $10,000 (third account) + $10,000 (fourth account) × 6 (for each year).

the time, his expected penalty if examined outside of the OVDP would be $18,619,500.[57]

Mr. Full will consider a variety of factors to determine whether or not he should enter the OVDP. First, he will consider his chances of the IRS catching him outside the OVDP. Mr. Full may look at whether the IRS is scrutinizing banks from the foreign jurisdiction and whether the foreign jurisdiction is entering into new tax agreements with the United States. Second, Mr. Full will find that entering the OVDP provides a very beneficial penalty framework. If he enters, he will save $15,197,175 as opposed to not entering the Program and being caught by the IRS. Third, Mr. Full will have to consider how much he values being compliant with tax law. Fourth, Mr. Full will have to consider how much he values the certainty of knowing how much he will pay and when he will pay it. Given that he lives off the money, this may be important for him. Finally, Mr. Full will have to decide whether he may be subject to criminal penalties. Since the IRS may find that he violated the FBAR Reporting Requirement willfully, this is a potential concern. Overall, this is a complex decision for Mr. Full, and it will depend on how heavily he weighs each factor. See Table 1 for a graphical summary of Mr. Full's decision.

Ms. Bar will also have a difficult decision to make. If the IRS finds Ms. Bar to have acted willfully, her FBAR penalties will be $37,068,000.[58] However, if the IRS finds her to have acted nonwillfully, her penalty will just be $171,500.[59] Given that the IRS would find her to be willful a projected 5% of the time, her expected penalty if examined outside of the OVDP is $2,015,850.[60] However, her expected penalty outside the OVDP is lower than the Offshore Penalty. If she does enter, she would likely opt out, and pay an expected $2,015,850.

Like Mr. Full, Ms. Bar will consider a variety of factors in deciding whether or not to disclose. First, like Mr. Full, she will consider the possibility of the IRS auditing her and specifically look at the IRS's international efforts in the foreign jurisdiction where her accounts are located. Second, Ms. Bar will not consider entering the OVDP a benefit in terms of the penalty framework, as she pays the same amount whether she enters (and opts out) or the IRS catches her outside the OVDP. Third, there is a good chance that Ms. Bar will want to enter the OVDP because of the utility of being compliant; as she always acted without an intent to violate the law, she will want to avoid being labeled a "tax cheat." Fourth, certainty is not likely to be important for her, because she does not live off the money. Finally, since it is unlikely that she acted willfully, criminal prosecution will not be a concern. Depending on how

[57] $18,619,500 (expected penalty) = willful (0.50 × $37,068,000.00) + nonwillful (0.50 × $171,000.00).

[58] $37,068,000 (Willful Penalty) = ($5,000 (first account) + $8,000 (second account) + $165,000 (third account) + $6,000,000 (fourth account)) × 6 (for each year).

[59] $171,000 (nonwillful penalty) = ($3,500 (first account) + $5,000 (second account) + $10,000 (third account) + $10,000 (fourth account)) × 6 (for each year).

[60] $2,015,8000 (expected penalty) = willful (0.05 × $37,068,000) + nonwillful (0.95 × $171,000).

heavily she weighs each of these factors, she will make her decision. No one can predict what decision either Mr. Full or Ms. Bar would make; however, by understanding what each taxpayer is considering, we can see how a change in the OVDP would affect their decisions. See Table 1 for a graphical summary of Ms. Bar's decision.

Table 1. Initial Decision Matrix for Ms. Bar and Mr. Full

	Enter the OVDP	**Avoid the OVDP and Risk Audit**
Ms. Bar (5% Willful; 80% Nonwillful)	Expected Penalty of $2,015,850 (after opt out); Enter Compliance	Expected Penalty of $2,015,850 if Examined; Potential to Avoid Penalty If No Audit
Mr. Full (50% Willful; 50% Nonwillful)	Guaranteed Penalty of $3,442,375; Enter Compliance; Avoid Criminal Prosecution; Certainty of Penalty Liability	Expected Penalty of $18,619,500 if Examined; Potential to Avoid Penalty If No Audit

Based on these two taxpayers, the goals of the OVDP are met. The utility of being compliant attracts a taxpayer like Ms. Bar to the OVDP. Likewise, the OVDP is attractive to Mr. Bar because it offers a lower expected tax liability, removal possible criminal penalties, and the certainty of the payment amount and timing. The decision for both taxpayers is not clear; it depends on how each taxpayer weighs the factors. However, the OVDPs wide range of incentives will likely convince many taxpayers to enter their overseas wealth.

In terms of equity, the OVDP does an acceptable job. A taxpayer like Mr. Full pays a reduced penalty compared to what he would have faced if caught outside the OVDP. That penalty, however, is still higher than for a taxpayer like Ms. Bar who will opt out and pay a lower FBAR Penalty.

III. POTENTIAL PROBLEMS AFTER *WILLIAMS*

A. The Changing Civil Willfulness Standard

The decision whether or not to enter the OVDP depends on whether the expected FBAR Penalty faced outside of the OVDP is higher or lower than the Offshore Penalty faced inside.[61] Thus, measurement of the

[61] Under the authority of 31 U.S.C. § 5314 (2013), enacted through the Bank Secrecy Act, the IRS requires taxpayers having a financial interest in or signature authority over one or more financial accounts held internationally, valued at a collective minimum of $10,000, to file an annual FBAR. In order to enforce the FBAR requirement, the IRS was given the power to assess civil penalties for failure to file. 31 C.F.R. § 103.56 (2013). The FBAR must be filed before June 30 of the calendar year after the account was recorded. Any person in the U.S., as a resident or a citizen, is subject to these reporting rules, and must file an FBAR. This is not limited to individuals; corporations, limited

FBAR penalty levies a great impact on the success of the OVDP. To determine the expected FBAR penalty for a specific taxpayer, the IRS considers three factors: the size of the account, the number of accounts, and the level of willfulness in committing the violation.[62] The first two factors are rather straightforward, and cause little controversy.[63] The final factor, level of willfulness, presents the most debate.

The IRS and various U.S. courts have been drawing a picture of what they consider a willful violation. On July 20, 2012, however, the civil willfulness standard underwent a potentially dramatic change after the Fourth Circuit Court handed down *United States v. Williams*, which was the first U.S. circuit court case ruling on the standard.[64] In this nonbinding opinion, the Appellate Court took a staunch position. Recently, a U.S. District Court in Utah followed a similar legal strategy as *Williams*.[65]

A review of the civil willfulness standard is necessary before examining how it potentially changed after *Williams*. The IRS considers three distinct levels of conduct: negligence, nonwillful, and willful. The negligence penalty applies only to businesses, and thus, is not a focus of this paper.[66] Regarding the latter two categories of conduct, the IRS levies a lower FBAR penalty on taxpayers who violate the FBAR requirement nonwillfully than those who did so willfully.[67] A nonwillful violator faces a maximum penalty of $10,000 per account per year.[68] The IRS offers the possibility of mitigation to reduce penalties based on

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liability corporations, and partnerships must also comply. Bank accounts and financial securities must be reported, as well as other financial accounts, such as shares of insurance proceeds, mutual funds, and annuities with a cash value. The IRS says that an FBAR must be filed for "tangible assets such as real estate or art; and intangible assets such as patents or stock or other interests in a U.S. or foreign business." *FAQ*, *supra* note 1, at 35. Any account held in a foreign bank is a foreign account, and must be reported. A bank is considered foreign for this purpose if the funds are actually kept in a foreign country, regardless of where the bank's headquarters are located. Thus, if funds are kept in a bank in foreign county, which has headquarters in the U.S., the bank is considered foreign. The penalty for an FBAR violation can be significant. It is important to first note that the IRS does not have to impose any penalties on a violation; rather, the IRS can issue a warning letter. The IRS will make that decision when "the facts and circumstances" do not justify a penalty. *See Id.* at 5. In these cases, a FBAR warning letter (I.R.M. § 4.26.17) is issued.

[62] I.R.M. § 4.26.14.4 (2008).

[63] This may be an understatement for the variable related to the number of individual accounts. A taxpayer who fails to file FBARs related to ten individual accounts, each worth $1,000,000, is liable for penalties commensurate to $1,000,000. However, a taxpayer who fails to file an FBAR for an individual account of $10,000,000 is liable for penalties commensurate to $100,000. The distinction is made to reflect the fact that an FBAR must be filed for each account, and thus the first taxpayer actually incurred ten separate violations, whereas the second taxpayer incurred only one. However, in this case, the IRS fails to adhere to principles of horizontal equity. There is a need to address this concern.

[64] Williams, *supra* note 8.

[65] *See* United States v. McBride, 908 F. Supp. 2d 1186 (D. Utah 2012).

[66] I.R.M. § 4.26.16.4.3 (2008).

[67] It is important to note that the IRS will generally pursue mitigation when possible. The purpose of the FBAR penalties is not to enforce punitive damages but to ensure compliance. Therefore, if IRS agents feel that a warning letter will, "promote compliance," and, "achieve the desired result of improving compliance in the future," the IRS Manual instructs agents to only offer the letter. I.R.M. § 4.26.16.4.7 (2008).

[68] I.R.M., *supra* note 62, at 4.26.14.4.

account size.[69] See Table 2 for a graphical explanation of the nonwillful penalty mitigation.

Table 2. Nonwillful Penalties Per Taxpayer Per Year

Penalty Level	Penalty Guideline	Penalty
Level 1	If the aggregate balance for all accounts in violation does not exceed $50,000, a Level 1 penalty applies.	$500 for each violation, not to exceed $5,000 for all violations.
Level 2	If a Level 1 penalty does not apply, and if the balance of an account to which the violations relate does not exceed $250,000, a Level 2 penalty applies.	$5,000 for each Level 2 violation, not to exceed 10% of the balance in each Level 2 accounts.
Level 3	If a Level 1 penalty does not apply, and if the balance of an account to which the violations relate exceeds $250,000, a Level 3 penalty applies.	$10,000 for each Level 3 violation.

The penalty for a willful violation is harsher. The IRS can hold any taxpayer liable for at least $100,000 per account per year, or 50% of the value of each account per year.[70] Once again, the IRS offers a penalty mitigation guideline. See Table 3 below for a graphical view.

[69] Mitigation is not available in all circumstances. The IRS agents are generally encouraged to offer mitigation to both willful and nonwillful violators when four conditions are met: (1) the taxpayer has no history of past FBAR penalty assessments, (2) no money passing through the foreign accounts in question is associated with an illegal source or used to further a criminal purpose, (3) the taxpayer cooperated through the FBAR investigation, and (4) the IRS did not pursue a claim for civil fraud for any year in question. I.R.M. § 4.26.16.4.5.6 (2008).

[70] I.R.M. § 4.26.16.4.5 (2008).

Table 3. Willful Penalties Per Taxpayer Per Year

Penalty Level	Penalty Guideline	Penalty
Level 1	If the aggregate balance for all accounts to which the violations relate did not exceed $50,000, a Level 1 penalty applies.	A minimum of $1,000 per violation or 5% of the balance of each account.
Level 2	If a Level 1 penalty does not apply, and if the balance an account to which the violations relate does not exceed $250,000, a Level 2 penalty applies.	A minimum of $5,000 per Level 2 violation or 10% of the balance for each Level 2 account.
Level 3	If the balance of an account to which the violations relate exceeds $250,000, but is less than $1,000,000, a Level 3 penalty applies.	A minimum of 10% of the balance of each Level 3 account or 50% of the closing balance of each Level 3 account as of the last day for filing the FBAR.
Level 4	If the balance of an account to which the violations relate exceeds $1,000,000, the Level 4 penalty applies.	A minimum of $100,000 per Level 4 violation or 50% of the closing balance of each Level 4 account as of the last day for filing the FBAR.

Consider how the IRS would have calculated Mr. Full's and Ms. Bar's expected FBAR penalties. If either taxpayer nonwillingly violated the FBAR reporting requirement each would face an FBAR penalty of $29,500 per year for six years.[71] However, if either taxpayer was willful, each would face an FBAR penalty of $6,272,500 each year for six years.[72] For Ms. Bar, there is an expected penalty of $2,015,850 ($1,853,400 from the 5% of being willful, and an expected $162,450 from the 95% of being nonwillful).[73] For Mr. Full, there is an expected penalty of $18,619,500 ($18,534,000 from the 50% chance of being willful and an expected $85,500 from the 50% chance of being

[71] The two smaller accounts would be level two violations, and the taxpayers will be liable for $9,500 ($5,000 + $4,500). The two larger accounts would be level three violations, totaling $20,000 ($10,000 each).

[72] The two smallest amounts will be considered Level 2 violations, totaling $10,000 of liability ($5,000 each). The next two higher accounts would be Level 3, and 4 violations, totaling liability of $6,262,500 ($162,500 + $6,100,000).

[73] *See* I.R.M., *supra* note 61, at 4.26.14.4.

nonwillful).[74] Even though both taxpayers have identical accounts, their expected FBAR penalties would vary significantly depending on their level of willfulness.

Given the significant difference between a willful penalty and a nonwillful penalty, it is vital for taxpayers to clearly understand the distinction between "willful" and "non-willful." Remarkably, prior to July 20, 2012, no case in a federal appellate court had defined *civil* willfulness in an FBAR case.[75] Instead, the IRS instructed taxpayers to rely on the *criminal* definition of willfulness when dealing with *civil* FBAR matters.[76] The IRS argued that the adoption of the criminal definition was appropriate because both statutes use the word "willful" in similar contexts.[77] See *United States v. Sturman*.[78]

The premier case interpreting willfulness is *Cheek v. United States.*[79] In *Cheek*, an individual, after attending a series tax seminars, withheld taxes because he believed that the income tax system was unconstitutional.[80] Mr. Cheek claimed that his genuine belief that taxes are unconstitutional indicated that he did not behave "willfully."[81] The Court defined willfulness as a "voluntary, intentional violation of a known legal duty."[82] The definition requires proof that (1) the law imposed a duty on the defendant, (2) the taxpayer knew of the duty, and (3) the taxpayer voluntarily and intentionally violated the duty.[83] Therefore, the Court found that Mr. Cheek acted willfully because he was aware of the duty to pay taxes and intentionally violated that duty; his belief that a duty is unconstitutional does not overturn the knowledge of it.[84]

The Supreme Court further refined its interpretation of willfulness in *Ratzlaf v. United States*[85] whereby the Court considered the concept of willfulness in a provision of the Bank Secrecy Act.[86] Although Ratzlaf

[74] *See* United States v. McBride, 908 F. Supp. 2d 1186 (D. Utah 2012).

[75] IRS Chief. Couns. Mem. 200603026 (Sept. 1, 2005).

[76] "Both section 5321(a)(5), providing for a civil penalty, and section 5322(a), providing for criminal penalties, contain similar 'willfulness' requirements…. The same word, willful, is used in both of these sections. Statutory construction rules suggest that the same word used in related sections have the same definition." *Id.*

[77] *Id.*

[78] The definitive case that applies here, and defines the criminal willfulness standard in an FBAR concept is United States v. Sturman, 951 F.2d 1466 (6th Cir. 1991). The taxpayers formed over 150 companies, five of which were located in a foreign country. *Id.* In addition to evidence of deceit, the taxpayer admitted to being aware of the Schedule B requirement. *Id.* The court cited Cheek v. United States, 498 U.S. 192 (1991) in that the willfulness standard was a, "voluntary, intentional violation of a known legal duty." *Id.* The corporations were created to conceal income, and therefore, the taxpayer did not report the corporations on his FBAR. *Id.* The Court found that "evidence of acts to conceal income and financial information" along with the taxpayers' failure to pursue the reporting requirements as Schedule B suggests. *Id.*

[79] 498 U.S. 192, 200 (1991).

[80] *Id.*

[81] *Id.*

[82] *Id.*

[83] *Id.*

[84] The case would have been different if Mr. Cheek's failure to file was a result of the complexity of the law. *Id.*

[85] Ratzlaf v. United States, 510 U.S. 135 (1994).

[86] This is the same act as the FBAR.

admitted to willfully committing a physical act that violated the Bank Secrecy Act, he denied that his actions were "willful," because he did not know that the physical action would violate the law.[87] The Court agreed with his argument, and found that to convict "willfully," the taxpayer had to violate a known law with the intent to violate that law.[88] Thus, the term willful, "consistently has been read by the Courts of Appeals to require both knowledge of the reporting requirement and a specific intent to commit the crime."[89] Additionally, the Court determined that circumstantial evidence may be enough.[90]

Courts have also relied on the concept of "recklessness." In *Safeco Insurance Co. of America v. Burr*[91] the Court held, regarding recklessness, that, "where willfulness is a statutory condition of civil liability, it is generally taken to cover not only violations of a standard made knowingly, but also recklessly."[92] It determined that "willfully" was a, "word of many meanings whose construction is often dependent on the context of which it appears."[93] Therefore, the difference between willful, wanton and reckless is meaningless.[94] The case culminated with the following: "at some point…a repeated failure to comply with *known* regulations can move a defendant's conduct from inadvertence neglect into reckless or deliberate disregard, and thus willfulness."[95]

The IRS has also equated willful blindness with willfulness. The IRS manual explains that, "willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements.[96] The IRS has provided an example of willful blindness to the FBAR requirement: "A taxpayer admits knowledge of and fails to answer a question concerning signature authority at foreign banks in Schedule B of his income tax returns. A failure to follow up by looking at the FBAR instructions to see if you have to file would provide some evidence of willful blindness."[97]

The IRS argues that signing a return constitutes willful evasion if the taxpayer fails to file a required FBAR. There are two bases for this argument. First, if the taxpayer reviewed the required instructions as part of question 7a, she had knowledge of the requirement and, thus, the

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[87] Ratzlaf, 510 U.S. at 141.

[88] *Id.*

[89] *Id.*

[90] In *United States v. Bilbrey*, 142 F.3d 437 (6th Cir. 1998) the court determined that signing a Form 1040 was not enough for a willful conviction, but additional circumstantial evidence may be. The taxpayer did not report all of her income on her tax returns, but did sign them. The court focused not only on the signature but on the fact that the taxpayer played an active role in the business, and had knowledge of the undisclosed income and revenue. There was additional evidence that she should have known that her tax returns did not report all the income, as she was living off the undisclosed income.

[91] America v. Burr, 551 U.S. 47 (2007).

[92] *Id.*

[93] *Id.*

[94] *Id.*

[95] Am. Arms Int'l v. Herbert, 563 F.3d 78, 85 (4th Cir. 2009). The IRS manual does not endorse this method. *Id.*

[96] *Id.*

[97] *Id.*

failure was willful. Second, if the taxpayer did not review the instructions required as part of question 7a, the taxpayer actively chose not to become aware of the law and was therefore willfully blind. Thus, as long as the taxpayer signed her return, she was (or should have been) aware of the FBAR requirement and the violation was willful. Before July 20, 2012, courts rejected this as prima facie evidence.[98]

In *Lurding v. United States,*[99] the court found that although signing a return makes the document, "his own," it does not give rise to enough knowledge, without other circumstances, to claim that the taxpayer willfully violated. Also, in *United States v. Mohney,*[100] the court said, "willfulness requires proof of specific intent to do something that the law forbids; more than a showing of careless disregard for the trusty is required."[101] Therefore, according to *Mohney*, a taxpayer's signature on a return does not in itself prove his knowledge, but knowledge can be inferred from surrounding facts and circumstances. Examples of such facts and circumstances are knowledge of business revenues, active role in operations, hiring of an accounting firm and payment of taxes.[102]

On July 20, 2012, the U.S. Court of Appeals for the Fourth Circuit released the first judicial opinion outside of the U.S. Tax Court which specifically adjudicated the civil willfulness standard in an FBAR context.[103] Prior to this decision, tax practitioners could not rely any upper level court for guidance as to the definition of willfulness in an FBAR context. In *United States v. Williams*, Mr. Williams opened two bank accounts located in Switzerland, which contained over $7,000,000 in principal and created over $800,000 in income through 2000. During that time, Mr. Williams failed to report both the income earned from this account (as required in 26 USC § 61) and the presence of this account on his FBAR (as required in 26 USC § 5314). Form 1040, question 7a asked: "At any time during 2000, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See instructions for exceptions and filing requirements for Form TD F 90-22.1."[104]

Mr. Williams checked "No" for this answer, and did not review the instructions or send in an FBAR. After the IRS became aware of Mr. Williams' violations, it began a criminal investigation into his actions.[105] Mr. Williams pled guilty to conspiracy to defraud the IRS and criminal tax evasion. He admitted to knowing about the obligation to file an FBAR since 1993.[106] The IRS subsequently assessed a civil penalty of

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[98] *See* United States v. Bilbrey, 142 F.3d 437 (6th Cir. 1998); United States v. Sturman, 951 F.2d 1466, 1474 (6th Cir. 1991).

[99] Lurding v. United States*,* 179 F.2d 419 (6th Cir. 1950).

[100] United States v. Mohney, 949 F.2d 1397 (6th Cir. 1991).

[101] *Id.*

[102] *Id.*

[103] United States v. Williams, 489 F. App'x 655 (2012).

[104] I.R.M.*, supra* note 62, at 4.26.16.1.

[105] Williams, 489 F. App'x at 657 n.2.

[106] *Id.*

$200,000 against Mr. Williams for failure to file his 2000 FBAR.[107] The district court ruled that the IRS failed to establish that Mr. Williams willfully violated the law. The IRS appealed that decision to the Fourth Circuit.[108]

On appeal, both parties agreed that a violation occurred; the question before the court was whether the violation occurred willfully. The court began its analysis with a reminder that Mr. Williams signed his 2000 tax return under a penalty of perjury, and that, "a taxpayer who signs a tax return will not be heard to claim innocence for not having actually read the return, as he or she is charged with constructive knowledge of its contents."[109] The court concluded that because Mr. Williams signed his return he knew the contents of his return, specifically line 7a.[110]

Mr. Williams, however, claimed to have never read line 7a, or the instructions for the FBAR.[111] The court held that Mr. Williams engaged in a, "conscious effort to avoid learning about reporting requirements," or willful blindness.[112] Additionally, the court viewed his admission in the criminal case that he was aware of the requirement as further evidence of his willful behavior. The court, therefore, overruled the district court and found Mr. Williams guilty for willfully failing to file an FBAR.[113]

Although decided by the Fourth Circuit Court, the case was unpublished, and thus, not binding on any subsequent court.[114] This gives other courts the latitude to make their own decisions, and potentially diverge from the *Williams* case. Practitioners, however, must now consider the possibility that other courts will follow *Williams* and view checking "No" on question 7a as an important factor.

Substantively, the *Williams* case pursued a different method for viewing the civil willfulness standard than the lower courts.[115] The court considered the fact that Mr. Williams signed his Form 1040 and said "No" for question 7a, the main factor in finding him liable, and only minimally discussed the circumstantial evidence against him. This contrasts with the previous approach taken by lower courts to analyze the facts before rendering a decision on willfulness. Practitioners must now be more careful when advising clients. There is now a possibility that courts will be more likely to find willfulness in the case of a box checked "No." While the Fourth Circuit stopped short of declaring a strict liability

[107] *Id.*
[108] *Id.*
[109] Williams, 489 F. App'x. at 659 (citing Greer v. Commissioner of Internal Revenue, 595 F.3d 338, 347 n.4 (2010)).
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *Id.*
[114] *Id.*
[115] Not only is *Williams* significant because it used a different method of viewing the issue, but also because it took place at a higher court.

standard, many observers feel such a standard will virtually be applied going forward.[116]

The *Williams* ruling will make the IRS more likely to find taxpayers willful, given many taxpayers check "No" on question 7a and do not file an FBAR. This increased liability affects nearly half of taxpayers. In a study conducted in July 2010, attorneys were questioned about question 7a.[117] The survey estimated that out of those cases that enter the OVDP, slightly less than half of the returns checked "No."[118] Most often, tax practitioners noted, the error was caused either by return preparation software or a simple oversight.[119] In spite of the reason for checking "No," the new *Williams* standard turns the odds against taxpayers in a willfulness determination.

B. Why a Changing Willfulness Standard Affects the OVDP

The potential effect of this stringent civil willfulness standard on those who checked "No" will be significant to the OVDP in two ways. First, *Williams* may make it more beneficial for a taxpayer to join the OVDP because under *Williams* the expected tax liability of avoiding the OVDP is increased. Second, if the expected FBAR penalty outside the Program increases, it will make entry to the OVDP, and taking the 27.5% offshore penalty, more attractive.

Consider how this change would affect Mr. Full and Ms. Bar. For Ms. Bar, we estimated that there was an initial probability of 5% that the IRS would find her willful. However, if we factor in the potential of *Williams*, it is reasonable to estimate that the probability the IRS will find the taxpayer willful may rise to 20%. Thus, we can predict that her expected FBAR penalty outside of the OVDP will be $7,550,400, an increase of about 275%.[120] Mr. Full will see a relatively lower impact based on *Williams*. Initially, he had a projected 50% chance of being found willful. Considering *Williams*, we can be more confident that the IRS will find willfulness and estimate his probability at 75%. Thus, his expected FBAR penalty outside the OVDP is $27,843,750, [121] an increase of almost 50%.

Williams will also change the estimated payment for entering the OVDP. Although taxpayers may still opt out of the OVDP and accept the normal FBAR penalty, *Williams* increases the expected FBAR penalty obtained through opting out. After *Williams*, it is likely that the expected

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[116] Jeremiah Coder, *FBAR Penalty Case Reversal Raises Questions About Civil Willfulness Standard*, TAX NOTES TODAY, July 24, 2012, *available at* 2012 TNT 142-2.

[117] Daniel L. Gottfried, *Proving Willfulness in FBARS – Checking 'No' Ain't Apropos*, TAX NOTES TODAY, Sept. 2010, *available at* 2010 TNT 188-14.

[118] *Id.*

[119] *Id.*

[120] $7,550,400 (expected penalty) = willful (0.20 × $37,068,000) + nonwillful (0.80 × $171,000).

[121] $27,843,750 (expected penalty) = willful (0.75 × $37,068,000) + nonwillful (0.25 × $171,000).

liability of the FBAR penalty will be higher than the offshore penalty, thus making the opt out less beneficial. The taxpayer who would have previously opted out may find that accepting the offshore penalty is the best option. This makes the OVDP more appealing, as the offshore penalty provides a more beneficial framework.

Consider how these changes affect our two taxpayers' decision to enter OVDP. If Ms. Bar avoids the OVDP, her expected liability rises to $7,550,400, and she is therefore more likely to enter. By entering the OVDP, she will have to pay the offshore penalty of $3,422,375, as opting out is not optimal. However, she will now have a lower penalty by entering the OVDP than if the IRS caught her outside the OVDP. In comparison, Ms. Bar previously would have paid the same penalty inside the OVDP (by opting out) as she would outside. Her decision matrix is reduced to whether paying $3,422,374, plus being compliant and knowing liability (rather than being subject to an audit), is better than the possibility of never getting caught (which would cost $7,550,400). Although we cannot be sure what she will do, she has more incentive to enter the OVDP.

If Mr. Full stays outside the OVDP, he will have an expected FBAR penalty of $27,843,750. However, by entering the OVDP, he will only pay the offshore penalty of $3,422,375. Thus, after *Williams*, Mr. Full will pay $24,471,375 less by entering the OVDP than if caught by the IRS. By comparison, without the *Williams* decision, Mr. Full would have had to pay $18,619,500 if caught by the IRS and only $3,422,375 if he entered the OVDP. Like Ms. Bar, his decision matrix is reduced to whether paying $3,422,375, plus being compliant and knowing liability (rather than being subject to an audit), is better than the possibility of never getting caught (which would cost $27,843,750). He is clearly more incentivized to enter the OVDP.

Table 4. Decision Matrix After *Williams* for Ms. Bar and Mr. Full

	Enter the OVDP	Avoid the OVDP and Risk Audit
Ms. Bar (20% Willful; 80% Nonwillful)	Guaranteed Penalty of $3,422,375; Enter Compliance	Expected Penalty of $7,550,400 if Examined; Potential to Avoid Penalty If No Audit
Mr. Full (70% Willful; 30% Nonwillful)	Guaranteed Penalty of $3,442,375; Enter Compliance; Avoid Criminal Prosecution; Certainty of Penalty Liability	Expected Penalty of $27,843,750 if Examined; Potential to Avoid Penalty If No Audit

From an efficiency perspective, the *Williams* case will make Mr. Full and taxpayers like him more inclined to enter into the OVDP. If Mr. Full was previously on the fence about entering the OVDP, the *Williams* case may motivate him to enter. It is unclear whether the *Williams* case will make Ms. Bar and taxpayers like her more inclined to enter the OVDP. For the taxpayer like Ms. Bar, the cost of entering the OVDP has significantly increased. With the opt out potentially not as important, she will likely face the offshore penalty if she enters the OVDP. However, the cost of staying outside the OVDP has also increased dramatically. In Ms. Bar's situation, it makes *slightly* more sense quantitatively for her to enter the OVDP. However, Ms. Bar may now be more willing to sit out and hope that the IRS will not audit her, considering the penalty levels are higher.

Nina Olson, the National Taxpayer Advocate, addressed this problem by writing that, "[i]ncreasing the danger that taxpayers who have reasonably and in good faith tried to comply will nonetheless be penalized may achieve an opposite result: that the IRS or the tax rules will be perceived as unfair, and voluntary compliance will suffer."[122]

From an equity perspective, the OVDP becomes more flawed after *Williams*. Before the *Williams* case, the IRS treated Mr. Full and Ms. Bar differently, reflecting the clear difference in their levels of willfulness, despite having the same amount in accounts overseas. If Mr. Full entered the OVDP, he would pay the 27.5% offshore penalty of $3,442,375, whereas if Ms. Bar entered the OVDP she would opt out and have an expected payment of only $2,180,225. Ms. Bar would have paid $1,200,000 less. After *Williams*, however, either taxpayer would be better off paying the 27.5% offshore penalty of $3,442,375 under the OVDP.

Although *Williams* will make some taxpayers (those for whom the opt out is not optimal) more likely to enter, it causes equity problems for those who would have benefitted from the opt out under a gentler willfulness standard. It is unjust to treat Mr. Full and Ms. Bar in the same manner by asking each to pay the same 27.5% penalty. Equity was not a concern pre-*Williams* because of the opt out procedure. However, policymakers need a new solution if the current opt out option will not provide equitable solutions to taxpayers like Ms. Bar.

IV. SUGGESTED NEW APPROACH TO THE OVDP

The future success of the OVDP is in question because of the equity problems created by *Williams*. Policymakers must devise a solution to address that problem, but also to preserve the success the IRS has had encouraging taxpayers to disclose foreign taxes while keeping administrative costs low. Policymakers must create a solution that holds taxpayers liable for different penalties based on culpability.

An excellent starting point for a potential solution is a program described by Nina Olson, the National Taxpayer Advocate. In a July 2012 report, prior to *Williams*, Ms. Olson proposed a tri-level OVDP to further promote equity. Given that *Williams* only exacerbated any previous equity problem, this solution is more relevant today than ever

[122] TAXPAYER ADVOCATE SERVICE, 2011 ANN. REP. at 198.

before. Under Ms. Olson's program the IRS must establish "broad but clearly defined categories for these taxpayers, based on the level of noncompliance."[123] The three suggested categories are:

1. Full Relief from FBAR and Information Reporting Penalties
    a. Taxpayers who have properly reported taxable income but did not file FBARs; and
    b. Taxpayers who did not properly report all taxable income, but the tax liability is below a threshold amount.
2. Taxpayers Who Have Reasonable Cause and Acted Nonwillfully
    a. Nonresident United States taxpayers who do not qualify for category 1 because they did not file tax returns and owe more in tax than the threshold amount; and
    b. Violators that the IRS cannot prove acted willfully.
3. Taxpayers Not Included in Category 1 or 2
    a. All other taxpayers[124]

Under the first prong of Ms. Olson's Program there are two circumstances which allow the disclosing taxpayer to have full relief from FBAR penalties. First, taxpayers who have been properly reporting income, but did not file an FBAR are immune from penalties.[125] Second, taxpayers whose taxable liability falls under a threshold amount will also not be penalized. There is no de minimus provision in the current OVDP. The second prong enforces a nonwillful FBAR penalty for taxpayers whom the IRS cannot prove acted willfully. Finally, the IRS will reserve the third prong for taxpayers who do not fall into the previous two categories, presumably willful violators who will be required to pay the offshore penalty.

The strength of Ms. Olson's program is that it forces taxpayers to opt out and choose a category. This will once again restore equity, as the IRS treats individual taxpayers differently. This is more beneficial than the current OVDP, because presently, when a taxpayer opts out and cannot prove nonwillfulness, the IRS charges a high FBAR penalty. However, in Ms. Olson's program, if the taxpayer does not fit, the second prong fails; presumably the taxpayer would simply pay the offshore penalty under the third prong. Given that for many taxpayers the offshore penalty is substantially lower than the willful FBAR penalty, this will reduce the expected liability for most nonwillful taxpayers. The OVDP, however, is more difficult to administer. Almost every taxpayer would find it beneficial to argue for nonwillfulness. The only cost for a taxpayer who chooses to make this argument is additional attorney's fees.

This paper proposes tweaking Ms. Olson's program to streamline the administrative concerns. The first prong, also assessing no liability, should be modified to include taxpayers who failed to file an FBAR but

[123] TAXPAYER ADVOCATE SERVICE, 2013 FISCAL ANNUAL OBJECTIVES.
[124] *Id.*
[125] There is a similar provision in the IRS's FAQ. *See FAQ, supra* note 1, at 17.

have been reporting income, and taxpayers owing a back tax liability of less than $1,500, before interest and penalties. The de minimus provision would greatly reduce the administrative burden of the IRS without giving up substantial revenue. It also might induce more disclosure, which is the most important goal of the OVDP.

The modified program reserves the second prong for taxpayers taking the nonwillful penalty. Taxpayers either take the nonwillful penalty because the IRS could not prove that they acted willfully, or they have an aggregate balance under $100,000. The IRS would have the right to bring any taxpayer claiming they belong in the second prong to a tribunal to prove willfulness. If the IRS proves willfulness, it would subject the taxpayer to the third prong, and its 27.5% offshore penalty. The aggregate balance provision is as a de minimus provision, estopping the IRS from challenging relatively small accounts. When the IRS is determining the nonwillful penalty, it should assume all individual accounts were aggregated as one, as not to assess FBAR penalties for each individual account.

The third prong is for all other taxpayers, presumably those who clearly acted willfully. The IRS would assess the offshore penalty of 27.5%. Taxpayers choosing the third prong, however, would only be penalized 20% rather than being rerouted from the second prong. In short, Ms. Olsen's modified proposal is:

1. <u>Full Relief from FBAR and Information Reporting Penalties</u>
    a. Taxpayers who Failed to File an FBAR but Either Properly Reported the Income; or
    b. Taxpayers who Owe Less than $1,500 of Tax Liability Before Interest and Penalties
2. <u>Nonwillful Penalty Structure</u>
    a. All Taxpayers with an Aggregate Account Balance Under $100,000; or
    b. Taxpayers for whom the IRS Cannot Prove Willfulness
3. <u>Offshore Penalty Structure</u>
    a. All Other Taxpayers

This penalty structure addresses the administrative concerns of Ms. Olson's proposal. By giving taxpayers a 7.5% penalty reduction for initially entering the third prong, taxpayers who are clearly willful would be incentivized to forego the argument. The IRS would also have little incentive to attempt to prove the willfulness of taxpayers who are clearly nonwillful. This structure promotes equity while reducing administrative waste.

Consider how Ms. Bar's and Mr. Full's decision changes under this new Program.

Table 5. Decision Matrix After New Solution for Ms. Bar and Mr. Full

	Enter the OVDP	Avoid the OVDP and Risk Audit
Ms. Bar (20% Willful; 80% Nonwillful)	Expected Penalty of $732,475; Enter Compliance; Certainty of Penalty Liability	Expected Penalty of $7,550,400; Potential to Avoid Penalty If Not Audit
Mr. Full (70% Willful; 30% Nonwillful)	Expected Penalty of $2,489,000 (Accept 20% Penalty); Enter Compliance; Avoid Criminal Prosecution; Certainty of Penalty Liability	Expected Penalty of $27,843,750 if Examined; Potential to Avoid Penalty If No Audit

For Ms. Bar, the expected penalty of avoiding the OVDP remains at $7,550,400. The expected penalty, however, of entering the OVDP is reduced to $732,475. For Mr. Full, the expected penalty of avoiding the OVDP remains at $27,843,750. The expected penalty, however, of entering the OVDP is $2,489,000; higher than Ms. Bar's penalty but still lower than the penalty assessed under the current OVDP.

Under the modified OVDP, Ms. Bar and Mr. Full are incentivized to disclose. Ms. Bar's expected tax liability inside the OVDP is over ten times lower than her expected penalty if caught outside of the Program. Her expected penalty inside the OVDP falls from $3,422,375 to $732,475. That provides a remarkably better incentive for her to disclose under the modified solution. Furthermore, her likelihood of disclosure is increased by the certainty and utility of compliance. Mr. Full's expected tax liability inside the OVDP is more than nine times lower than his expected penalty if caught outside of the OVDP. His expected penalty inside the OVDP would fall from $3,422,375 to $2,489,000. This lower penalty gives him a marginally better reason to disclose under the modified OVDP. Although it is impossible to say whether either taxpayer would disclose, the more beneficial penalty framework would certainly make them more likely to disclose.

The modified OVDP not only improves disclosure incentives, but increases equity as well. Before this solution, both Mr. Full and Ms. Bar were best served paying the same offshore penalty under the OVDP. Given the new structure, Ms. Bar would likely argue that she is nonwillful, while Mr. Full would likely accept the third prong. Both taxpayers pay different expected tax liabilities, thus restoring the OVDP equity concerns caused by *Williams*.

V. CONCLUSION

Given the popularity and relative success of the OVDP over the last four years, the IRS cannot afford a decline in its effectiveness. As this paper explained, the OVDP has been successful according to its goals, and has given taxpayers a variety of reasons to disclose. Given the potentially powerful changes of the *Williams* case, however, the continued success of the OVDP is uncertain. Although it seems that there will still be incentives for taxpayers (especially willful taxpayers) to enter the OVDP, there are equity problems with the OVDP created by *Williams*.

This paper proposes a solution to ensure the OVDP's success by preserving administrative resources, and encouraging taxpayers to enter, while fixing equity concerns. Although this modified OVDP may sacrifice some revenue, the overall result will be a net gain from additional disclosure, thus assisting the IRS in future prosecutions.