

Volume 2

TAS RESEARCH AND RELATED STUDIES

# An Analysis of Tax Settlement Programs as Amnesties

## An Analysis of Tax Settlement Programs as Amnesties<sup>1</sup>

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## EXECUTIVE SUMMARY

Research generally suggests that broad and frequent one-size-fits-all amnesties can reduce government revenues in the long run. They can reduce future compliance by eroding perceptions of fairness, revealing noncompliance norms, or diluting economic deterrence.<sup>2</sup> However, the IRS and tax agencies around the world routinely adopt amnesties, such as programs to address mass-marketed tax schemes or undisclosed and untaxed funds held in other countries (*i.e.*, offshore voluntary disclosure programs or OVDPs). This discussion reviews amnesty research to identify when and how tax administrators can use settlement programs to minimize unnecessary burdens and disputes, and improve future compliance.

Narrowly-tailored settlement programs aimed at specific objectives are less likely to threaten future compliance than broad amnesties aimed at accelerating short-term revenues. More importantly, settlement programs should be coupled with other compliance-enhancing measures. For example, they may help smooth the transition from widespread noncompliance to compliance norms, provided the agency can credibly commit to maintain the new norms (*e.g.*, by increased service, monitoring, or enforcement). Increases in penalties and new automated information exchanges (including third-party reporting) provide opportunities for tax agencies to make credible commitments to improve compliance norms, provided the agencies can also assure taxpayers that penalties will be applied fairly and their private financial information will not be used inappropriately.<sup>3</sup>

In addition, settlement programs should take into account the motivational posture of the taxpayer (*i.e.*, were they trying to comply or game the system?). When those who made honest mistakes have a reasonable and easy way to correct them without facing unexpectedly harsh consequences designed for bad actors, the program may promote compliance by improving trust for the agency. An analysis of the IRS's OVDPs suggests there are risks to a one size-fits-all approach.

## INTRODUCTION

Research suggests that broad and frequent tax amnesty programs generally do not generate revenue that exceeds their true long-term costs.<sup>4</sup> Their costs may include (1) the cost of foregone revenue (*i.e.*, the waiver of penalties, interest, and taxes) that might otherwise have been collected, (2) the costs of administering the amnesty, and (3) the potential for a reduction in future compliance.<sup>5</sup>

Despite the potential costs of amnesties, tax settlement programs, including OVDPs, generally provide some level of amnesty. The Organization for Economic Cooperation and Development (OECD) recommends that tax agencies consider voluntary disclosure programs as they receive more information about citizens' and residents' assets in other countries, and at least 47 countries have adopted OVDPs,

2 Economic deterrence is when a person complies because he or she expects that the economic cost of noncompliance (including penalties and interest) will exceed the expected economic gains. For the foundations of this theory, see, *e.g.*, Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1 193 (1985); A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. ECON. LIT. 45 (2000). For a tax-specific application, see, *e.g.*, Maurice Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323-38 (1972).

3 This paper does not explore the legitimate concerns raised about the protection, use, and misuse of tax-related information.

4 See KATHERINE BAER & ERIC LE BORGNE, *TAX AMNESTY: THEORY, TRENDS, AND SOME ALTERNATIVES* 55-59 (International Monetary Fund, 2008).

5 *Id.*

including the U.S.<sup>6</sup> Research on amnesties can inform the structure and design of a settlement program such as an OVDP.

Tax agencies may offer amnesty to:<sup>7</sup>

- (1) Collect back taxes that would not otherwise be identified or collected;<sup>8</sup>
- (2) Avoid the administrative costs of enforcement and appeals;<sup>9</sup>
- (3) Improve future compliance by reducing the cost of rejoining the tax system, and increasing the likelihood that future noncompliance will be detected and punished;<sup>10</sup>
- (4) Obtain information about who is noncompliant and why;<sup>11</sup>
- (5) Induce the repatriation of capital;<sup>12</sup> and
- (6) Be fair to noncompliant taxpayers by giving them a chance to comply before enforcing previously unenforced rules or implementing stiffer penalties, information reporting, or enforcement initiatives.<sup>13</sup>

- 6 Organization for Economic Cooperation and Development (OECD), *Update on Voluntary Disclosure Programs: A Pathway to Tax Compliance* 6-7 (2015), <http://www.oecd.org/ctp/exchange-of-tax-information/Voluntary-Disclosure-Programmes-2015.pdf>. See also OECD, *Improving Access to Bank Information for Tax Purposes, The 2007 Progress Report* 26-34 (2007), <https://www.oecd.org/ctp/exchange-of-tax-information/39327984.pdf>. OECD's decision tree for designing voluntary disclosure programs requires decisions about (1) reasons for the amnesty, (2) scope, (3) terms, (4) reporting requirements, (5) intelligence gathering opportunities, and (6) communications strategy. See OECD, *Starting A Voluntary Disclosure Initiative or Program – Decision Tree*, <https://www.oecd.org/tax/forum-on-tax-administration/publications-and-products/vdp-decision-tree.pdf> (last visited Nov. 29, 2017).
- 7 For a general discussion of amnesties and the reasons for them, see, e.g., Bessie Ross, *Federal Tax Amnesty: Reflecting on the States' Experiences*, 40 *Tax Law.* 145, 156-57 (1986); Arun Malik & Robert Schwab, *The Economics of Tax Amnesties*, 46 *J. Public Econ.* 29-49 (1991); Herman Leonard & Richard Zeckhauser, *Amnesty Enforcement and Tax Policy*, in *Tax Policy and the Economy*, Vol. 1, 55-85 (Lawrence Summers, ed., 1987), <http://www.nber.org/chapters/c10929.pdf>.
- 8 See, e.g., John Hasseldine, *Tax Amnesties: An International Review*, 52 *Bulletin for International Fiscal Doc.* 303, 307 (1998) (finding that revenues from the 43 state tax amnesties offered between 1982 and 1998 ranged from 0.008% to over 2% of state tax revenues); Ralph Bayer et al., *Amnesty Information from US States Between 1981 and 2011*, 125 *J. Pub. Econ.* 70, 79-81 (2015) (finding that amnesties brought in between 0.001% and 1.5% of a state's revenue and that the likelihood of a U.S. state offering an amnesty appeared to be driven mainly by its fiscal requirements). For some of the same reasons, the IRS may accept an offer in compromise to settle tax liabilities that the taxpayer cannot pay. See Internal Revenue Code (IRC) § 7122.
- 9 Dominika Langenmayr, *Voluntary Disclosure of Evaded Taxes — Increasing Revenue, or Increasing Incentives to Evade?*, 151 *J. Pub. Econ.* 110–125 (2017) (finding that Offshore Voluntary Disclosure Programs (OVDP)s can save significant administrative resources). Under some state voluntary compliance initiatives, taxpayers who wanted appeal rights had to give up some of the benefits of the amnesty. LeAnn Luna, et al., *State Tax Amnesties: Forgiveness Is Divine – And Possibly Profitable*, 41 *State Tax Notes* 497, 507 (Aug. 21, 2006). Perhaps for the same reason, taxpayers who fail to pay the tax they reported on a timely-filed return can receive a reduced failure-to-pay penalty rate for any month during which they have an installment agreement in effect. IRC § 6651(h). Similarly, a statutory period of limitations is a form of amnesty for old violations, which could be justified, in part, on the basis that it would take more resources to pursue them. See IRC § 6501.
- 10 See, e.g., Bessie Ross, *Federal Tax Amnesty: Reflecting on the States' Experiences*, 40 *Tax Law.* 145, 156-57 (1986). Offers in compromise may also further this objective, as they include a requirement to file and pay for the following five-year period. IRS Form 656, *Offer in Compromise* (Mar. 2017).
- 11 See, e.g., Herman Leonard & Richard Zeckhauser, *Amnesty Enforcement and Tax Policy*, in *Tax Policy and the Economy*, Vol. 1, 55, 61 (Lawrence Summers, ed., 1987), <http://www.nber.org/chapters/c10929.pdf> (“Parking ticket amnesties result in a current address list useful in future collection efforts, thus making future compliance more likely. An amnesty for toxic waste dumps might permit society to find out where they are before poisons filter into groundwater. And a tax amnesty makes future adherence to the tax code more likely by removing the need to conceal past sins.”).
- 12 See, e.g., KATHERINE BAER & ERIC LE BORGNE, *Tax Amnesty: Theory, Trends, and Some Alternatives* 6 (International Monetary Fund, 2008).
- 13 See, e.g., Herman Leonard & Richard Zeckhauser, *Amnesty Enforcement and Tax Policy*, in *Tax Policy and the Economy*, Vol. 1, 55, 62 (Lawrence Summers, ed., 1987); Craig M. Boise, *Breaking Open Offshore Piggybanks: Deferral and the Utility of Amnesty*, 14 *Geo. Mason L. Rev.* 667, 709 (2007).

The broadest form of tax amnesty forgives tax, interest, and penalties, even for noncompliance that has already been detected. Broad amnesties provide a strong financial incentive to participate. Tax agencies may use them to promote future compliance when taxpayers have acted reasonably or the government contributed to the noncompliance. For example, the U.S. Supreme Court has called into question the legality of the requirement for out-of-state sellers to collect certain state sales and use taxes.<sup>14</sup> Some states have responded by offering sellers broad amnesty if they agree to collect these taxes in the future.<sup>15</sup> Broad amnesty may also be offered for other reasons on a case-by-case basis, for example, as part of an offer in compromise (OIC) or settlement agreement.<sup>16</sup> By contrast, the narrow amnesties may forgive only criminal penalties.<sup>17</sup>

## DISCUSSION

### Broad Amnesties Can Erode Voluntary Compliance, Particularly If Repeated

The government's short-term goal of using an amnesty to raise short-term revenue can sometimes conflict with its long-term goal of improving voluntary compliance.<sup>18</sup> An amnesty could potentially reduce voluntary compliance if it:

- (1) Is viewed as unfair because it allows noncompliant taxpayers to pay less than compliant ones (after inflation), potentially eroding tax morale;<sup>19</sup>
- (2) Reveals that a large percentage of the population evades taxes or otherwise reduces the stigma of noncompliance, potentially eroding social norms (*i.e.*, reducing the motivation to comply based on whether people think others do);<sup>20</sup> or

14 See, e.g., *National Bellas Hess, Inc. v. Dept. of Revenue*, 386 U.S. 753 (1967); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

15 See LeAnn Luna, et al., *State Tax Amnesties: Forgiveness Is Divine – And Possibly Profitable*, 41 STATE TAX NOTES 497, 504-05 (2006).

16 See, e.g., IRC §§ 7121 and 7122.

17 Another type of amnesty is for a tax agency to agree not to audit taxpayers who amend their returns to report and pay more than a specified amount. See, e.g., KATHERINE BAER & ERIC LE BORGNE, *TAX AMNESTY: THEORY, TRENDS, AND SOME ALTERNATIVES* 9-10 (International Monetary Fund, 2008). Amnesties may also be categorized as covering returns, investigations, or prosecutions. See Luigi Alberto Franzoni, *Punishment and Grace: On the Economics of Permanent Amnesties* 3 (Univ. of Bologna Dep't of Econ., Working Paper No. 252, 1996), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.199.7787&rep=rep1&type=pdf>.

18 For example, governments can potentially increase amnesty revenues by allowing those who have already been detected to participate and by providing amnesty for both penalties and interest. See James Alm & William Beck, *Wiping the Slate Clean: Individual Response to State Tax Amnesties*, 57 SOUTHERN ECON. J. 1043-53 (1991); John Mikesell & Justin Ross, *Fast Money? Contribution of State Tax Amnesties to Public Revenue Systems* 65 NAT'L TAX J. 529-62 (2012).

19 See, e.g., Treasury Department Report to the President, *Tax Reform for Fairness, Simplicity, and Economic Growth*, vol. 1, 91 (1984), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Tax-Reform-v1-1984.pdf> (opposing amnesties because they send the message: "Don't bother to pay now. We may forget you owe anything. Even if you have to pay tax, we won't charge interest"); Leo Martinez, *Federal Tax Amnesty: Crime and Punishment Revisited*, 10 VA. TAX. REV. 535-85 (1990).

20 See, e.g., John Hasseldine, *Tax Amnesties: An International Review*, 52 BULLETIN FOR INT'L FISCAL DOC. 303, 304 (1998); Lars Feld and Bruno Frey, *Tax Amnesties and the Psychological Tax Contract* 21 (Ga. State Univ., Int'l Studies Prog., Working Paper 07-29, 2007).

- (3) Reveals a tax agency's inability to detect noncompliance, lack of resources for enforcement, or increases the expectation that a broad amnesty will be offered in the future, potentially diluting economic deterrence.<sup>21</sup>

These problems are exacerbated if the government offers broad amnesties to everyone on a regular basis.<sup>22</sup> Governments can potentially offset these negative effects by coupling an amnesty with a credible commitment that it will change noncompliance norms, for example, by making compliance easier or through stepped-up monitoring (*e.g.*, information reporting or exchanges), enforcement, services, or increased penalties.<sup>23</sup> Moreover, if the agency has the ability to improve compliance norms, amnesties can accelerate those improvements.<sup>24</sup>

### Limited Amnesties or Amnesty Alternatives Do Not Raise the Same Concerns

Amnesties that simply allow people to pay their back taxes with interest before their noncompliance is detected should have little effect on economic deterrence (*i.e.*, the expected economic costs (and benefits) of noncompliance).<sup>25</sup> Because such narrow amnesties do not change the economic incentive to any significant extent, they are most likely to attract taxpayers whose noncompliance was inadvertent or

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- 21 James Alm & William Beck, *Tax Amnesties and Tax Revenues*, PUBLIC FINANCE QTRLY 433 (Oct. 1990) (finding that compliance decreased after a broad amnesty); Arun Malik & Robert Schwab, *The Economics of Tax Amnesties*, 46 J. PUB. ECON. 29-49 (1991) (suggesting that taxpayers should report less income as the probability of an amnesty rises). For the same reasons, the Joint Committee on Taxation (JCT) scored a broad amnesty as a revenue loser. See JCT, JCS-2-98, *Tax Amnesty* (1998). However, an earlier review of international amnesties concluded that “a well-designed tax amnesty program, accompanied by structural and tax reforms, has the potential to lead to beneficial results in both developed and developing countries.” Eliot Uchitelle, *The Effectiveness of Tax Amnesty Programs in Selected Countries*, FED. RES. BANK N.Y. QTRLY REV. 48, 53 (Autumn 1989), [https://www.newyorkfed.org/medialibrary/media/research/quarterly\\_review/1989v14/v14n3article5.pdf](https://www.newyorkfed.org/medialibrary/media/research/quarterly_review/1989v14/v14n3article5.pdf).
- 22 See, *e.g.*, Hari Luitel & Russell Sobel, *The Revenue Impact of Repeated Tax Amnesties*, 27 PUB. BUDGETING & FIN. 19-38 (2007) (finding that states that offer repeated tax amnesties generate less revenue from them than the initial amnesties, and that compliance declines afterward); Tonia Padiaditaki, *Tax Amnesties and Tax Compliance: The Case of Greece* (International Conference on Taxpayer Rights Washington, D.C., Nov. 18-19, 2015), <http://slideplayer.com/slide/9361648/> (discussing problems with Greece's repeated amnesties).
- 23 See, *e.g.*, James Alm & William Beck, *Tax Amnesties and Compliance in the Long Run: A Time Series Analysis*, 46 NAT'L TAX J. 53-60 (Mar., 1993) (finding an amnesty in Colorado that applied to civil and criminal penalties and excluded those who had been detected had no significant effect on voluntary compliance when coupled with stepped-up enforcement and increased penalties); James Alm, Jorge Martinez-Vazquez, & Sally Wallace, *Do Tax Amnesties Work? The Impacts of Tax Amnesties During the Transition in the Russian Federation*, 39 ECON. ANALYSIS POL. 235, 248 (2009) (finding the amnesties offered during the transition in the Russian Federation had no impact on the level or the trend of tax collections, even though they were expected to be repeated and not necessarily combined with increased enforcement or tax reform); Julio Lopez-Laborda & Fernando Rodrigo, *Tax Amnesties and Income Tax Compliance: The Case of Spain*, 24 FISC. STUDIES 73-96 (2003) (finding a 1991 amnesty in Spain had no effect on tax collection); Lars Feld & Bruno Frey, *Tax Evasion, Tax Amnesties and the Psychological Tax Contract*, 21 (Ga. State Univ., Int'l Studies Prog., Working Paper 07-29, 2007) (arguing that if amnesties are implemented “very infrequently, *e.g.*, only every two generations, the negative side effects on honest taxpayers could be kept moderate.”); KATHERINE BAER AND ERIC LE BORGNE, *TAX AMNESTY: THEORY, TRENDS, AND SOME ALTERNATIVES* 57 (International Monetary Fund 2008) (concluding “if combined with a credible closing of the sources of noncompliance... and a fundamental change in the way tax administration operates, [an amnesty program] may be appropriate ...”).
- 24 See Inés Macho-Stadler, Pau Olivella, & David Pérez-Castrillo, *Tax Amnesties in a Dynamic Model of Tax Evasion*, J. PUB. ECON. THEORY, 439, 440 (1999) (“if the government does not proclaim an amnesty in the presence of such improvements [in enforcement], the economy will only converge slowly to the new steady state [of increased compliance], whereas the simultaneous proclamation of an amnesty accelerates the process (or even makes it instantaneous).”).
- 25 See, *e.g.*, Arun Malik & Robert Schwab, *The Economics of Tax Amnesties*, 46 J. PUB. ECON. 29, 30-31 (1991) (observing that under the standard model of tax evasion even if an amnesty “led the taxpayer to believe that amnesties might be offered in the future, his future behavior would not change (as long as he believed that interest on unpaid taxes would never be forgiven ... [it] would predict that no one would ever take advantage of an amnesty and the possibility of future amnesties would never affect people's future decisions.”).

whose views have changed,<sup>26</sup> rather than those committed to tax evasion.<sup>27</sup> Moreover, those who are not committed to future compliance are less likely to participate if they feel their participation may subject them to greater scrutiny in the future.<sup>28</sup>

Indeed, a review of state tax amnesties suggests that they generally attract people who owe relatively small amounts, rather than those with large chronic delinquencies.<sup>29</sup> Even among those whose original noncompliance was intentional, one survey of state amnesty participants found that it was due, in large part, to their inability to pay.<sup>30</sup> Some have suggested that amnesties can be a helpful way to identify those who want to comply.<sup>31</sup> An analysis of OVDP participation around the world suggests that one major category of holdouts includes those who remain “unwilling to pay the tax due.”<sup>32</sup>

By contrast, those who want to pay but cannot are better candidates for individualized amnesties, such as the IRS’s OIC program, which requires future compliance.<sup>33</sup> Because the IRS is probably not going to collect from these taxpayers in any event, the offer program probably does more to generate economic growth and future tax revenue than to increase the incentive for evasion.<sup>34</sup>

Providing penalty relief to those with small delinquencies whose misreporting was inadvertent and who correct it before being contacted by the tax agency, and who are most likely committed to future compliance, does not raise the same concerns about fairness, tax morale, or norms as a broader amnesty. Participants are following the norm of paying taxes with interest, albeit late. They may not even be

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- 26 See, e.g., Arun Malik and Robert Schwab, *The Economics of Tax Amnesties*, 46 J. PUB. ECON. 29, 31 (1991) (arguing that a person may participate in an amnesty simply because he discovers that “the cost of lying awake at night worrying that his hidden income will be discovered is larger than the benefit of lower taxes.”).
- 27 One study found that extrinsic factors (e.g., economic considerations) account for about two-thirds of the overall decision to make a tax amnesty disclosure and intrinsic factors (e.g., a feeling of responsibility to pay taxes) accounted for about one-third. Jonathan Farrar & Cass Hausserman, *An Exploratory Investigation of Extrinsic and Intrinsic Motivations in Tax Amnesty Decision-Making*, 2 J. TAX ADMIN. 47 (Portland State U., 2016).
- 28 OECD, *Update on Voluntary Disclosure Programs: A Pathway to Tax Compliance* 23-24 (Aug. 2015) (“Other concerns expressed related to...the risk that a disclosure would influence future risk assessments and trigger wider or future audit activity.”). One scholar also points out that if an amnesty reduces black market activity, it could reduce future enforcement revenue. See Arindam Das-Gupta and Dilip Mookherjee, *Tax Amnesties as Asset-Laundering Devices*, 12 J. L. ECON. & ORG. 408, 410 (1996).
- 29 See, e.g., Ronald Fisher, John Goddeeris & James Young, *Participation in Tax Amnesties: The Individual Income Tax*, 42 NAT’L TAX J. 15, 18 (1989) (finding most amnesty participants had relatively small delinquencies); David Joulfaian, *Participation in Tax Amnesties: Evidence from a State*, in PROCEEDINGS OF THE EIGHTY-FIRST ANNUAL CONFERENCE ON TAXATION, 128, 32 (National Tax Assoc., 1988) (finding amnesties “were most successful in attracting those with known liabilities and non-filers. However, they failed to attract those with long history of noncompliance. They also failed to attract individuals who file but under-report income.”); Charles Christian et al., *Evidence on Subsequent Filing from the State of Michigan’s Income Tax Amnesty*, 55(4) NAT’L TAX J. 703–21 (2002) (finding that about two-thirds of new filers and nine-tenths of previous filers who filed amended returns under Michigan’s amnesty, subsequently filed income tax returns, but that the additional revenue raised from these taxpayers was relatively small.).
- 30 Christina M. Ritsema et al., *Economic and Behavioral Determinants of Tax Compliance: Evidence from the 1997 Arkansas Tax Penalty Amnesty Program*, IRS Research Conference (2003), <https://www.irs.gov/pub/irs-soi/ritsema.pdf>.
- 31 See Luigi Alberto Franzoni, *Punishment and Grace: On the Economics of Permanent Amnesties* 3 (U. of Bologna Dep’t of Econ., Working Paper No. 252, 1996), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.199.7787&rep=rep1&type=pdf>. (“Amnesties induce taxpayers with the highest willingness to pay to self-select themselves and to elude the standard enforcement/prosecution procedure (which is costly to the administration)”).
- 32 OECD, *Update on Voluntary Disclosure Programs: A Pathway to Tax Compliance* 23-24 (Aug. 2015).
- 33 See, e.g., IRS Form 656, *Offer in Compromise* (2017) (items j and k).
- 34 While the possibility of compromising a tax liability may reduce the financial risk of noncompliance to some extent, the offer program does not reduce those risks very much. Those who cannot pay may avoid severe economic hardship either by accessing the social safety net or by entering the underground economy. However, the offer program allows the IRS to administer the terms under which a safety net will be offered and provides it with an opportunity to capture the goodwill that it produces.



viewed as getting special treatment because all taxpayers can avoid accuracy-related penalties, even after detection, if they can establish the misreporting was due to reasonable cause.<sup>35</sup> Indeed, such an amnesty could be viewed as fairer than applying penalties to every violation, potentially increasing trust for the agency along with voluntary compliance.<sup>36</sup>

Perhaps for this reason, the IRS has a longstanding amnesty program that allows taxpayers who have underreported their income to avoid the accuracy-related penalty (but not the failure to pay penalty) by filing “qualified amended returns” (QARs) any time before being contacted by the IRS.<sup>37</sup> If they come forward before being detected, they can also generally avoid being recommended for criminal prosecution under the IRS’s longstanding voluntary disclosure practice (VDP), as long as they follow through by cooperating and paying the liability.<sup>38</sup> Similarly, a survey of VDPs around the world by the OECD found that close to half of the countries (19 out of 47) that responded waived all monetary penalties for taxpayers who make voluntary disclosures.<sup>39</sup> Because amnesties that merely reduce or eliminate penalties are significantly different from broader amnesties — presenting smaller risks to voluntary compliance — we refer to them as amnesty alternatives.

## Offering Amnesty Alternatives Before Enforcement Is Consistent With the Responsive Regulation Model, Which Promotes Voluntary Compliance

### *The Responsive Regulation Model Requires Agencies to Respond Reasonably and Proportionally*

Adopting tax administration strategies that are responsive to the taxpayer’s motivational posture — applying education, amnesty, or amnesty alternatives to those who made honest mistakes, and reserving enforcement-oriented treatments for those committed to noncompliance — is consistent with the so-called “responsive regulation” tax compliance model. This model, which has been endorsed by the OECD Forum on Tax Administration Compliance Sub-group, and a number of tax agencies throughout the world, is shown in Figure 1.<sup>40</sup>

35 See IRC § 6664(c).

36 One simulation found that when an amnesty is regarded as fair it increases tax compliance. See Silvia Rechberger et al., *Tax Amnesties, Justice Perceptions, and Filing Behavior: A Simulation Study*, 32 L. & POLICY 214-25 (Apr. 2010). Another found that amnesties had significantly greater positive effects on voluntary compliance when citizens were engaged in discussion about them and then voted on them before they were implemented. See Benno Torgler, Christoph Schaltegger, & Markus Schaffner, *Is Forgiveness Divine? A Cross-Culture Comparison of Tax Amnesties*, 139 SWISS J. OF ECON. & STAT. 375-96 (2003), <http://www.sjes.ch/papers/2003-III-7.pdf>. See also, Bruno S. Frey & Lars P. Feld, *Deterrence and Morale in Taxation: An Empirical Analysis* 23 (CESIFO Working Paper No. 760, 2002) (concluding that a “‘respectful’ relationship of the tax authorities to the taxpayers crowds in tax morale while an ‘authoritarian’ relationship using instruments of deterrence has two countervailing effects: on the one hand the change in relative prices (the higher probability of being punished) reduces the incentives to evade taxes but on the other hand tax morale is undermined or crowded out.”).

37 See Treas. Reg. § 1.6664-2(c).

38 Internal Revenue Manual (IRM) 9.5.11.9 (Dec. 2, 2009) (requiring that (a) “A taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his/her correct tax liability.” and (b) “The taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.”).

39 OECD, *Update on Voluntary Disclosure Programs: A Pathway to Tax Compliance* 31 (Aug. 2015), <http://www.oecd.org/ctp/exchange-of-tax-information/Voluntary-Disclosure-Programmes-2015.pdf>.

40 See OECD, Forum on Tax Administration Compliance Sub-group, *Managing and Improving Tax Compliance*, 47, 70 (Oct. 2004), <http://www.oecd.org/dataoecd/44/19/33818656.pdf>. See also Valerie Braithwaite and Jenny Job, *The Theoretical Base for the ATO Compliance Model*, Centre for Tax System Integrity — Research Note 5 (2003), <https://digitalcollections.anu.edu.au/bitstream/1885/42101/2/researchnote5.pdf>; Swedish Tax Agency, *Right from the Start, Research and Strategies* 8, 110-16 (Aug. 2005). The OECD subsequently endorsed the “Co-operative Compliance” framework, pursuant to which the tax agency works collaboratively with large corporations that are willing to be transparent, establish tax compliance systems, and work with the agency to get early resolution of tax uncertainty. See, e.g., OECD, *Co-operative Compliance: A Framework* (2013). This new framework seems consistent with the responsive regulation model.



**FIGURE 1, Responsive Regulation Compliance Model**

The OECD explains responsive regulation as follows:

Taxpayers are more likely to increase voluntary compliance when they believe that the revenue authority acts in a way that is fair and reasonable. Regulatory response that is consistent with a framework such as the compliance pyramid reinforces this belief because taxpayers tend to regard tough enforcement action as more procedurally fair when persuasion has been tried first. Further, while taxpayers' value being trusted themselves, they want to know that the authority carries a big stick to deal with others who cannot be trusted. In this way, responsive regulation builds community confidence and belief in the legitimacy of the tax system.<sup>41</sup>

In other words, the use of an enforcement approach that assumes all violations are intentional (*e.g.*, by always asserting penalties) is inconsistent with responsive regulation and can reduce the perceived legitimacy of the agency and the tax system. Therefore, in certain situations an appropriately-structured amnesty or amnesty alternative can be consistent with the responsive regulation model, potentially even increasing public confidence in the tax agency.

*Sudden Enforcement of Previously-Ignored Laws May Not Be Viewed As Reasonable and Proportionate Without an Amnesty or Amnesty Alternative*

A tax agency's silence in the face of widespread noncompliance norms may be viewed as acquiescence. When the government does not enforce a law, it encourages otherwise-honorable people to mirror the government's priorities and view compliance as unimportant. Sudden and severe sanctions against these otherwise-honorable people may be seen as unfair, undermining the agency's legitimacy.<sup>42</sup> As one commentator has explained:

Both privately and publicly, we generally avoid the apparent unfairness that comes from changing our implicit contracts about enforcement. As our children grow older and more responsible, we do not enforce rules retroactively even if they were aware of them. We declare that prior violations are exempt (amnestied), but that in the future punishment will be consistent and more severe. The principle of not subjecting people to punishment more

41 OECD, Forum on Tax Administration Compliance Sub-group, *Managing and Improving Tax Compliance* 70 (Oct. 2004).

42 Accord Frank McKenna, *The Perceived Legitimacy of Intervention: A Key Feature for Road Safety* 9 (AAA Foundation for Traffic Safety, 2007) ("By warning drivers of the presence of enforcement, the aim is to provide the driver with every opportunity to change behavior. If the enforcement is transparent and warnings have been presented, then it is hard for the offending driver to claim that the procedure is unfair.").

severe than what they can reasonably be said to have risked when they committed the offense is embodied in our norms for parental behavior, our common law, and our constitutional prohibition against *ex post facto* laws.<sup>43</sup>

For this reason, increasing enforcement or increasing the penalties for previously unenforced or lightly-penalized conduct is likely to seem fairer if preceded by an amnesty or amnesty alternative.<sup>44</sup> Once an agency has allowed noncompliance norms to develop, it should consider an amnesty alternative. Doing so may support voluntary compliance and the failure to offer one may pose risks to future compliance, as otherwise-honest taxpayers may perceive the agency is treating them unfairly — upending the norms it allowed to develop without giving them an opportunity for self-correction. In any event, it may be impractical to change community norms by imposing penalties against the small minority of people that the agency has the resources to audit. Moreover, if as a practical matter only a small proportion of the violators are subject to a penalty, those who are penalized are more likely to feel unfairly singled out.

As an example, the Australian Taxation Office (ATO) reportedly damaged its reputation when addressing a mass-marketed tax scheme. Rather than proactively responding to questions about whether these schemes were legitimate, it was silent while tax professionals advised taxpayers that they were.<sup>45</sup> It waited until they invested, then adjusted their accounts and suggested they were tax cheats.<sup>46</sup> The ATO subsequently adopted a settlement program that waived interest and penalties, but the damage had already been done. Years later most participants still thought the settlement was unfair, held more negative views toward the agency, and reported about the same level of efforts to minimize taxes as before the ATO adjusted their accounts.<sup>47</sup>

Moreover, experiments suggest that people reciprocate by punishing unfair behavior even if it is not in their economic self-interest to do so.<sup>48</sup> Similarly, trust for the agency and the government is correlated with voluntary tax compliance.<sup>49</sup> Thus, when a tax agency's actions seem unfair, they can erode voluntary compliance. Conversely, an amnesty alternative could improve voluntary compliance if it seems fair, puts people on notice that noncompliance will be punished in the future, and fosters trust that the tax agency will address noncompliance in a reasonable and proportional manner that takes the taxpayer's facts and circumstances into account (*e.g.*, the taxpayer's motivational posture). At the margin, there is no reason to think that these factors are less important than economic deterrence.

43 Herman Leonard & Richard Zeckhauser, *Amnesty Enforcement and Tax Policy*, in *Tax Policy and the Economy*, Vol. 1 55, 62 n.7 (Lawrence Summers, ed., 1987), <http://www.nber.org/chapters/c10929.pdf>.

44 Similarly, the IRS sometimes delays the implementation of penalties for failure to comply with new requirements so that people have time to comply with them. See, *e.g.*, Notice 2013-56, 2013-39 I.R.B. 262 (delaying the implementation of penalties for failure to comply with new information reporting requirements).

45 See, *e.g.*, Kristina Murphy, *Procedural Justice and the Australian Tax Office: A Study of Scheme Investors* (Ctr. for Tax Sys. Integrity, Working Paper No. 35, 2002).

46 *Id.*

47 See Bevan Murphy, Kristina Murphy & Malcolm Mearns, *The Australian Tax System Survey of Tax Scheme Investors': Methodology and Preliminary Findings for the Third Follow-Up Survey 24-26* (Alfred Deakin Res. Inst., Working Paper No. 13, 2010).

48 See, *e.g.*, Matthew Rabin, *Incorporating Fairness into Game Theory and Economics*, 85 *AM. ECON. REV.* 1281-1302 (Dec. 1993), <https://people.hss.caltech.edu/~camerer/NYU/07-Rabin.pdf>; Colin Camerer and Richard H. Thaler, *Ultimatums, Dictators and Manners*, 9 *J. Econ. Persp.*, 209-19 (1995), <http://authors.library.caltech.edu/22127/1/2138174%5B1%5D.pdf>; Christine Jolls *et al.*, *A Behavioral Approach to Law and Economics*, 50 *STAN. L. REV.* 1471 (1998), [http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2797&context=fss\\_papers&sei-redir=1](http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2797&context=fss_papers&sei-redir=1).

49 See, *e.g.*, National Taxpayer Advocate 2012 Annual Report to Congress vol. 2, 1-70 (Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*) (finding that trust for the government and the IRS are correlated with estimated reporting compliance by small businesses).

### A Case Study: The IRS's Offshore Voluntary Disclosure Settlement Programs

An analysis of the IRS's OVDPs reinforces the findings discussed above. As the IRS was ramping up enforcement of the international information reporting requirements and Congress was increasing applicable penalties, the IRS offered a series of OVDPs. Possibly in an attempt to avoid diluting economic deterrence or discouraging compliant taxpayers, however, the IRS initially offered a very narrow one-size-fits-all amnesty alternative that required participants — typically those least committed to noncompliance — to pay hefty penalties. The IRS's one-size-fits all approach, which lumped people who made honest mistakes in with tax evaders — contrary to the responsive regulation model — likely damaged the perceived legitimacy of the IRS and its OVD programs.<sup>50</sup> The government's relatively sudden shift — from virtually no enforcement before 2004 to disproportionate penalties<sup>51</sup> — did nothing to promote the view that it was reasonable or trustworthy. Indeed, one study suggested that its 2009 OVDP increased tax evasion.<sup>52</sup>

### Noncompliance Was the Norm

U.S. persons have long been required to report foreign accounts on a Report of Foreign Bank and Financial Accounts (FBAR).<sup>53</sup> Before 2004, however, the FBAR filing requirements were not well known, noncompliance was the norm, the requirements were rarely enforced, and violations were lightly punished.<sup>54</sup> In 2002, the IRS reported the FBAR compliance rate was less than 20 percent.<sup>55</sup> The government imposed civil FBAR penalties in only two cases between 1993 and 2002.<sup>56</sup>

Beginning in 2000, as part of its Offshore Credit Card Project (OCCP), the government used John Doe summonses to try to obtain the identities of U.S. taxpayers who held credit or debit cards issued by

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- 50 See, e.g., National Taxpayer Advocate 2017 Objectives Report to Congress 164-76; National Taxpayer Advocate 2014 Annual Report to Congress 79-93; National Taxpayer Advocate 2013 Annual Report to Congress 228-37; National Taxpayer Advocate 2012 Annual Report to Congress 134-53; National Taxpayer Advocate 2011 Annual Report to Congress 191-205 and 206-72; National Taxpayer Advocate 2018 Objectives Report to Congress; National Taxpayer Advocate 2017 Objectives Report to Congress 164-76; National Taxpayer Advocate 2014 Objectives Report to Congress 36-39; National Taxpayer Advocate 2013 Objectives Report to Congress 9 and 21-29.
- 51 For a discussion of the lack of prior enforcement, see U.S. Department of the Treasury, *A Report to Congress in Accordance with § 361(B) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* 8-10 (Apr. 26, 2002). Some tax attorneys observed that many of their clients had never heard of the requirements before the government started cracking down on them. See, e.g., David D. Stewart, *IRS Voluntary Disclosure Program Gets High Marks from Practitioners, So Far*, 2009 TNT 169-3 (Sept. 3, 2009).
- 52 See Dominika Langenmayr, *Voluntary Disclosure of Evaded Taxes — Increasing Revenue, or Increasing Incentives to Evade?*, 151 J. PUB. ECON. 110, 119 (2017) (speculating that the projected increase in noncompliance was due to the expectation of a future amnesty).
- 53 See, e.g., 31 U.S.C. § 5314; 31 C.F.R. § 1010.350(a); 31 C.F.R. § 1010.306(c). Before March 1, 2011, the FBAR rules were at 31 C.F.R. part 103. See *Transfer and Reorganization of Bank Secrecy Act Regulations*, 75 Fed. Reg. 65,806 (Oct. 26, 2010).
- 54 U.S. Department of the Treasury, *A Report to Congress in Accordance with § 361(B) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* 6 (Apr. 26, 2002). Prior to October 22, 2004, there was no penalty for a non-willful failure to file and the maximum civil penalty for willful violations was capped at \$100,000. The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 821(a), 118 Stat. 1586 (Oct. 22, 2004) (amending 31 U.S.C. § 5321(a)(5)) established a penalty for non-willful violations, subject to a reasonable cause exception, and increased the penalty for willful violations. Now, the maximum civil penalty is \$10,000 for each non-willful failure; and if the government establishes the failure was willful, the maximum penalty is the greater of \$100,000 or 50 percent of the balance of the undisclosed account each year. 31 U.S.C. § 5321(a)(5). The penalties cited in this footnote are indexed for inflation. See 31 C.F.R. 1010.821(b).
- 55 U.S. Department of the Treasury, *A Report to Congress in Accordance with § 361(B) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* 6 (Apr. 26, 2002); IRS Sets New Audit Priorities, FS-2002-12 (Sept. 2002).
- 56 U.S. Department of the Treasury, *A Report to Congress in Accordance with § 361(B) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* 8-10 (Apr. 26, 2002).

offshore banks on the suspicion that they were engaged in tax evasion.<sup>57</sup> It also took steps to improve its exchange of information with other countries.<sup>58</sup> Thus, the IRS was increasingly able to identify people with unreported offshore accounts. When it examined the returns of those identified through the OCCP, however, it generally did not assess any additional tax.<sup>59</sup> Beginning in 2003, the government offered a series of settlement programs.<sup>60</sup>

### *The IRS Offered a Limited Amnesty Alternative –The Offshore Voluntary Compliance Initiative*

Between January 14, 2003, and April 15, 2003, the IRS offered the Offshore Voluntary Compliance Initiative (OVCI) to persons using offshore payment cards or similar arrangements to improperly avoid paying taxes, provided it had not yet identified them.<sup>61</sup> Participants would have to pay six years of back taxes, interest, and certain accuracy and delinquency penalties, but would not face any civil fraud or information return penalties (including FBAR).<sup>62</sup>

The program: (1) encouraged voluntary compliance by those the IRS had not yet identified, (2) gave people a chance to settle before the IRS resorted to enforcement, (3) tried to preserve economic deterrence and perceptions of fairness by still imposing penalties, and (4) reduced the costs of addressing noncompliance by participants. However, the OVCI's limits on who could participate, as well as its one-size-fits-all terms and the availability of better alternatives for many taxpayers — the qualified amended return (QAR) process and IRS's longstanding criminal VDP — probably hurt its popularity. Moreover, it was not coupled with a visible increase in the risk of detection, except for John Doe summonses. In addition, it was difficult for the IRS to use John Doe summonses to take timely enforcement action.<sup>63</sup> Nor did the government simplify the reporting requirements or make extraordinary efforts to educate the public about them.<sup>64</sup> Thus, there was little reason for taxpayers to think that the government could change compliance norms.

The IRS received about 1,326 OVCI applications and reportedly collected about \$225 million, mostly from relatively compliant taxpayers.<sup>65</sup> More than half of the OVCI applicants had reported their

57 Tax Analysts, *IRS Issues Chronology on Credit Card Tax-Avoidance Schemes, John Doe Summonses*, 2003 TNT 10-12 (Jan. 15, 2003); *Hearing Before the U.S. Senate Committee on Finance on the Tax Gap and Tax Shelters* (July 21, 2004) (testimony of Pamela J. Gardiner, Acting Inspector General, TIGTA), [https://www.treasury.gov/tigta/congress/congress\\_07212004.htm](https://www.treasury.gov/tigta/congress/congress_07212004.htm).

58 See generally Cynthia Blum, *Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail?*, 6 FLA. TAX REV. 579 (2004).

59 *Hearing Before the U.S. Senate Committee on Finance on the Tax Gap and Tax Shelters* (July 21, 2004) (testimony of Pamela J. Gardiner, Acting Inspector General, TIGTA) (noting “the vast majority of the more than 3,000 completed [OCCP] cases have been closed without an assessment of any additional taxes”).

60 For further discussion of the OVDP and the context in which it arose, see Leandra Lederman, *The Use of Voluntary Disclosure Initiatives in the Battle Against Offshore Tax Evasion*, 57 VILL. L. REV. 499 (2012).

61 2003 IR-2003-5 (Jan. 14, 2003); Rev. Proc. 2003-11, 2003-1 C.B. 311.

62 See, e.g., Rev. Proc. 2003-11, §§ 2.01 and 2.02, 2003-1 C.B. 311 (waiving the FBAR penalties, the civil fraud penalty under IRC § 6663, the fraudulent failure to file penalty under IRC § 6651(f), the civil penalties for failure to comply with the information return requirements of IRC §§ 6035, 6038, 6038A, 6038B, 6038C, 6039F, 6046, 6046A, and 6048). A 2003 OVCI submission would also be treated as an application for the IRS's longstanding voluntary compliance practice, minimizing the risk of criminal prosecution. *Id.* at 2.03.

63 See, e.g., Keith Fogg, *Go West: How the IRS Should Foster Innovation in Its Agents*, 57 VIL. L. REV. 441, 463 (2012).

64 Responsibility for FBAR enforcement and education was transferred from FinCen to the IRS and it made some efforts at education. See U.S. Department of the Treasury, *A Report to Congress in Accordance With § 361(B) of The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* 8-9 (2005), <https://www.hsdl.org/?view&did=5097>.

65 IRS, Response to TAS information request (Sept. 14, 2011).

offshore income and paid taxes, but were merely rectifying the failure to file an FBAR.<sup>66</sup> Only 16 percent had used a promoter.<sup>67</sup> Moreover, even among those who owed tax, they owed a median of only \$5,400, suggesting that an audit strategy might also fail to uncover significant tax noncompliance unless it focused on those who did not participate.<sup>68</sup>

### *The IRS Offered an Amnesty Alternative to Settle Existing Disputes — The Last Chance Compliance Initiative*

Between 2003 and 2009, the IRS tried to settle cases by issuing letters to taxpayers who had been identified as holding an offshore payment card (or similar arrangement) to access an undisclosed account, offering them the so-called Last Chance Compliance Initiative (LCCI). This filled a gap left by the OVCI, which did not apply to those who had been identified. Under LCCI, the IRS would waive certain penalties for failure to file information returns and would only impose the civil fraud and FBAR penalties for a single year, even if they could be applied to multiple years.<sup>69</sup> Notably, it did not supplant the longstanding QAR or voluntary disclosure practice or eliminate the option to settle on more favorable terms when warranted.<sup>70</sup> Because the LCCI applied to those who had been identified, its primary purpose seems to have been to reduce the costs of the enforcement process.<sup>71</sup> It was particularly important to have a way of reducing enforcement costs, as the OVCI data suggested that audits might not always be worthwhile.

### *The IRS Offered Another Limited Amnesty Alternative — The Offshore Voluntary Disclosure Programs (OVDPs) — and Reduced Access to Longstanding Alternatives*

In 2004, Congress imposed a new penalty for non-willful failures to file an FBAR and drastically increased the penalty for willful violations.<sup>72</sup> This increase provided a unique opportunity for the IRS to promote compliance using a settlement program. In 2009, the IRS “strongly encouraged” anyone who had failed to file FBARs and similar returns reporting income from foreign accounts to participate in an offshore voluntary disclosure program (OVDP).<sup>73</sup> It discouraged them from quietly filing amended returns and paying any taxes due, as permitted under the longstanding QAR program. It warned that taxpayers making such “quiet” disclosures could be “criminally prosecuted,” while OVDP participants

66 General Accounting Office, *Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions*, GAO-04-972T (July 21, 2004), <https://www.gao.gov/assets/120/111191.html> (Testimony of Michael Brostek before the U.S. Senate Committee on Finance).

67 *Id.*

68 *Id.*

69 See Notice 1341 (2007); Letter 3649 (2007); IRM 4.26.16.4.6.4(4) (July 1, 2008).

70 See, e.g., CCA 2006-03026 (Sept. 1, 2005) (noting that “instructions to agents contained in the Guidelines for Mitigation of the FBAR Civil Penalty for Last Chance Compliance Initiative (LCCI) Cases provide: ‘The examiner may determine that the facts and circumstances of a particular case may warrant that a penalty under these guidelines is not appropriate or that a lesser amount than the guidelines would otherwise provide is appropriate.’ If agents follow these guidelines we need not be imposing the FBAR penalty arbitrarily in cases in which it clearly does not apply.”).

71 According to the IRS, “the results of the LCCI were not tracked.” IRS response to TAS information request (Sept. 20, 2011). The IRS later provided limited information that it said “may not be representative of the program as a whole.” IRS response to TAS information request (Nov. 14, 2017).

72 The American Jobs Creation Act of 2004, Pub. L. No. 108-357, Title VIII, § 821(a), 118 Stat. 1586 (Oct. 22, 2004) (amending 31 U.S.C. § 5321(a)(5)).

73 See IRS, *Voluntary Disclosure: Questions and Answers* (first posted May 6, 2009), <https://www.irs.gov/newsroom/voluntary-disclosure-questions-and-answers> (hereinafter “2009 OVDP FAQ”).

would generally be subject to a fairly-severe “offshore” penalty in lieu of various other penalties, including FBAR.<sup>74</sup> Under the 2009 OVDP, taxpayers were required to pay:

- All unpaid taxes;
- A 20 percent accuracy-related penalty; and
- An “offshore penalty” of 20 percent of their highest offshore account balance (plus foreign assets) during a six-year period (2003-2008).<sup>75</sup>

The penalty rate would recover the present value of the unpaid tax on the accounts for the last 23 years, assuming the taxpayer earned 5 percent in interest that went unreported each year.<sup>76</sup> Thus, the IRS was careful to preserve economic deterrence, but in doing so, circumvented the QAR process as well as the long-standing amnesty granted by Congress when it established a statute of limitations.<sup>77</sup> Moreover, the IRS seemed to assume that its earlier programs had changed norms to such an extent that only intentional tax cheats were not complying with the rules, notwithstanding the fact that OVCI applicants included many with inadvertent or minor violations.<sup>78</sup>

### *The OVDP Was Not Reasonable or Proportionate for Those With Inadvertent or Minor Violations, Leaving Some Feeling Coerced*

The IRS expected those taxpayers who thought the offshore penalty was too severe to apply to the OVDP and then opt out. However, it warned that “all relevant years and issues will be subject to a *complete examination ... [and] all applicable penalties (including information return and FBAR penalties) will be imposed*” [emphasis added] against those who opt out.<sup>79</sup> This suggested that the IRS might seek the maximum penalties against people who were trying to comply or whose violations were not willful, and that they should expect a costly and burdensome examination. OVCI data suggested that the IRS was bluffing because it would not have been a wise use of resources to do so. However, the IRS’s message seemed to abandon the responsive regulation model, undermining the trust the model is designed to promote.

74 2009 OVDP FAQ #10.

75 2009 OVDP FAQs #'s 12, 13, 20, 32, and 33.

76 See Government Accountability Office (GAO), GAO-13-318, *IRS Has Collected Billions of Dollars, but May Be Missing Continued Evasion* 50-51 (Mar. 2013).

77 See IRC § 6501(a) (providing a general three-year limitations period); IRC § 6501(e)(1) (six-year limitations period for 25 percent omission of gross income or omissions attributable to assets not reported on certain information returns); IRC § 6501(c) (providing exceptions, such as for those filing a fraudulent return or no return, or who do not disclose certain foreign transfers).

78 See GAO, *Taxpayer Information: Data Sharing and Analysis May Enhance Tax Compliance and Improve Immigration Eligibility Decisions*, GAO-04-972T (July 21, 2004), <https://www.gao.gov/assets/120/111191.html> (Testimony of Michael Brostek before the U.S. Senate Committee on Finance).

79 2009 OVDP FAQ #34.



After the National Taxpayer Advocate and external stakeholders raised concerns about the 2009 OVDI,<sup>80</sup> the IRS established the 2011 Offshore Voluntary Disclosure Initiative (OVDI) (also referred to as an OVDP).<sup>81</sup> After the 2011 program closed on September 9, 2011, it was succeeded by the 2012 OVDP, which was open ended, and the so-called 2014 OVDP which is a continuation of the 2012 program under slightly modified terms.<sup>82</sup> The offshore penalty rose to 25 percent of the highest account balance during an eight-year period under the 2011 OVDP, to 27.5 percent under the 2012 OVDP, and up to 50 percent (still over an eight-year period) under the 2014 program.<sup>83</sup> With few exceptions, the 2011 OVDP applied the same offshore penalty to benign and bad actors. The exceptions included:

- A 5 percent penalty for those holding inactive offshore accounts funded with previously-taxed proceeds and for certain foreign residents;<sup>84</sup> and
- A 12.5 percent penalty for those with accounts never exceeding \$75,000.<sup>85</sup>

The IRS also established so-called “streamlined programs” that allowed certain “low risk” foreign residents with a *de minimis* amount of unreported income (e.g., owing less than \$1,500 in tax) to bypass the OVD program by filing returns without triggering penalties (*i.e.*, an amnesty that was more responsive to specific segment’s situation). However, they could still be deemed “high risk” by the IRS and audited.<sup>86</sup>

The 2011 OVDP still seemed unfair to benign actors because the IRS narrowly construed the exceptions under which taxpayers could receive lower 5 or 12.5 percent offshore penalty rates. Fewer than two percent of the offshore penalties were assessed at these lower rates.<sup>87</sup>

However, the streamlined program provided an appropriate alternative for those who were eligible — nearly all of whom had made relatively small and probably unintentional errors. Between September 1, 2012, and April 24, 2014, the streamlined program attracted 8,851 taxpayers, and only eight percent

80 See, e.g., National Taxpayer Advocate 2014 Annual Report to Congress 79-93; National Taxpayer Advocate 2013 Annual Report to Congress 228-237; National Taxpayer Advocate 2012 Annual Report to Congress 134-53; National Taxpayer Advocate 2011 Annual Report to Congress 191-205 and 206-72; National Taxpayer Advocate 2013 Objectives Report to Congress 9 and 21-29; National Taxpayer Advocate 2014 Objectives Report to Congress 36-39; Taxpayer Advocate Directive 2011-1 (Aug. 16, 2011) (collectively, the “OVD Reports”); New York State Bar Association Tax Section (NYSBA), *NYSBA Tax Section Comments on FAQ for 2011 Offshore Voluntary Disclosure Initiative*, 2011 TNT 153-13 (Aug. 9, 2011); American Citizens Abroad, *Letter to IRS Commissioner* (Nov. 1, 2011); Marie Saphire, *Frustration Grows for Canadians in OVDI*, 2012 TNT 169-1 (Aug. 29, 2012); Baker & McKenzie, *Experiences With The ‘New’ Voluntary Disclosure Program — Some Good, Some Bad*, 113 J. TAX’N 46 (2010); Marie Saphire, *More Written Guidance Needed As OVDI Deadline Nears*, 2011 TNT 168-1 (Aug. 29, 2011). See also Barrie McKenna, *Ottawa Seeks Leniency for Canadians in U.S. Tax Hunt*, *The Globe and Mail* (Oct. 18, 2011). For more recent comments, see, e.g., American Bar Association (ABA) Section of Taxation, *Comments on 2014 Offshore Voluntary Disclosure Program and the Streamlined Programs* (Oct.14, 2015); AICPA, *Comments on the 2014 Offshore Voluntary Disclosure Program and the Streamlined Programs* (Mar. 9, 2016).

81 IRS, *2011 Offshore Voluntary Disclosure Initiative*, <https://www.irs.gov/newsroom/2011-offshore-voluntary-disclosure-initiative> (last updated, Aug. 12, 2017). The 2011 OVDI FAQs are no longer posted to the IRS website.

82 2012 OVDP FAQ #3 (posted June, 26, 2009) (no longer posted in the same form); IRS, *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2014*, FAQ #1, <https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers-2012-revised> (last updated Nov. 8, 2017) (effective for OVDP submissions on or after July 1, 2014).

83 2014 OVDP FAQ #9; 2012 OVDP FAQ #8; 2011 OVDI FAQ #8.

84 2011 OVDI FAQ #52; 2012 OVDP FAQ #52 (eliminated under the 2014 program).

85 2011 OVDI FAQ #53; 2012 OVDP FAQ #53 (eliminated under the 2014 program).

86 See Form 14438, *Streamlined Filing Compliance Procedures for Non-Resident, Non-Filer* (Aug. 2013); IRS, *Streamlined Filing Compliance Procedures* (Oct. 9, 2014), <http://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures> (describing changes to the streamlined program first announced in 2012).

87 See National Taxpayer Advocate 2014 Annual Report to Congress 79, 84-85.

(or 697 taxpayers) were classified as high risk and examined.<sup>88</sup> Even among the “high risk” group, most returns (51 percent) were not changed by the IRS.<sup>89</sup> Even among those whose returns were adjusted, the average adjustment was only \$810 per return.<sup>90</sup>

The only other option for benign actors was to opt out of the OVD programs and be examined. However, because those opting out faced prolonged uncertainty, the expense and stress of an examination, potential appeals, and the risk of even more severe penalties, some agreed to pay the (offshore) penalty designed for bad actors, as described in prior reports.<sup>91</sup> Inside the 2009 OVD, the median offshore penalty paid by those with the smallest accounts was nearly six times the median unreported tax, and unrepresented taxpayers generally paid even more — significantly more than represented taxpayers with the largest accounts, as shown in Figure 2.<sup>92</sup>

**FIGURE 2, Comparison of Median Offshore Penalties to Unpaid Tax by Median Account Size and Representation for the 2009 OVD Program**

	Bottom 10%	Middle 80%	Top 10%
Offshore account(s) balance	\$44,855	\$607,875	\$7,259,580
2009 OVD penalty	\$8,540	\$117,803	\$1,410,517
Additional tax, tax years 2002-2011	\$1,472	\$30,894	\$452,966
Offshore penalty as a percent of tax assessed	580%	381%	311%
Unrepresented percent	31%	11%	4%
Offshore penalty as a percent of tax assessed (unrepresented taxpayers only)	772%	474%	398%

88 See National Taxpayer Advocate 2014 Annual Report to Congress 79, 84.

89 *Id.*

90 *Id.*

91 See, e.g., OVD Reports; National Taxpayer Advocate 2017 Objectives Report to Congress 164-76.

92 See National Taxpayer Advocate 2014 Annual Report to Congress 79, 86. All figures are medians rather than averages because the data contains extreme outliers. The unreported tax includes all tax assessed over a ten-year period, even if the assessment was unrelated to the OVD program. For the purposes of this analysis, we consider unrepresented taxpayers to be those without a Transaction Code 960 present on the Compliance Data Warehouse (CDW) Individual Master File Transaction History table as of October 3, 2013. If the IRS Master File database indicated that a taxpayer had a representative on any tax module for any of tax years 2003-2012, then the taxpayer was considered represented, even though he or she may have been unrepresented in connection with the OVD program. *Id.* at 86 n.39. The IRS has asked TAS not to disclose updated information concerning its OVDPs.

As of October 2016, 55,800 participants had paid more than \$9.9 billion in connection with these programs, dwarfing the 2003 OVCI.<sup>93</sup> But, for many taxpayers there was no evidence that penalties were warranted and the costs and long-term consequences are still unknown.<sup>94</sup>

Perhaps because most of the taxpayers with significant offshore assets who wanted to participate had already done so and because the penalty rate increased under the 2011 OVDI, the disproportionality of the offshore penalty increased under the 2011 OVDI, as taxpayers with the smallest accounts paid over eight times the median unreported tax, as shown in Figure 3.<sup>95</sup>

**FIGURE 3, Comparison of median offshore penalties to unpaid tax by median account size and representation for the 2011 OVD program**

	Bottom 10%	Middle 80%	Top 10%
Offshore account(s) balance	\$17,368	\$183,993	\$3,833,152
2011 OVD penalty	\$2,202	\$41,238	\$888,943
Additional tax, tax years 2003-2012	\$268	\$5,845	\$190,579
Offshore penalty as a percent of tax assessed	821%	706%	466%
Unrepresented percent	53%	30%	10%
Offshore penalty as a percent of tax assessed (unrepresented taxpayers only)	788%	736%	705%

Moreover, the participant's accounts generally became smaller with each new program.<sup>96</sup> This makes sense because the programs were not initially designed to attract middle-class taxpayers whose violations were not willful, but they were increasingly learning about the FBAR requirements, the potential for draconian penalties, and the IRS's enforcement efforts, and were terrified. Thus, they came into the program under fear of prosecution, despite the IRS's previous lack of enforcement.

93 IRS, IR-2016-137, *Offshore Voluntary Compliance Efforts Top \$10 Billion; More Than 100,000 Taxpayers Come Back into Compliance* (Oct. 21, 2016), <https://www.irs.gov/uac/newsroom/offshore-voluntary-compliance-efforts-top-10-billion-more-than-100000-taxpayers-come-back-into-compliance>.

94 See, e.g., Matthew Morris, *FATCA and the Road to Expatriation*, 149 *Tax Notes* 691 (Nov. 2, 2015) ("Even though benign actors constituted the vast majority of OVDI applicants, very few opted out because of the risk of these potentially devastating FBAR penalties"); Robert B. Stack & Doug Andre, *Expedited Opt-Out Needed for OVDI Participants Who Owe No Tax*, 134 *Tax Notes* 561 (Jan. 30, 2012) ("the OVDI is being administered in a manner that nonetheless subjects taxpayers without any tax liability to the OVDI penalty regime ... with their only hope being access to a vaguely defined 'opt out' mechanism that itself would be time-consuming, expensive for both the IRS and taxpayers, and uncertain."); Andrew Velarde, *IRS Official Defends OVDI Against Calls for Greater Flexibility*, 141 *Tax Notes* 470 (Nov. 4, 2013) ("Given the horror stories of accidentally noncompliant taxpayers facing large penalties, practitioners are losing confidence in the way the [OVDI] program is working, Matthews said."); William Sharp, *Navigating Offshore Tax Hazards: An Update*, 139 *Tax Notes* 779 (May 13, 2013) ([observing that some inadvertent violations] "automatically will be characterized as willfulness and that it will subject the taxpayer to a 27.5 percent offshore penalty under the OVDI"); Thomas Zehnle, *Rethinking the Approach to Voluntary Disclosures*, 134 *Tax Notes* 575 (Jan. 30, 2012) ("what surprised many private practitioners (and presumably the IRS) was the large number of taxpayers whose [OVDI] cases exhibited little, if any, indicia of fraud ... Innocent or negligent taxpayers were (or will be) processed and penalized the same as the intentional wrongdoer.").

95 National Taxpayer Advocate 2017 Objectives Report to Congress 164-76; National Taxpayer Advocate 2014 Annual Report to Congress 79, 87. A slightly different methodology was used to pull the 2009 OVD program data, as discussed in the 2014 report. National Taxpayer Advocate 2014 Annual Report to Congress 79, 87 n.40.

96 National Taxpayer Advocate 2017 Objectives Report to Congress 164-76.

On June 18, 2014, when the IRS established the 2014 OVDP, it created two new “streamlined” programs and eliminated the lower 5 and 12.5 percent penalty rates.<sup>97</sup> Taxpayers who certified their violations were not willful, reported income from the unreported account(s), and paid any resulting taxes would be subject to a reduced five percent penalty if they were U.S. residents (under the so-called Streamlined Domestic Offshore Procedures (SDOP)) or no penalty if they were non-residents (under the so-called the Streamlined Foreign Offshore Procedures (SFOP)).<sup>98</sup> In addition, on May 13, 2015, the IRS instructed its examiners “in most cases” to limit penalties for FBAR violations to 50 percent of the highest aggregate balance of the unreported account(s) during the year(s) at issue if they are willful and \$10,000 per year if they are not.<sup>99</sup> This guidance reduced the risk to benign actors of opting out of the OVDP. Perhaps because this guidance and the streamlined programs have provided alternatives to the OVDP for benign actors, the disproportionality of the offshore penalty appears to have declined under the 2012 OVDP, as shown in Figure 4.<sup>100</sup>

**FIGURE 4, Comparison of Median Offshore Penalties to Unreported Tax by Median Account Size and Representation for the 2012 OVD Program**

	Bottom 10%	Middle 80%	Top 10%
Offshore account(s) balance	\$19,480	\$287,726	\$3,354,782
2012 OVD penalty	\$2,420	\$73,004	\$914,110
Additional tax, tax years 2003-2015	\$681	\$14,009	\$220,365
Offshore penalty as a percent of tax assessed	355%	521%	415%
Unrepresented percent	26%	16%	10%
Offshore penalty as a percent of tax assessed (unrepresented taxpayers only)	454%	515%	398%

Under the SDOP (the U.S. resident initiative), the IRS was still proposing to penalize U.S. residents who came forward voluntarily and whose violations were not willful, but the five percent penalty rate was more proportionate. Moreover, the IRS stopped lumping them in with tax evaders. However, it refused to provide refunds to people who would have been eligible for streamlined treatment if they had

97 IRS, Streamlined Filing Compliance Procedures, <https://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures> (last updated Sept. 11, 2017); IRS, *Transition Rules: FAQs*, <https://www.irs.gov/individuals/international-taxpayers/transition-rules-frequently-asked-questions-faqs> (last updated Aug. 3, 2017).

98 IRS, Streamlined Filing Compliance Procedures, <https://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures> (last updated Sept. 11, 2017); IRS, *Transition Rules: FAQs*, <https://www.irs.gov/individuals/international-taxpayers/transition-rules-frequently-asked-questions-faqs> (last updated Aug. 3, 2017).

99 Interim Guidance Memo (IGM), SBSE-04-0515-0025, *Interim Guidance for Report of Foreign Bank and Financial Accounts (FBAR) Penalties* (May 13, 2015), [https://www.irs.gov/pub/foia/ig/spder/SBSE-04-0515-0025\[1\].pdf](https://www.irs.gov/pub/foia/ig/spder/SBSE-04-0515-0025[1].pdf); IRM 4.26.16.6.4.1 (Nov. 6, 2015); IRM 4.26.16.6.5.3 (Nov. 6, 2015). While this guidance did not directly apply to Appeals, it creates litigating hazards for the government if Appeals takes a harder line, particularly in light of pre-existing hazards already acknowledged by the government. See, e.g., Jeremiah Coder, *Taxpayers Face Hurdles and Risks When Opting out of OVDP*, 2013 TNT 12-4 (Jan. 16, 2013) (discussing the hazards).

100 AIMS Database (Mar. 7, 2016). TAS used the same methodology to pull this 2012 OVD program data as we did for the 2011 OVD program data (above). These figures do not include taxpayers who entered the 2012 OVD program before the IRS announced the 2014 streamlined program, but ultimately transitioned into the streamlined program.

already agreed to a higher offshore penalty pursuant to a signed closing agreement.<sup>101</sup> Like the ATO's attempts to deal with mass marketed tax schemes, the negative perceptions that the IRS's OVDPs created could persist for many years.

## CONCLUSION

Settlement programs that provide broad amnesty are generally not a reliable way to raise revenue in the long run. If properly designed, however, settlement programs can demonstrate that the tax agency is trustworthy, accelerate compliance gains, collect information about the reasons for noncompliance, and avoid controversy and enforcement costs.

Settlement programs should take compliance norms into account. For example, if compliance is the norm and taxpayers have been put on notice about what is expected and given an opportunity for self-correction, then any program should be aimed primarily at settling cases that the government might not otherwise identify or pursue due to a lack of resources, or at resolving a liability that the taxpayer might not otherwise be able to pay. In such cases, it may also be appropriate to attach conditions to improve compliance, like the requirement to timely file and pay taxes for five years after receiving an OIC.<sup>102</sup>

Tax agencies may also use settlement programs when taxpayers have acted reasonably or the government contributed to the noncompliance, even if only by failing to enforce the rules for an extended period. Any program should be tailored to account for the taxpayer's motivational posture. It should recognize that participants are not committed to noncompliance and are complying voluntarily. Accordingly, lesser penalties should be applied to participants than would be applied outside the program, especially when violations were minor, unintentional, or corrected before being detected.

Settlement programs may be particularly effective if the agency can credibly commit to improve compliance norms, whether by enhancing its ability to detect discrepancies or other means. In such cases, a program could raise revenue and accelerate compliance gains without creating the perception that the agency is unfairly surprising otherwise honest people with its compliance initiative. This approach is consistent with the responsive regulation model, as well as the taxpayer *rights to be informed, quality service, privacy, and to a fair and just tax system*.<sup>103</sup>

Under normal circumstances it may be difficult for tax agencies to credibly commit to change compliance norms. However, the IRS is beginning to receive information as a result of the Foreign

101. IRS, Streamlined Filing Compliance Procedures, <https://www.irs.gov/Individuals/International-Taxpayers/Streamlined-Filing-Compliance-Procedures> (last updated Sept. 11, 2017) (Coordination between streamlined procedures and OVDP). By contrast, when the IRS established the lower penalty rates for the 2011 OVDP, it allowed eligible taxpayers who signed agreements under the 2009 OVDP to amend them to take advantage of the lower rates. See 2011 OVDP FAQ #52 ("Taxpayers who participated in the 2009 OVDP whose cases have been resolved and closed with a Form 906 closing agreement who believe the facts of their case qualify them for the 5% reduced penalty criteria of the 2011 OVDI, but paid a higher penalty amount under the 2009 OVDP should provide a statement to this effect ... Upon receipt of this information, the case will be assigned to an examiner to review and make a determination."); 2011 OVDP FAQ #53 (same). Deviating from this prior practice likely increased the sense that the IRS was arbitrarily singling out some groups for unfair treatment. The National Taxpayer Advocate proposed legislation to reverse this result. See National Taxpayer Advocate 2014 Annual Report to Congress 331, 341-42.

102. IRS Form 656, *Offer in Compromise* (2017) (items j and k). Similarly, the Mexican VDP required participants to repatriate their offshore funds and keep them in the country for two years. See William Hoke, *Government Announces Amnesty, Asset Expensing for Smaller Firms*, 85 TAX NOTES INT'L 338 (Jan. 23, 2017).

103. See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

Account Tax Compliance Act (FATCA), which provides an incentive for foreign financial institutions to report information on their U.S. clients to the IRS and for foreign governments to sign bilateral automatic information exchange agreements.<sup>104</sup> Many countries have also agreed to the automatic exchange of information under the Common Reporting Standard (CRS),<sup>105</sup> and the OECD has recommended that member countries consider OVDs before these exchanges begin.<sup>106</sup> Those that have done so often attribute the success of their OVDs to these automatic exchange agreements.<sup>107</sup>

When the agency offers a settlement program in conjunction with a credible commitment to address noncompliance in the future, previously-compliant taxpayers may be annoyed, but should not feel silly for complying given the increased likelihood that any underreporting will be detected. Participants save the government money that it would otherwise have to spend on enforcement; and subsequent noncompliance by participants is more likely to be detected and punished, freeing up resources for the agency to go after more recalcitrant offenders who do not participate. For everyone else, the program shows that the agency can be trusted to pursue only reasonable and proportionate penalties against those who have been put on notice, removing at least one excuse for future noncompliance (*i.e.*, the agency's lack of fairness and proportionality). Therefore, as new automated information exchanges and other types of third party information reporting become available, tax agencies have a rare opportunity to use settlement programs as a lower-cost way to improve compliance norms while respecting taxpayer rights, provided they can address legitimate concerns about the misuse of confidential tax information.

104 Foreign Account Tax Compliance Act (FATCA) was passed as part of the Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71, 97-117 (2010).

105 See, e.g., OECD, *Automatic Exchange Portal*, <http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/> (last visited Nov. 29, 2017).

106 OECD, *Update on Voluntary Disclosure Programs: A Pathway to Tax Compliance* (Aug. 2015) ("This is therefore a crucial moment for countries to consider launching, enhancing or drawing public attention to their respective voluntary disclosure programs. In doing so, countries can explicitly provide their taxpayer with an opportunity to regularize past non-compliance prior to the entry into force of the automatic exchange of information.").

107 See, e.g., William Hoke, *\$90 Billion of Assets Reported under Amnesty Program*, 85 TAX NOTES INT'L 153 (Jan. 9, 2017) (citing a December 23, 2016 agreement for automatic exchanges with U.S., as one reason for the Argentinian VDP's success); William Hoke, *Government Announces Amnesty, Asset Expensing for Smaller Firms*, 85 TAX NOTES INT'L 338 (Jan. 23, 2017) (citing the OECD automatic exchange program (called CRS) as contributing to the Mexican VDP's success, though it was held back by a requirement to repatriate funds for two years, political instability, and the potential for a Mexican currency devaluation); Teri Sprackland, *Panama Papers Helped Norway's Amnesty Program*, 85 TAX NOTES INT'L 715 (Feb. 20, 2017) (indicating that the Panama papers, Bahamas Leaks, and the CRS generated interest in Norway's permanent VDP, though taxpayers already identified by the tax agency were not eligible).