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Hot Issues Alerts – Law Firms

Amnesty By Any Other Name: Government Enforcement Drive Against Foreign Bank Account Holders Highlights Little Known IRS Voluntary Disclosure Policy

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The recent, public hearings conducted by Senator Levin's Sub-Committee on offshore tax havens and their bank secrecy laws and the well-publicized parallel IRS summons enforcement efforts to compel Swiss banking giant UBS to provide the names and account records of the 53,000 U.S. taxpayers for whom UBS has admitted to maintaining undisclosed foreign bank accounts, have put the spotlight on a massive non-compliance problem affecting those taxpayers and perhaps the same number or more who have accounts at other banks in Switzerland or in other tax haven countries.

Failure to report the existence of or earnings on these accounts on U.S. tax returns and not filing other required forms, such as Foreign Bank Account Reports ("FBARs") are felonies and the U.S. taxpayers involved face both potential criminal prosecution and confiscatory civil penalties that could far exceed the sum on deposit overseas. 26 U.S.C. §7201, §7206(1), 31 U.S.C. §5314 and 31 U.S.C. §5322.

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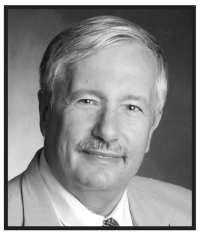

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Press coverage has also focused attention on statements by IRS Commissioner Douglas Shulman urging taxpayers with foreign accounts to come in and disclose their situation under the IRS' Voluntary Disclosure Policy before the IRS finds them. The Voluntary Disclosure Policy is, indeed, the solution to this problem for many (but not all) of the affected taxpayers. I.R.M. §9.5.3.3.1.2.1. However, this policy, formerly known only to a few practitioners specializing in IRS criminal tax matters, has a long history and applies to a much broader group of situations outside the foreign bank account area. Effective use of the policy can be a practical solution to a myriad of potentially criminal tax compliance issues that may arise in the context of pending or potential business or matrimonial litigation and/or in the regulatory context and is something that every practicing lawyer should be aware of.

For over 50 years the Internal Revenue Service has had a policy under which taxpayers who, for whatever reason, have been noncompliant, can approach the IRS Criminal Investigation Division through counsel and avoid criminal prosecution and often mitigate the civil penalties involved. To do this, they must fully disclose all noncompliant prior behavior, file delinquent or amended tax returns (usually six prior years) and fully cooperate with the IRS in paying the taxes, interest and penalties owed and in verifying the accuracy and completeness of the disclosures made.

The policy applies broadly to all types of tax non-compliance, including failure to file tax returns as well as prior false filings with limited exceptions, *i.e.* the taxpayer must not be engaged in a criminal occupation and/or the income involved must not be the product of illegal activity (*e.g.* kickbacks, commercial bribery, etc.).

Since 2003, the policy has been broadened to treat as "voluntary" the disclosures which previously could have been viewed as "triggered" by the taxpayer's knowledge that the noncompliant behavior could come to light in the course of business or other (*e.g.* matrimonial) litigation. Under the current policy a voluntary disclosure is "timely" if made prior to the taxpayer being notified that he/she is under IRS audit or criminal investigation by the IRS or other law enforcement agency.

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The situations where voluntary disclosure has been useful to business and individual taxpayers are as varied as life stories, but some examples are:

- A foreign-owned financial services entity, about to apply for additional U.S. licensing and concerned about prior practices whereby non-U.S. citizen managerial employees are paid bonuses offshore by its foreign parent to avoid U.S. tax, successfully used the policy to resolve its liabilities and those of its non-U.S. citizen employees without anyone still with the firm being criminally prosecuted.
- A business considering suing a former employee for unfair competition but reluctant to sue because the employee is aware of transactions in which the business omitted sales income or claimed false expenses and concerned that information would come out in litigation, successfully completed a voluntary disclosure prior to commencing suit and was able to proceed without fear of causing it and its senior officers to be prosecuted for tax evasion if the information became public.
- An individual in matrimonial litigation with his spouse is required by the matrimonial court to explain how his claimed expenses (submitted to justify why he cannot pay alimony) square with his reported income (as reflected on his last few tax returns) was able to utilize the voluntary disclosure policy to revise his reporting prior to having to testify in the matrimonial case.

As can be seen from these examples, in each case the taxpayer attempting the voluntary disclosure previously engaged in what is arguably criminal tax evasion, now faces a current problem which was likely to bring the prior problem to light and was presented an impossible dilemma – not pursue an otherwise meritorious position out of fear that the IRS issue will surface or go forward with fingers and toes crossed and hope that the IRS issue will not surface. Preemptive use of the voluntary disclosure policy is the potential solution.

However, as both the Internal Revenue Manual and prior case law make clear, voluntary disclosure is only one factor in the IRS decision not to prosecute, and the policy guidelines do not establish substantive rights or legal protections against prosecution. *United States v. Hebel*, 668 F.2d 995 (8th Cir.), *cert. denied*, 456 U.S. 946 (1982). In practice, however, voluntary disclosure is the key factor in the decision to prosecute or not to prosecute.

Navigating such a situation successfully requires skilled counsel specializing in IRS criminal tax investigations to assist the taxpayer's existing counsel in developing and presenting the facts needed to make a truthful and complete voluntary disclosure to the Internal Revenue Service Criminal Investigation Division.

The manner in which the process was implemented has evolved in the wake of the UBS investigation and now, more than ever, counsel without expertise in criminal tax matters should not be approaching the IRS on a taxpayer's behalf under the policy as such counsel often lacks the IRS-specific experience necessary to address all of the issues that typically arise in bringing a voluntary disclosure to a successful conclusion.

Accountants, with or without IRS experience, should never be engaged to explore making a voluntary disclosure for a taxpayer as they lack the cloak of the attorney-client privilege which shields exploratory and/or investigative discussions preliminary to deciding to approach the IRS under the voluntary disclosure policy.[1] Thus, if the taxpayer determines not to pursue the voluntary disclosure or it is rejected for some reason and later a criminal tax, S.E.C. or other investigation ensues, anything disclosed to the accountant (*unless* the accountant is assisting and working under the direction of counsel pursuant to a *Kovel* engagement[2]) is *not* privileged and must be disclosed if a subpoena or summons is served on the accountant.

Under new IRS voluntary disclosure procedures announced last month dealing with UBS accountholders, taxpayers who wish to be considered for acceptance under the policy may be required to submit to in-person interviews with IRS Special Agents about the details of their non-compliance and to commit to fully cooperate after acceptance into the program by providing back-up records to IRS auditors, paying all sums owed, making full disclosure of finances, etc.

Where IRS deems a taxpayer has breached this duty of cooperation, it has pursued criminal prosecution of the taxpayer and used the information provided under the policy as part of its case. The Courts have upheld convictions obtained in such circumstances because, as the written policy states, voluntary disclosure is a policy, not a statutory protection. *Tenzer v. United States*, 127 F.3d 222 (2d Cir. 1997).

In the foreign account area, most taxpayers have little to lose by coming forward under the policy since IRS will eventually get their names from the bank in summons or other enforcement proceedings; however, in most other potential voluntary disclosure cases, there is no already-pending IRS inquiry likely to eventually lead to the taxpayer, only the taxpayer's concern that doing nothing or taking some non-IRS related action may cause the issue to come to IRS' attention later.

"… now, more than ever, counsel without expertise in criminal tax matters should not be approaching the IRS on a taxpayer's behalf under the policy as such counsel often lacks the IRS-specific experience necessary …"

IRS recognizes that, rarely, if ever, is a voluntary disclosure made for purely altruistic or noble motives. It expects that the vast majority of taxpayers who attempt a voluntary disclosure have engaged in conduct that, if discovered independently, would likely merit criminal prosecution. However, because the taxpayer is coming to IRS before IRS finds them, IRS is willing to forego criminal prosecution in most cases, although not required to do so.

Counsel's knowledge of and experience with how prior situations have been handled by the Criminal Investigation Division (as well as evaluating how the taxpayer may be expected to handle an in-person IRS interview) is part of the preliminary analysis that must be made in advising a taxpayer and/or non-tax counsel on whether pursuing voluntary disclosure as a solution makes sense in any individual case.

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[1] *While 26 U.S.C. §7525 provides a limited privilege for accountants and certain other tax professionals rendering "tax advice" within the scope of licensed activity, the privilege does not apply in any criminal tax investigation or any other non-tax investigation.*

[2] United States v. Kovel, *296 F.2d 918 (2d Cir. 1961).*