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No More Mr. Nice Guy: IRS Tightens Voluntary Disclosure Procedures

The IRS announced new -- less "taxpayer friendly" -- internal procedures for taxpayers who wish to avoid criminal prosecution for domestic or offshore tax evasion conduct.

The IRS ended its Offshore Voluntary Disclosure Program (OVDI) on Sept. 28, 2018, and recently announced new internal procedures for taxpayers who wish to avoid criminal prosecution for domestic or offshore tax evasion conduct. These new procedures are far less "taxpayer friendly" and signal a return to the way voluntary disclosures were handled prior to OVDI.

The new voluntary disclosure rules do *not* affect the existing Streamlined Filing Compliance Procedure, Delinquent FBAR Filing Procedure, or Delinquent Information Returns Filing Procedures available to taxpayers with "non-willful" foreign compliance issues.

The IRS voluntary disclosure *policy* long predated OVDI, but making a voluntary disclosure was historically a "one off" decision only made after a taxpayer had concluded that there was no other option to avoiding prosecution, even if doing so meant paying large civil penalties.

Traditional voluntary disclosure involved a "no names," hypothetical initial approach to local IRS Criminal Investigation Division (IRS-CI) personnel by a taxpayer representative experienced in criminal tax matters. Local management decided whether to proceed or not. If so, the taxpayer's identifying information was then provided so IRS-CI could confirm it was not yet aware of the taxpayer's non-compliance.

Amended returns (typically for six years) were then delivered to the local IRS-CI contact. The only paperwork generated was usually a cover letter confirming the prior discussions. That completed the traditional voluntary disclosure process.

IRS-CI had no role in civil closing. There was no pre-ordained limitation on what penalties the IRS might impose civilly. Typically, the taxpayer faced a rigorous audit to determine his/her civil tax exposure, and *all* tax deficiencies were subject to the imposition 75 percent civil fraud penalties.

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Offshore non-compliance presented IRS with some unique concerns.

Offshore non-compliance did not involve "one off" situations. OVDI was a limited form of "tax amnesty" available to an unidentified large group of similarly non-compliant taxpayers. This solved the IRS' problem of how to identify and audit those involved—most of the affected group was invited to come in and self-confess. OVDI's pre-defined civil penalty "caps" addressed the concern over the financially ruinous civil penalties potentially applicable to offshore non-compliance that held back some potential "volunteers."

OVDI worked so well that IRS-CI adopted it as a model for handling domestic voluntary disclosures as well.

How the New Rules Change Voluntary Disclosure Practice

There is still a three-step process, but with significant differences:

(1) **Preclearance.** Under OVDI, the first step taken by a taxpayer was to request "preclearance" to determine if IRS already had his/her name from another source. A preclearance request was optional at the taxpayer's election and involved, *at a minimum,* providing the names and identifying numbers of each Taxpayer seeking preclearance. Preclearance replaced the "no names" pre-OVDI approach in which the underlying facts were first disclosed hypothetically. Preclearing based only on identifying data, provided some assurance that the taxpayer had not already been identified and could now safely reveal the details of his non-compliance and that those revelations would not be used against him.

Preclearance is no longer optional. Taxpayers now making any voluntary disclosures (domestic or offshore) *must* submit a request for preclearance. A yet-to-be-issued revised version of IRS Form 14457 must be used. What else in addition to identifying data has to be provided now is not clear; the memorandum simply says: "IRM 9.5.11.9 (which sets forth the traditional criteria for a disclosure being deemed "voluntary") will continue to serve as the basis for determining taxpayer eligibility."

(2) **Preliminary Acceptance.** After the taxpayer received preclearance (or elected not to request it) he was required to submit information regarding the noncompliance under penalty of perjury on Form 14457 to a centralized "IRS-CI Lead Development Center," where it was reviewed to determine if IRS-CI should issue a "preliminary acceptance" letter.

There was no required format or content for what the taxpayer chose to include on Form 14457 beyond a number of "yes" or "no" answers to specific questions.

Going forward, taxpayers must now submit "all required voluntary disclosure *documents* using a forthcoming revision of Form 14457." What these "documents" are remains to be seen, but the new Form 14457 will now be a two-part form (one part used to obtain preclearance, and a separate second part to be submitted as part of a new "preliminary acceptance" process) and "will require information related to taxpayer non-compliance, including a narrative providing the facts and circumstances, assets, entities, related parties and any professional advisers involved in the non-compliance."

It appears that IRS-CI will now require that the submission provide (in narrative format) information about specific issues relating to the non-compliant behavior such as what the taxpayer provided or told his preparer, whether the preparer was aware of the issue, etc. This information will almost certainly lock the taxpayer into acknowledging fraudulent intent in order to obtain preliminary acceptance. However, this same written "narrative" will also tie the taxpayer's hands later in dealing with a revenue agent about what civil penalties are appropriate and work to the taxpayer's detriment.

(3) **Submitting the Corrected or Delinquent Filings.** Under OVDI, a preliminarily accepted taxpayer was done dealing with IRS-CI. He then submitted six or eight years of amended or delinquent returns and other necessary filings to a central IRS location, along with full payment of the additional tax, interest and penalties, and waited for the case to be assigned to a field agent for "certification."

"Certification" was a limited review to confirm that the amended/delinquent filings tied back to source records. "Certification" did *not* constitute an "examination" or formal audit.

The new procedures diverge significantly.

The taxpayer now does *not* have to submit amended/delinquent filings *until* contacted by a Revenue Agent. However, once assigned, the Revenue Agent is going to conduct an "examination" (audit) and will no longer be limited to verifying the origin of the numbers on the taxpayer's amended/delinquent filings. That audit process will likely not involve the "give and take" that routinely occurs in a normal audit.

Taxpayers will now be required to "promptly and fully cooperate during such civil examinations." This "cooperation" will likely include mandatory interviews of the taxpayer(s) and perhaps requests for a waiver of any claim of privilege that might otherwise apply. Failing to agree to "take it or else" IRS positions on disputed issues may be viewed as "non-cooperative." The examiner may request IRS-CI to "revoke preliminary acceptance" of Taxpayers who are deemed "non-cooperative."

Civil Penalty Protection

Under prior rules, a taxpayer filed a limited number of years' amended tax returns and paid only 20 percent "accuracy" penalties rather than 75 percent civil fraud penalties on any tax deficiencies.

For offshore cases, the taxpayer also paid a one-time 27.5 percent penalty on the highest aggregate annual balance of any previously undisclosed foreign bank balances or value of other foreign assets in the lookback period, in lieu of FBAR and other international information return penalties that might apply. This 27.5 percent penalty was non-statutory and was applied to all types of foreign assets in order to treat all taxpayers equally, even if the statutory penalties might vary significantly depending on the assets involved.

Under the new rules, the lookback period for all voluntary disclosures is either: (a) the most recent *six* tax years, or (b) if the non-compliance involves fewer than the most recent six years, all tax periods involved but "*… where the Taxpayer and the examiner do not reach agreement on the audit adjustments, the examiner is given discretion to expand the scope to include the full duration of non-compliance and may assert maximum penalties under the law with the approval of management.*"

This "examiner discretion" to decide how many years will be examined, depending on whether the taxpayer is deemed cooperative is troubling, especially since the memorandum makes clear that IRS expects taxpayers to reach agreement with the examiner at the end of the civil examination. Although there is a reference to taxpayers having the right to appeal, it is unclear what may be appealed or if a taxpayer exercising that option would be protected from an examiner deeming the taxpayer to be "non-cooperative" and expanding the audit period or imposing greater penalties.

The memorandum also states that "examiners will determine applicable taxes, interest and penalties under existing law and procedures" and expressly provides that the civil fraud penalty (75 percent of the tax due) *will* be imposed in the year with the largest tax liability. Nothing is said about what penalties may apply to the other five years, but it is likely that accuracy (20 percent of tax due) or, in the case of non-filing situations, failure to file and pay penalties will be applied to the tax due for the other years.

Examiners also have discretion to impose the fraud penalty for "up to all six years based on the facts and circumstances

of the case; for example, if there is no agreement as to the tax liability and to more than six years if the examinations is extended beyond six years." This again places unbridled power in the individual examiner's hands to force the taxpayer to agree to the IRS' positions during the examination.

Other Penalties in Offshore Cases

The 27.5 percent OVDI "miscellaneous offshore penalty" has been eliminated.

Under the new rules, in offshore cases involving foreign bank accounts, a "willful" FBAR penalty (50 percent of the highest aggregate balance in all offshore accounts during the disclosure period) "*will* be asserted in accordance with existing IRS penalty guidance." This means that generally one 50-percent penalty will be imposed, but with "examiner discretion" to impose multiple willful FBAR penalties up to 100 percent of the highest aggregate balance.

What penalties will apply to cases involving other types of assets (art, real estate, stock ownership in foreign businesses, etc.) is not specified. But it has been suggested that IRS examiners will take into account that there are no similarly large statutory reporting penalties for other foreign assets and will impose multiple civil fraud penalties on the tax deficiencies in those cases to compensate.

Voluntary Disclosure for Non Income Tax Issues

The new "statute based" approach may make correcting "cash payroll" or misclassified employee situations cost-prohibitive because untimely employment tax balances are subject to significant statutory failure-to-deposit and failure-to-file/pay penalties. Similarly, any estate tax deficiency (as well as deficiencies in the taxpayer's pre-death income tax reporting) will likely be subject to civil fraud penalties.

Conclusion

Advising a taxpayer whether to proceed under the new voluntary disclosure rules or to consider other alternatives is an immutable decision.

Given the uncertainty about the taxpayer's maximum potential civil exposure, and the danger that the taxpayer may be deemed "non-cooperative" and later find himself without protection against IRS-CI prosecution even after coming forward, the assistance of experienced counsel *prior* to making the decision to proceed will be critical.

The views and opinions expressed in this article are those of the authors and do not necessarily reflect those of Sills Cummis & Gross.