ThinkAdvisor
An ALM Website
JANUARY 15, 2021
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Commentary

Who Should Apply to IRS' Voluntary Disclosure Program?

This latest program allows for voluntarily disclosing of tax violations beyond those relating to income tax.

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Following the close of the highly successful Offshore Voluntary Disclosure Program in late 2018, the Internal Revenue Service updated its longstanding Voluntary Disclosure Program and, in April 2020, released a detailed form and instructions relating to participation in this new iteration of the program.

Then this past fall, the agency updated the voluntary disclosure section of the Internal Revenue Manual. It also launched a new website that describes the new program, identifies who may participate, and outlines the submission procedures.

Unlike some earlier compliance programs that generally were limited to individuals, this updated program is available to individuals, trustees, business entities and executors.

The program provides a means for voluntarily disclosing tax violations/deficiencies beyond those relating to income tax (domestic and foreign). Also, the program is open to individuals seeking to disclose potential issues related to employment, gift and estate tax.

As broad as the program may appear, however, it will not be a suitable option for many taxpayers, and anyone considering participation should be sure to consider its pros and cons, preferably with an experienced lawyer.

(Credit: Allison Bell/ALM)

Why use a voluntary disclosure program?

For years, the IRS has had programs that have allowed individuals to self-disclose tax violations to substantially lower the risk of criminal prosecution for tax crimes.

The OVDP, in particular, offered a high degree of predictability given its "one size fits all" penalty framework. Under that program, a set penalty amount was applied based on the tax year with the highest aggregate noncompliant account balance. This was in lieu of the normal penalties that would have otherwise applied under the Foreign Bank Account Report and foreign information return rules.

Many taxpayers participated due to this standard penalty structure. The updated program similarly provides a framework for coming into compliance with the tax laws in exchange for a reduced risk of criminal prosecution.

Although a submission need not involve an offshore issue, the government remains focused on criminal tax enforcement in the offshore context, so the program may be of particular interest to taxpayers who have criminal tax exposure that stems from the ownership of non-U.S. business entities and accounts.

How to Apply

To enter the program, taxpayers make a submission on the IRS Form 14457. The submission can be made by an individual, a trustee on behalf of a trust, a partnership, a corporation and, in some cases, an executor.

The submission can cover domestic and foreign income tax, estate and gift tax and employment tax. Notably, it cannot be used to disclose illegal source income, which includes income that is derived through illegal activities for federal purposes even if those activities are legal under state law (e.g., income related to the cannabis industry).

The form is divided into two parts. The first part is a mandatory pre-clearance, which determines whether a taxpayer is eligible to participate and whether the IRS is already aware of the taxpayer's noncompliance.

Acceptance in the program is not guaranteed, and a taxpayer should not submit prior year returns until the IRS has assigned an agent to the case and cleared the taxpayer to participate.

Once accepted, the taxpayer must provide a detailed narrative related to their history of tax noncompliance on the second part of the form. The narrative cannot be supplemented at a later stage, so it is critical to provide a complete story from the outset.

In general, there is a six-year lookback period for purposes of filing delinquent or amended returns, and the IRS will apply a civil fraud penalty to the year with the highest tax liability.

Specifics about the application of foreign information return penalties and penalties related to employment, gift, and estate tax issues are still unclear. Where Foreign Bank and Financial Accounts noncompliance is an issue, willful FBAR penalties likely will apply, which could represent a significant amount in monetary penalties.

Essential to program participation is that the taxpayer cooperates with the government in investigating others who may have assisted in the noncompliance. This is consistent with the Department of Justice and the IRS Criminal Investigations Unit's focus on third party advisors, known as professional enablers.

Form 14457 instructions require cooperation with the IRS in determining the taxpayer's own tax liability and reporting requirements, and also cooperation in the IRS's investigation of professional enablers.

To that end, detailed information on professional advisors and facilitators who provided services to them over the period of noncompliance must be provided by the taxpayer.

Who Should Apply?

Only taxpayers who have engaged in willful or fraudulent tax noncompliance and who face a material risk of criminal prosecution should consider applying. Such taxpayers generally fall into one of three categories:

1) Anxious taxpayers.

This category includes taxpayers losing sleep because they are worried about criminal consequences related to tax noncompliance. For the anxious client, monetary penalty uncertainty is unlikely to be a deterrent to participation in the program because the threat of jail time looms large.

This type of client similarly is not deterred by the need to fully disclose his or her own activity or the identities of others, and cooperation with the government is not an issue. For such clients, the potential drawbacks and uncertainties of the program are outweighed by the clear path it offers to come into tax compliance.

2) Taxpayers who fear disclosure by others.

The program is likely to be attractive to taxpayers who fear or even anticipate, disclosure of their tax misbehavior by others. Third-party disclosure could take several forms:

- Details about an individual's tax noncompliance may come to light in the course of a divorce proceeding.
- A state court litigation involving a taxpayer's business could make public certain facts that could lead to an IRS criminal investigation.
- A taxpayer's employee may initiate a whistleblower action.
- A financial institution or service provider could provide the government information in response to a John Doe summons, triggering a criminal tax investigation.

Those who anticipate third-party disclosure should engage counsel quickly to help evaluate the benefits of participation and to move quickly toward preclearance, if appropriate. A delay in applying may disqualify the taxpayer if the government has in the meantime already opened an investigation or otherwise become aware of the noncompliance.

3) Taxpayers whose costs of compliance may be relatively low.

Finally, there are taxpayers with criminal tax exposure for whom the program is advisable from an economic standpoint — typically in the case of purely domestic situations where willful FBAR penalties are not an issue.

For those types of individuals or businesses, it may be that the fraud penalty structure results in a significant, but manageable fine, and provides a way forward for the taxpayer to come into compliance without worrying about looming criminal exposure.

Who Shouldn't Apply?

The program may not be suitable for all noncompliant taxpayers. Specifically, those whose tax noncompliance is not criminal, those who are unwilling to disclose the full extent of their behavior relating to their tax noncompliance and those who are unwilling to cooperate with the IRS should seek alternative options, after consultation with counsel.

1) Taxpayers who have not engaged in criminal conduct.

A taxpayer with considerable tax and penalty exposure but whose conduct does not rise to criminal conduct should not use this Program.

A typical fact pattern includes a U.S. citizen who is a resident abroad with ownership of a number of foreign entities and accounts and who failed to file U.S. tax returns due to negligence or the (mistaken) belief that he or she was not required to file.

High tax and penalty exposure is common in the cross-border context; indeed, there are a variety of anti-deferral regimes that apply when U.S. persons have interests in non-U.S. entities, and the failure to disclose ownership in such foreign entities and accounts can result in penalties.

An individual may have been negligent for having failed to engage competent U.S. tax advisors, but absent affirmative steps taken to conceal income or otherwise avoid paying U.S. taxes, that individual is unlikely to have engaged in criminal tax behavior. This person should explore alternative compliance programs that deal specifically with unreported foreign assets and income.

2) Taxpayers who have engaged in other criminal acts and aren't willing to disclose the full scope of their conduct.

Any individual who has engaged in criminal acts related to tax noncompliance, but whose conduct also exposes that person to non-tax criminal liability and who, for that reason, is unwilling to provide a complete discussion of the facts relevant to his tax noncompliance, should not apply.

It is critical that a taxpayer provides a detailed narrative that describes the facts surrounding the tax noncompliance; providing less than a full story can result in removal from the program and criminal prosecution.

For some, it may be difficult to provide a complete story of a tax violation without also revealing other non-tax related criminal behavior, such as wire fraud.

The confidentiality of taxpayer return information, including information provided through the program, is generally protected by Section 6103 of the Internal Revenue Code.

Notwithstanding this general rule, the IRS is permitted to share information provided by a taxpayer through the program with state tax agencies and certain federal agencies for non-tax purposes, including for purposes of investigating non-tax crimes.

Taxpayers should carefully assess the risks of such disclosure with the help of counsel in assessing whether participation in the program is appropriate.

3) Taxpayers who are unwilling to fully cooperate with the IRS.

Other taxpayers who may feel comfortable disclosing their own tax noncompliance but may be unwilling to provide details related to their professional advisors who were involved in the noncompliance shouldn't apply.

Form 14457 instructions are clear. Those who participate in the program must disclose information about third-party service providers who assisted the taxpayer during the years at issue, and must cooperate with the government in an investigation of those "professional enablers."

The investigation of professional enablers remains a high priority of criminal tax enforcement, so this requirement should not be taken lightly.

Additional Protections

In assessing a taxpayer's options, discussions likely will involve sensitive issues for which privilege and confidentiality may be in the taxpayer's best interest. Taxpayers considering their options and non-attorney advisors would be well-served to retain the services of an attorney sooner rather than later.

Communications involving third party advisors, such as accountants, may in certain cases be protected under an extension of the attorney-client privilege known as the Kovel doctrine. For this privilege to apply, however, the purpose of the third-party communication must be to assist the attorney in providing legal advice.

In this respect, courts are more likely to find that privilege attaches when the third party interprets information or otherwise assists the attorney in understanding the situation and issues involved, as opposed to acting in other capacities, such as providing accounting services, tax return preparation services, factual information, or independent tax advice.

Accordingly, taxpayers should exercise caution in communications with their non-attorney advisors, particularly with regard to tax compliance issues.

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