

Area of Focus #12 TAS Will Advocate for Greater Clarity and Certainty With Respect to the IRS's Updated Voluntary Disclosure Practice

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Be Informed*
- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Finality*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

DISCUSSION

Over the years, the IRS has developed various programs to encourage taxpayers who learn they could be subject to draconian civil and criminal penalties to come into compliance voluntarily. Pursuant to its longstanding voluntary disclosure practice (VDP), the IRS would take a person's voluntary disclosure into account in determining whether to refer them for criminal prosecution (*i.e.*, a disclosure would significantly reduce the risk for a taxpayer being referred for criminal prosecution).² To qualify, the person had to (a) make a timely disclosure (*i.e.*, generally before the government begins an investigation or learns of the noncompliance), (b) cooperate with the IRS, and (c) arrange to pay the liability in full.³

Historically, taxpayers who made a voluntary disclosure could often avoid civil penalties as well.⁴ Some practitioners advised that if penalties did apply to a voluntary disclosure involving an offshore account, they would typically amount to 12 to 15 percent of the balance of the undisclosed account in question.⁵ However, people could often achieve a similar result (*i.e.*, no criminal penalties and little or no civil

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

2 Internal Revenue Manual (IRM) 9.5.11.9, *Voluntary Disclosure Practice* (Dec. 2, 2009). Technically, the IRS can still refer a taxpayer who makes a voluntary disclosure for criminal prosecution, but it must consider the disclosure in making that decision. *Id.*

3 *Id.* The voluntary disclosure practice (VDP) is not available to those with illegal-source income. *Id.*

4 See, e.g., Mark E. Matthews and Scott D. Michel, *IRS's Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1, 5 (Sept. 21, 2010) (noting that before the offshore voluntary disclosure program (OVDP), "taxpayers rarely paid any penalties in connection with voluntary disclosures on offshore accounts. Indeed, most taxpayers, relying on the advice of skilled tax professionals, many of whom have decades of prior experience in the Justice Department (DOJ), or IRS, simply filed amended returns and paid the tax and interest. They were never audited. No penalties were ever asserted...").

5 Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. INT'L. TAX'N 36, 43 (2010).

penalties) by making a “quiet” disclosure—filing an amended return and paying any tax delinquency—without making a formal voluntary disclosure.⁶

Beginning in 2009, the IRS offered a series of offshore voluntary disclosure (OVD) programs to settle with taxpayers who had failed to report offshore income and file one or more related information returns (e.g., Form 114, *Report of Foreign Bank and Financial Accounts (FBAR)*). As the National Taxpayer Advocate described in prior reports, these programs applied a one-size-fits-all approach designed for “bad actors” who intentionally tried to evade taxes, to “benign actors” who inadvertently violated the rules, requiring them to opt-in and then opt-out, and threatening them with lengthy examinations and draconian civil and criminal penalties.⁷

Overview of Initiatives Available for Taxpayers With Unfiled Returns or Unreported Income

On September 28, 2018, the IRS ended its latest variation of the OVD program.⁸ In lieu of an OVD program, the IRS recently announced changes to its VDP.⁹

Like the longstanding VDP, the objective of the updated VDP is to provide an avenue for taxpayers with potential exposure to criminal liability with a means “to come into compliance with the law and potentially avoid criminal prosecution.”¹⁰ The updated VDP provides continued opportunities to make domestic or offshore voluntary disclosures.¹¹ However, the updated VDP gives examiners less discretion in the application of civil penalties.¹²

6 See, e.g., Mark E. Matthews and Scott D. Michel, *IRS’s Voluntary Disclosure Program for Offshore Accounts: A Critical Assessment After One Year*, 181 DTR J-1 (Sept. 21, 2010); Baker and McKenzie, *Undeclared Money Held Offshore: U.S. Voluntary Compliance Programs (Part 2)*, 21 J. INT’L. TAX’N 36, 43 (2010) (“most practitioners generally recommended to their clients the use of informal or ‘quiet’ disclosures. In theory, the taxpayer ran the risk of being ‘caught’ but, in practice, the taxpayer rarely heard anything back from the Service or DOJ. Further, if one did participate in the formal voluntary disclosure process, most, if not all, penalties generally were abated.”).

7 The National Taxpayer Advocate discussed the IRS’s OVD in eleven reports to Congress and in Taxpayer Advocate Directive (TAD) 2011-1, which was elevated to former Commissioner of Internal Revenue Douglas Shulman. See, e.g., National Taxpayer Advocate Fiscal Year (FY) 2018 Objectives Report to Congress 43-50; National Taxpayer Advocate 2017 Annual Report to Congress vol. 2 210-228; National Taxpayer Advocate FY 2016 Objectives Report to Congress vol. 2 32-35; National Taxpayer Advocate FY 2015 Objectives Report to Congress vol. 2 91-95; National Taxpayer Advocate FY 2014 Objectives Report to Congress 36-39; National Taxpayer Advocate 2014 Annual Report to Congress 79-93; National Taxpayer Advocate FY 2013 Objectives Report to Congress 21-29; National Taxpayer Advocate 2013 Annual Report to Congress 222-237; National Taxpayer Advocate FY 2012 Objectives Report to Congress 23-24; National Taxpayer Advocate 2012 Annual Report to Congress 134-153; National Taxpayer Advocate 2011 Annual Report to Congress 206-272 (including TAD 2011-1 and the IRS response). See also *IRS Reform: Lessons Learned from the National Taxpayer Advocate: Hearing Before the H. Comm. on Ways and Means, Subcomm. on Oversight* 115th Cong. 24 (2017) (testimony of Nina E. Olson, National Taxpayer Advocate).

8 See IRS, *IRS to End Offshore Voluntary Disclosure Program; Taxpayers With Undisclosed Foreign Assets Urged to Come Forward Now*, IR-2018-52 (Mar. 13, 2018).

9 Memorandum for Division Commissioners, Chief, Criminal Investigation, *Updated Voluntary Disclosure Practice* (Nov. 20, 2018). The VDP permits both domestic and offshore disclosures. *Id.*

10 *Id.*

11 *Id.*

12 *Id.*

Taxpayers who are not concerned about criminal liability can still make “quiet” disclosures, or in certain circumstances they may be eligible for the:

- (1) Streamlined Filing Compliance Procedures (SFCP);¹³
- (2) Delinquent FBAR Submission Procedures;¹⁴ or
- (3) Delinquent International Information Return Submission Procedures.¹⁵

None of these options provide the taxpayer with the finality that their tax issues are resolved because the IRS can still audit their returns and theoretically even refer them for criminal prosecution.¹⁶

Taxpayers May Be Unclear About Which Option to Use

A taxpayer may be confused whether a voluntary disclosure is appropriate because the IRS is routing all voluntary disclosures from the IRS Criminal Investigation Division to the Large Business & International (LB&I) Division and then from LB&I to the appropriate IRS division.¹⁷ This may create the perception that the updated VDP is only available for LB&I taxpayers.¹⁸ Additionally, having LB&I serve as a routing function could result in increased timeframes for non-corporate, domestic filers because of the additional routing involved and the possibility of increased errors in routing from LB&I to the appropriate function.

Additionally, some taxpayers may not know whether their conduct was willful, and therefore subject to enhanced penalties, including the possibility of criminal prosecution. Given this uncertainty, some who were not even clearly negligent are going to want to apply to the VDP to reduce the already-low possibility that they might have to pay to defend themselves in public against criminal charges.

Because “willfulness” can be inferred based on various facts and circumstances, taxpayers who feel they have acted reasonably might still be concerned that the IRS would view their conduct as willful and

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- 13 For additional information about the Streamlined Filing Compliance Program, see IRS, *Streamlined Filing Compliance Procedures*, <https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures> (last visited Apr. 5, 2019). The IRS indicated it may end the Streamlined Filing Compliance Program in the future. IRS, *IRS Reminds Those With Foreign Assets of Annual April 15 FBAR Deadline*, IR-2019-63 (Apr. 4, 2019); IRS, *IRS To End Offshore Voluntary Disclosure Program; Taxpayers With Undisclosed Foreign Assets Urged to Come Forward Now*, IR-2018-52 (Mar. 13, 2018).
 - 14 For additional information about the Delinquent Report of Foreign Bank and Financial Accounts (FBAR) Submission Procedures, see IRS, *Delinquent FBAR Submission Procedures*, <https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures> (last visited Apr. 5, 2019).
 - 15 For additional information about the Delinquent International Informational Return Submission Procedures, see IRS, *Delinquent International Informational Return Submission Procedures*, <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-informational-return-submission-procedures> (last visited Apr. 5, 2019).
 - 16 Returns filed under the Streamlined Filing Compliance Procedures will not be acknowledged by the IRS and will not result in a closing agreement. See IRS, *Streamlined Filing Compliance Procedures*, <https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures> (last visited Apr. 5, 2019). FBARs may be selected for audit through existing audit selection procedures. See IRS, *Delinquent FBAR Submission Procedures*, <https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures> (last visited Apr. 5, 2019). Information returns filed with amended returns may be selected for audit through existing audit selection procedures. See IRS, *Delinquent International Informational Return Submission Procedures*, <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-informational-return-submission-procedures> (last visited Apr. 5, 2019).
 - 17 Memorandum for Division Commissioners, Chief, Criminal Investigation, *Updated Voluntary Disclosure Practice* (Nov. 20, 2018).
 - 18 The Large Business & International (LB&I) Division serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million. See IRS, *Large Business and International Division At-a-Glance*, <https://www.irs.gov/businesses/international-businesses/large-business-and-international-division-at-a-glance> (last visited Apr. 8, 2019). The LB&I Division also serves international taxpayers. See IRS, *Full List of LB Large Business and International Campaigns*, <https://www.irs.gov/businesses/full-list-of-lb-large-business-and-international-campaigns> (last visited Apr. 8, 2019).

assert draconian civil and possibly even criminal penalties.¹⁹ To avoid this risk and to settle the matter with finality, some will apply to the VDP. When they do, taxpayers will find they face the choice of paying penalties designed for criminals or proving their innocence without the normal procedural protections.

The Updated VDP Is More Favorable to Taxpayers Who Engaged in Willful or Criminal Behavior

The burden of proving fraud has always been the responsibility of the IRS.²⁰ However, the updated VDP *presupposes* fraud.²¹ While the guidance permits a taxpayer to seek a penalty other than civil fraud, the guidance says “imposition of lesser penalties is expected to be exceptional.”²² The IRS is avoiding its legal responsibility by starting with the premise that fraud exists and then requiring the taxpayer to bear the burden of proving a lesser penalty.

A taxpayer who has engaged in willful or criminal behavior, such as the purposeful underreporting of their offshore income by hiding income in offshore accounts, will likely benefit from the VDP. By cooperating and agreeing with the examiner, the taxpayer will be assessed either a civil fraud penalty or a fraudulent failure to file penalty for the one tax year with the highest tax liability.²³

However, taxpayers who joined the VDP merely because they were concerned they may have a scintilla of criminal exposure will have a greater threshold to overcome to obtain a reasonable settlement. These taxpayers will have to convince the examiner that their conduct is not fraudulent. Additionally, if the examiner perceives a taxpayer as not agreeing or being uncooperative, the examiner could apply the fraud penalty to all six years of the disclosure period or beyond.²⁴

Taxpayers May Fear Requesting an Independent Appeal if They Do Not Agree With the Examiner

Unlike the OVD programs, the updated VDP guidance allows taxpayers the right to request an appeal with the Office of Appeals.²⁵ The Office of Appeals is an impartial, independent organization within the IRS available to taxpayers to resolve tax disputes with the IRS.²⁶ Allowing such appeals is consistent with the taxpayer’s *right to appeal an IRS decision in an independent forum*.²⁷

However, the VDP makes it seem risky for taxpayers to request an appeal. An appeals conference is generally requested at the conclusion of an exam, by filing a written protest, after the taxpayer has failed to reach an agreement with the examiner.²⁸ Disturbingly, the VDP guidance states that if a voluntary

19 Although willfulness is generally not inferred in a criminal context, taxpayers whose conduct the IRS deems willful for the purpose of civil penalties might still be concerned about the cost and burden of defending criminal charges. See, e.g., IRC § 7201.

20 See, e.g., IRC § 7454(a); *DiLeo v. Comm’r*, 96 T.C. 858, 873 (1991), *aff’d*, 959 F.2d 16 (2d Cir. 1992).

21 Memorandum for Division Commissioners; Chief, Criminal Investigation, *Updated Voluntary Disclosure Practice* (Nov. 20, 2018).

22 *Id.*

23 *Id.*

24 *Id.*

25 *Id.*

26 IRS, *About the Office of Appeals*, <https://www.irs.gov/appeals> (last visited Apr. 8, 2019).

27 IRC § 7803(a)(3)(E).

28 IRS, *Requesting An Appeal*, <https://www.irs.gov/appeals/preparing-a-request-for-appeals> (last visited Apr. 8, 2019).

disclosure is “not resolved by an agreement,” the examiner has the discretion to expand the scope and to assert the maximum penalties under the law.²⁹

This suggests that after a taxpayer requests an appeal, the examiner could expand the scope of the examination, and assert maximum penalties under the law. Without further clarification, the guidance sends the message to taxpayers that they could be punished for exercising their rights.

Additional VDP Guidance is Warranted

The IRS should provide guidance about what constitutes full payment for the disclosure period. The guidance should clarify whether a taxpayer is permitted to enter into an installment agreement to satisfy the taxes, interest, and penalties resulting from a voluntary disclosure.

The IRS should also provide additional guidance regarding the application of penalties. The guidance should describe the facts and circumstances in which examiners may apply the civil fraud or fraudulent failure to file penalty to more than one year, including when other penalties such as when the failure to file information returns and willful FBAR penalties, will be imposed and to which tax years.

CONCLUSION

The IRS should modify the VDP so that those who fear their particular circumstances may rise to criminal exposure do not have to convince the IRS of their innocence. Additionally, the IRS should clarify that examiners should not expand the scope of a disclosure or assess more penalties solely because a taxpayer may disagree with the examiner and requests an appeals conference. Lastly, the IRS should provide additional guidance on whether installment agreements will be permitted, and what facts and circumstances will allow an examiner to assess additional penalties.

FOCUS FOR FISCAL YEAR 2020

In fiscal year 2020, TAS will:

- Advocate for taxpayers experiencing problems with the IRS’s VDP and streamlined programs, including issuing Taxpayer Assistance Orders where appropriate;
- Advocate for the IRS to modify its VDP guidance to clarify that an examiner will not expand the scope of the disclosure or assess more penalties just because a taxpayer has exercised his or her appeal rights; and
- Propose VDP guidance changes to expressly allow installment agreements and to clarify what facts and circumstances will result in additional penalties under the VDP.

²⁹ Memorandum for Division Commissioners, Chief, Criminal Investigation, *Updated Voluntary Disclosure Practice* (Nov. 20, 2018).