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The 2020 Revision to the Internal Revenue Manual's Voluntary Disclosure Practice: More Consistency with Greater Risk

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There is consensus in the tax community that given limited enforcement resources (increasingly so in recent years) and an extremely complex tax code, offering taxpayers a mechanism to self-correct prior noncompliance is sound tax administration. Since 1952, the Internal Revenue Service, in one form or another, has promoted and followed its ''Voluntary Disclosure Practice'' (VDP), generally allowing taxpayers who had failed to comply with the tax law in prior years to come forward if not yet under scrutiny by the IRS, and, if the elements of the VDP were met, avoid criminal prosecution. The VDP was found in a longstanding provision of the Internal Revenue Manual (IRM), Section 9.5.11.9. For years, the IRM was the only VDP guidance available to taxpayers and practitioners, but at various times the IRS supplemented the IRM provision with more extensive procedures, most recently in the various iterations of the Offshore Voluntary Disclosure Programs (OVDP), with detailed rules set out in FAQs. Throughout the years, however, 9.5.11.9 provided a general framework for taxpayer advice.

In late September 2020, without any publicity, the Service revised this key provision. The nearly total rewrite conforms the IRM to the voluntary disclosure practices announced in November 2018 (IRS Memorandum LB&I-09-1118-014) (''the LB&I Memo''), which expired on November 20, 2020, and has apparently been removed from the IRS website. It also conforms to the recently revised instructions provided for IRS Form 14457, now the entry point for any taxpayer attempting a voluntary disclosure. (An excellent summary of the changes contained in the LB&I Memorandum is at ''Deal or No Deal: The Unknown Cost of the IRS's New Voluntary Disclosure Practice,'' Z. Ziering and A. Borsos, *White Collar Crime Committee Newsletter*, Winter/Spring 2019 (ABA Criminal Justice Section) http://www.capdale.com/files/25424_deal_or_no_deal_the_unknown_cost_of_the_irss_new_voluntary_disclosure_practice.pdf).

The revised IRM provision makes plain that it is intended to provide a ''compliance option'' only for taxpayers who have engaged in criminal activity, IRM 9.5.11.9(2), and provides guidance on how a taxpayer who wishes to make a voluntary disclosure should proceed. The civil penalty consequences of initiating a voluntary disclosure, described previously in the LB&I Memo, have been incorporated into the instructions to Form 14457. The revised IRM provision and the instructions to Form 14457 create an institutionalized and consistent structure for disclosures where the taxpayer is hoping to avoid criminal prosecution and provide the road map for, and some of the likely consequences of, completing the process.

Uncertainties, however, remain over what constitutes a ''timely'' disclosure and what civil penalties might be imposed resulting from the seemingly unfettered discretion left to the examining agent. More important, and more troubling, the IRM formalizes the changes to the ''pre-clearance'' process adopted in 2014 and implemented and expanded in the recent revisions to Form 14457 and the relevant instructions. These changes require taxpayers to make potentially significant and incriminating admissions simply to determine whether a disclosure would be timely. Thus, the IRM revision underscores that a taxpayer who wishes to make a formal

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voluntary disclosure faces many unknowns, which may undermine any chance of a successful new VDP.

Background

The VDP has provided taxpayers with a mechanism to fix prior non-compliance in a framework without generally facing criminal prosecution. The IRS was always clear that the VDP was not an ''amnesty,'' nor did it guarantee criminal immunity. Yet over the years, if a taxpayer met the required elements of the VDP, the IRS would refrain from a criminal referral to the Department of Justice and resolve the case civilly, with the taxpayer escaping the risk of indictment or prison. Under the VDP, many thousands of taxpayers, quietly and confidentially, have disclosed their tax sins and avoided prosecution, some with staggering amounts of tax, interest and penalties. With the IRS having limited enforcement resources and unable to catch even a small fraction of all tax evaders, the VDP has always made enormous sense as tax administration policy.

The traditional and basic elements for a valid voluntary disclosure have not changed. A taxpayer must (i) come forward on a timely basis, (ii) make truthful and complete filings, (iii) pay, or make good faith arrangements to pay, the amounts at issue, and (iv) cooperate with any ensuing examination or investigation. The VDP applies to non-filers, as well as to taxpayers who had earlier filed false returns, but is unavailable to anyone reporting illegal source income, including from activity legal under state but not federal law. It extends not only to personal income tax returns, but to corporate, estate, gift, employment, and other returns. Practitioners have used 9.5.11.9 also as a basis to disclose significant information return issues, *e.g.*, Form 8300 and the reporting of cash transactions. The IRS supplemented the VDP in recent years with additional lanes into compliance for non-willful offshore conduct and delinquent international information return and financial account reporting, but the broad framework of the VDP has endured as a major component of the ''return to compliance'' fabric.

A New and More Consistent Structure

Before the 2009 implementation of OVDP, the issue of how to accomplish a voluntary disclosure was the subject of as much lore as clear guidance. Some practitioners preferred to contact their local IRS Criminal Investigation (CI) office to arrange a meeting to describe a hypothetical taxpayer and try to get some reasonable assurance that if the facts were as represented, CI would likely consider it a voluntary disclosure. Others would advise clients to file the delinquent or amended returns and pay the tax and interest. The IRM also allowed a taxpayer to initiate a disclosure by filing returns under a ''letter from an attorney'' that enclosed payment and was otherwise timely (referred to by some practitioners as a ''Manual Disclosure'').

The new provision now prescribes a single path. To complete a voluntary disclosure and receive criminal protection the taxpayer now can use only the process set forth in the IRM and the taxpayer ''must utilize Form 14457.'' IRM 9.5.11.9.1(2). In ''responding to inquiries concerning the IRS voluntary disclosure practices, all IRS employees will refer to Section 9.5.11.9,'' and if taxpayer representatives have questions, a centralized email address is provided. IRM 9.5.11.9.3. The IRM revision thus eliminates the options of a filing under a ''cover letter'' or a meeting with CI, or any other approach.

The IRM also is clear that it creates no ''substantive or procedural rights for taxpayers,'' and that CI's decisions as to whether any taxpayer qualifies or should remain in the program ''are not subject to any administrative or judicial review or appeal process.'' IRM 9.5.11.9.1(3), (4). The Manual lays out a centralized process for processing and examining all disclosures and for maintaining appropriate records. IRM 9.5.11.9.2; .5, .6, .8. Consistent with prior policy, a taxpayer's participation in VDP can be revoked for making false statements or failing to cooperate. IRM 9.5.11.9.7.

Thus, for a taxpayer seeking to avoid criminal prosecution Form 14457 is the required first step, and the IRS's administrative centralization is aimed at ensuring consistent treatment of all such cases. Some practitioners may miss the tactical discussions with clients or colleagues about the preferred method for a client to ''come in from the cold,'' but in most respects, the clarity and uniformity of the new procedures is a welcome feature for taxpayers who wish to rectify their criminal conduct. For disclosures where criminal protection is not sought, the IRS will apparently welcome the ''quiet'' filing of delinquent or amended returns. In special cases involving offshore assets and delinquent international information returns and FBARs, the IRS still offers its Streamlined and other similar offshore disclosure programs, and we urge that it continue to do so, as these programs provide a mechanism for self-correction with more predictable and appropriately modest penalties for this group of innocent, and often non-resident, taxpayers. For criminal protection, though, there is now one door in, and one door only.

Uncertainties about Timeliness Guidance

Some of the more noteworthy changes in the new 9.5.11.9 relate to the element of timeliness. In general, the VDP has always provided that if a taxpayer comes to the IRS before the IRS comes to the taxpayer, the disclosure would be considered timely. The IRS long ago abandoned the subjective inquiry into the taxpayer's motivation for coming forward in favor of a more objective approach, such as whether a taxpayer is already under audit or investigation, whether a whistleblower may have approached the IRS, or whether the IRS might otherwise have obtained incriminating information about the specific taxpayer from other sources. In an illustrative case regarding timeliness, a court found that where a Wisconsin contractor disappeared out of his back door while being visited by IRS agents, and soon thereafter had a lawyer approach local IRS office in an attempt to make a voluntary disclosure, he was too late. *U.S. v. Knottnerus*.

Often the circumstances do not offer up such bright lines, and the IRM over the years has sought to address a range of ''timeliness'' scenarios. The revised Manual provision reflects subtle, but potentially significant, changes from prior rules, and is inconsistent with the revised instructions to Form 14457 in material respects. All of this creates uncertainties for practitioners and their clients.

The new IRM provision states:

(7) A disclosure is timely if it is received before:

a. The IRS has commenced a civil examination or criminal investigation of the taxpayer or has notified the taxpayer that it intends to commence such an examination or investigation.

b. The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the taxpayer's noncompliance.

c. The IRS has acquired information directly related to the noncompliance of the taxpayer from an enforcement action (e.g., search warrant, summons, grand jury subpoena).

IRM 9.5.11.9(7).

Perhaps the most significant revision in these eligibility provisions relates to the concept of a ''related'' case. The old IRM had a fourth timeliness criteria, providing that a disclosure was too late if ''*the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer.*'' The revised IRM eliminates this language, as well as examples providing that a taxpayer would be untimely in reporting skimmed income from a partnership or constructive dividend income from a corporation if a business partner or the company was already under audit, even if the taxpayer was not. Under the old provisions, whether the taxpayer was aware of these ''related'' examinations did not matter.

Now, however, both the Manual and Form 14457, however, require the taxpayer to answer whether the IRS has *notified* the taxpayer, the taxpayer's spouse or ''any related entities'' that it intends to open a civil audit or criminal investigation, or whether such persons or entities are in fact under civil audit or criminal or other investigation by any law enforcement authority. The form requires an explanation if any answer is yes, and the Manual merely states that an affirmative answer ''may'' render the taxpayer ineligible. IRM 9.5.11.9.4(1). Thus, the impact on the timeliness question of an audit or investigation of a ''related entity,'' especially an inquiry not known to the taxpayer, is simply not clear.

A second source of uncertainty arises from the new Section (7)(c) relating to the IRS's receipt of information from an ''enforcement action.'' Under the old IRM, such information had to derive from a ''*criminal*'' enforcement action. The new provision eliminates the word ''criminal,'' leaving open that there are disqualifying civil enforcement actions, such as a summons issued in a civil exam or a collection-related action. The instructions to Form 14457, however, *retain* the narrower concept of a ''criminal'' enforcement action.

Third, the new IRM states that if the IRS has information ''alerting the IRS to'' or ''directly related to'' the ''taxpayer's non-compliance,'' it is disqualifying. But it removes specific examples that defined, and seemed to limit, this concept. For example, previously a disclosure would be considered timely if the IRS had received information from a ''civil compliance project,'' even where such information might ''lead to'' the taxpayer, so long as an examination of that taxpayer had not begun. Similarly, a non-filer could come forward after receiving a computer notice but before any audit or investigation. Old IRM 11.5.9.1(6)(b,c,d). These hypotheticals are gone, and now, in contrast, the instructions for Form 14457 (but not the new Manual provision) provide that information obtained from a John Doe summons itself may be potentially disqualifying.

The formerly clear and explicit distinction between the receipt of information that might lead the IRS to the taxpayer, and the existence of an examination or investigation of the taxpayer, has been useful and sensible. Over the years taxpayers initiated a number of voluntary disclosures out of a concern that a general IRS enforcement initiative might eventually ensnare their particular returns, or that IRS Collection would eventually open a specific inquiry after computer-generated notices were sent. Accepting such disclosures was smart from a policy perspective, as the IRS had not yet spent any material resources investigating the specific taxpayer.

The net result of these changes is far greater uncertainty for taxpayers who want to come forward. For example, would a taxpayer's disclosure be too late if a ''directly related'' examination is underway but the taxpayer does not know about it? Is there any significance to whether disqualifying information is obtained only from a non-criminal ''enforcement action?'' If the IRS obtains a taxpayer's name in connection with a compliance project but has not yet discerned whether the specific taxpayer may owe more tax or opened an audit, is the taxpayer too late in trying to enter VDP? This latter question is a matter of current significance in light of, for example, the IRS's publicized intentions to examine cryptocurrency issues and high income non-filers, and, in early December, its request to a number of Swiss banks for non-anonymized account information maintained under FATCA. (*See* http://federaltaxcrimes.blogspot.com/2020/12/irs-group-requests-to-swiss-fta-for.html).

If a client asked us to guess, we would probably advise that in the current enforcement climate, the IRS is more likely to interpret these ambiguities so as to deny access to the Program, where previously the taxpayer may well have been eligible to make a voluntary disclosure. If so, this is unfortunate—in our view, the more restrictions to entry, the less successful VDP will be.

On the other hand, it could be that no material changes to the timeliness rules were intended and that these issues get worked out as the IRS continues to edit and conform the new Manual provision and the instructions to Form 14457. But these nuances can be critical in specific cases to practitioners advising taxpayers who want to come clean. Such persons are generally wary enough, but adding vagueness to the process, or creating the impression that there are traps for anyone trying to get things right, is likely to deter some of them from coming forward, undermining tax compliance. We hope the IRS will develop unified and clearer guidance on timeliness. Until then, tax advisors can do nothing more than highlight the uncertainties for clients in cases where they might matter.

Significant Remaining Risks

With the revision to 9.5.11.9, the IRS has completed the process of formalizing and centralizing the VDP. In terms of results, two major areas of uncertainty remain, one involving the civil penalty dispositions and the other, and more serious, leaving the client at significant risk of self-incrimination before knowing whether the disclosure will be considered timely. The former is something that can be addressed over time and by fur-

ther guidance, and perhaps even tolerated by clients in many cases. The latter represents a significant impediment to the success of VDP going forward and could substantially reduce the number of disclosures.

Picking up from the LB&I Memo, Form 14457 describes in general terms the financial consequences of a voluntary disclosure (not referenced in 9.5.11.9, part of the criminal section of the IRM). The taxpayer should file six years of tax and information returns, and is likely to face the civil fraud penalty of 75% on the tax due at least for the year with the most newly reported income. Where an offshore financial account is disclosed, the taxpayer should, under related guidance, expect at least a one year FBAR penalty of 50% on the high balance.

IRS examiners, however, retain significant discretion, including whether to apply information return penalties, or penalties against estate, gift, employment, or excise taxes. This discretion can make a huge difference in the applicable penalties. Such penalties, particularly in the area of foreign trusts, can be enormous and may be the decisive factor as to whether a taxpayer will proceed with VDP. Historically, practitioners often advised clients that the IRS welcomes voluntary disclosures and will act reasonably so as not to discourage the process, but the IRS has not hesitated more recently to impose confiscatory penalties, especially in the offshore, FBAR, and foreign trust areas. Practitioners will have to warn the client making a good faith disclosure to prepare for worst case scenarios and to plan for a difficult administrative appeal in circumstances where criminal activity will be admitted. A clearer signal from the IRS that it will limit civil tax penalties to the one year fraud and FBAR penalties, and that it will limit or not impose other information return penalties, would add an element of greater certainty, encourage more disclosures, and promote the VDP's objectives.

To be sure, the VDP is explicitly aimed at, and only at, tax criminals, *i.e.*, cases where the taxpayer's need for criminal protection is the driver, and the taxpayer has, possibly, a lesser concern about the financial consequences of coming forward. There are numerous cases, however, where the question of willfulness is in a ''gray zone,'' and for some taxpayers in these circumstances, opting for VDP might still represent a good choice in bringing closure. The wider and harsher the range of potential financial consequences, especially in the area of foreign trusts, the less likely this group will be to elect to enter VDP.

The more significant uncertainty, however, derives from the IRM's continuing requirement that a taxpayer provide incriminating admissions and investigative leads simply to obtain ''pre-clearance,'' *i.e.*, to ascertain if the disclosure is timely. This jeopardizes the IRS's new approach. The IRM, like Form 14457, requires a taxpayer to list all non-compliant domestic and foreign bank accounts, and all corporations, trusts and other structures, whether domestic or foreign, relating to the taxpayer's non-compliance. All of this is simply to inquire into whether the taxpayer's disclosure would be deemed ''too late.'' Obviously, such information, especially if unknown to the Service, can constitute incriminating admissions or provide useful, if not dispositive, investigative leads. The risk of self-incrimination is heightened in light of the aforementioned uncertainties over timeliness. The IRS offers no promise that if a taxpayer is denied entry into VDP, criminal investigators will not use information provided in a good faith disclosure that turns out to be untimely.

To some extent, there has always been some element of risk in initiating a voluntary disclosure. A whistleblower or informant might have approached the IRS first, or an audit flag might have been raised on a taxpayer who had not received a notice. Beginning in 2009, the IRS thus implemented the ''pre-clearance'' process that enabled a taxpayer to provide basic identifying information to IRS CI in order to ascertain whether a disclosure would be considered timely. One would fax the taxpayer's name, address, TIN, date of birth and other identifying data to CI, and receive a return fax stating whether a disclosure from the taxpayer would be timely or whether it was too late. No substantive information about the case had to be provided.

In 2014, apparently after feeling ''burned'' by a timeliness issue involving a single bank's clients, the IRS began to require the taxpayer to identify relevant foreign banks and related foreign entities. This was a sea change. Now the taxpayer was required to provide incriminating leads with no assurance that the disclosure would be considered timely. Some taxpayers balked at moving forward with the process, but as this change was limited an offshore program, at a time when foreign banks were already providing information through the Swiss Bank Program or FATCA (and notifying account holders of their intent to do so), it was likely that the IRS would get the information anyway and thus the taxpayer simply had to move faster than their bank.

The expanded VDP disclosure requirements on Part I of Form 14457 for all voluntary disclosures, not just offshore issues, literally and significantly increases the ante just for a taxpayer to enter the program. The IRS requires a full inventory of non-compliant accounts and related entities, admissions that could certainly incriminate the taxpayer. In an era where the IRS benefits from enhanced international information exchange, highly sophisticated data analytics, and a much more active whistleblower bar, the chance of a disqualifying ''hit'' resulting from any of these specific disclosures is significantly greater than it was years ago. The opportunities for the IRS to play ''gotcha'' have increased, and we consider it unlikely that the use of leads provided in Form 14457 in any ensuing investigation would be prohibited.

This creates yet more uncertainty for a taxpayer considering VDP. The tough decision whether to supply potentially incriminating information is the client's call, and under Circular 230 practitioners must advise on the rules and procedures and the risks entailed by coming forward or not. Taxpayers will face the dilemma of, essentially, confessing to their crimes without any assurance that they will be protected, or continuing to try to evade IRS scrutiny. As most know, there is no legal requirement to fix prior tax problems, and more than a few clients have consulted practitioners about their disclosure options and then decided to leave and never be heard from again. Notwithstanding every tax lawyer's advice that unfiled current returns must be truthful and complete, the taxpayer who does not become the client is likely to continue to remain non-compliant.

A simpler and more straightforward ''pre-clearance'' mechanism that does not entail the degree of substantive confessions now required by Form 14457 would promote the concept of voluntary disclosure and ensure a greater degree of ongoing tax compliance. With its

new data analytics abilities, the IRS ought to be able to ''pre-clear'' (or not) a taxpayer based only on the types of identifying information supplied in the earlier days of OVDP. The detailed information now required in Part I simply to obtain pre-clearance could easily be shifted to Part II, to be provided after the taxpayer's disclosure is deemed timely, increasing the likelihood than more taxpayers would enter the program.

Conclusion

IRS voluntary disclosures have evolved significantly from an anecdotal practice with different techniques and strategies, through the frenzied early years of OVDP, to a more centralized, uniform and clarified process. Many lessons have been learned from various versions of OVDP and the related offshore disclosure regimes. The revision of 9.5.11.9 is apparently the final step in promoting consistent treatment of all taxpayers seeking to make disclosures, and this is to be applauded.

Any taxpayer considering VDP, however, still faces significant unknowns in deciding to come forward. For the true tax criminal, there may be less concern about providing incriminating leads because if they are too late and the investigation is underway, the information provided will likely come out. Financial consequences also generally do not drive such a taxpayer's decision.

Tax non-compliance, however, is not always black and white. Cases can exhibit both incriminating and mitigating facts and circumstances. Many taxpayers in these types of cases might elect to initiate a voluntary disclosure to obtain certainty that they will not be prosecuted, also ensuring, for the IRS, their future compliance. For this group, the gamesmanship entailed in the revised VDP is both unnecessary and counterproductive. A clearer definition of timeliness, a fixed set of financial consequences, and a simplified and less incriminating pre-clearance process would make VDP an easier decision and promote the program's purposes. Otherwise, taxpayers in the ''gray zone'' might be tempted to gamble on remaining undetected or to file quietly, knowing that given current audit rates, there is a reasonable chance they may escape audit, or if they do get examined, face only civil penalties that may not exceed what they would owe in VDP.

The IRS achieved enormous success with an OVDP procedure that let taxpayers learn simply and cleanly whether their disclosure was timely and that largely quantified the financial consequences of participation. The current effort to centralize the VDP process is commendable. We urge the Service, as it monitors and reviews these new procedures in coming months, to reconsider whether clarifying the timeliness rules, providing a more definitive penalty structure, and mitigating the jeopardy from self-incrimination might encourage more disclosures with little damage to the IRS. Since the IRS cannot catch every non-compliant taxpayer, cleaning up these concerns would seem preferable to continuing a system that many taxpayers will perceive as hazardous. From the front lines and with decades of tough client conversations under our belts, we can state with certainty that more people will come forward if they can do so without creating even greater risk for themselves and where they know what consequences they will face.

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