

# New York Law Journal



Web address: <http://www.law.com/ny>

VOLUME 229—NO. 11

THURSDAY, JANUARY 16, 2003

## TAX LITIGATION ISSUES

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### *The 'New' IRS Voluntary Disclosure Policy*

THE INTERNAL Revenue Service seeks to encourage taxpayers to comply with their obligations to pay taxes, and uses criminal prosecutions both to punish tax cheats and to deter others who may be tempted. There is, however, an important function to be served by providing a mechanism for individuals who have fallen out of compliance with their tax obligations — either by not filing returns or by filing false returns — to “come clean.” Such a mechanism, like the tax amnesty program currently under way in New York state,<sup>1</sup> enables the government to maximize revenues, while doing minimal violence to the goal of punishing tax violators.

Since the 1960s, the IRS has sought to balance its revenue collection and prosecutorial functions by means of a Voluntary Disclosure Policy, which in theory offers errant taxpayers the opportunity to bring themselves into compliance without subjecting themselves to criminal prosecution.<sup>2</sup> Unfortunately, the various iterations of the IRS' policy have failed to strike the appropriate balance between encouraging contrite violators to voluntarily comply with the tax laws and enabling an individ-



ual who learns that he is under investigation to thwart any prosecution by amending heretofore suspect returns under the guise of a “voluntary” disclosure.

On Dec. 11, 2002, the IRS yet again revised its Voluntary Disclosure Policy by tinkering with its definitions of what makes a disclosure sufficiently “timely” in order to qualify for consideration under that policy. In remarks accompanying the latest rendition of its policy, the Acting Director of the IRS, Bob Wenzel, correctly observed that “[s]ound tax administration, including the possible use of criminal prosecution, requires as much clarity as possible.” While Mr. Wenzel asserted that the revisions were designed to provide taxpayers and their advisers with a better understanding of the steps to follow in order to get “back into compliance with the tax laws,” the IRS has failed to provide adequate assurances of non-prosecution necessary to encourage non-compliant taxpayers to come forward and meet their tax obligations. Rather, the latest version of the policy provides that a taxpayer may be disqualified from protection by virtue of information known to the IRS, but about which the taxpayer is com-

pletely unaware. This possibility, coupled with the fact that the IRS retains unfettered discretion to recommend prosecution even where the disclosure is truly voluntary, means that no well-counseled taxpayer can be assured that a voluntary disclosure will protect him or her from prosecution. Indeed, a failed attempt to qualify for non-prosecution will expose the taxpayer to significant criminal liability, although it will offer the slight solace of the possibility of a downward departure. Thus, if the aim of the program is to encourage errant taxpayers to come clean, it has again missed its mark.

#### **Exercise of Discretion**

During the 1950s, the IRS abandoned its informal but widely recognized policy of granting immunity to taxpayers who came forward to disclose previously undetected tax liabilities. In 1973, the IRS adopted the precursor to its current Voluntary Disclosure Policy, providing that, in deciding whether to recommend prosecution, the IRS will take into consideration whether the taxpayer came forward of his own volition to correct some past under-reporting of tax liability. Significantly, throughout the policy's history, the IRS has expressly warned that the voluntary disclosure policy is a matter of internal practice, and it has reserved the right to pursue criminal charges against even those taxpayers who have met all the policy's requirements! Thus, the fact that a taxpayer has “made a clean breast of things” and essentially thrown himself on the mercy of the IRS is

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not dispositive.

Notwithstanding its perceived need to preserve its discretion to pursue egregious cases, the IRS has long recognized the value of providing taxpayers a significant degree of certainty that efforts to “come clean” will not be rewarded with a criminal prosecution. In fact, the success of a Voluntary Disclosure Policy is, in large part, predicated on the ability to predict whether a disclosure will lead to criminal charges: the IRS’ goal of maximizing compliance is best served by providing repentant taxpayers with assurances that by correcting past derelictions they are not packaging and delivering to the government virtually all the evidence needed to obtain convictions if it arbitrarily chooses to do so. At a minimum, the taxpayer considering such a disclosure should be able to determine whether he qualifies under the terms of the program. Yet, the latest revisions to the Voluntary Disclosure Policy, while acknowledging the value of clarity, fail to provide a reasonable degree of certainty to taxpayers who seek to fall within the program.

### **Voluntariness**

The heart of the problem lies with the IRS’ definition of what constitutes a “voluntary disclosure.” Under the prior version, a disclosure was deemed untimely (and thus involuntary) if made after the IRS had begun an inquiry likely to lead to the taxpayer, only if the taxpayer was “reasonably thought to be aware of that investigative activity,” or following an event “known by the taxpayer,” which was likely to cause an audit of the taxpayer’s liabilities.<sup>3</sup> Thus, under the former policy, when a taxpayer’s expiation was motivated by fear of detection because the IRS was on to him, rather than as a result of a true desire to come clean, the disclosure was not deemed “voluntary” and he would be ineligible for consideration under the policy.

Unlike the old policy, which enabled a taxpayer to know in advance that it was too late to try a voluntary disclosure, under the new policy, the purity of the taxpayer’s motive is irrelevant. No matter how sin-

cere his effort to make a clean breast may be, if the IRS has already begun an investigation or audit or obtained information that might lead it to the taxpayer, he will be ineligible, even if he is completely unaware of the IRS activity that disqualifies him. Thus, the revised policy defines the timeliness of a disclosure as requiring that it be made before a “triggering event,” which would have led the IRS to discover the taxpayer’s liability independent of the disclosure.

The new policy goes on to define “triggering events” as including (a) the IRS’ initiation of a civil examination or criminal investigation of the taxpayer, or its notification of the taxpayer that it intends to commence such an examination or investigation; (b) the IRS’ receipt of in-

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*[B]ecause the new policy defines the triggering events from the IRS’ perspective, it deprives taxpayers and advisers of the certainty necessary to [use] the program.*

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formation from a third party (e.g., informant, other governmental agency or the media) regarding a specific taxpayer’s non-compliance; and (c) the IRS’ acquisition of information directly related to the taxpayer’s specific liability from a criminal enforcement action (e.g., search warrant, grand jury subpoena). Thus, the new list of triggering events is more expansive than those enumerated in the previous version of the policy, which did not expressly include information obtained through third parties or criminal enforcement mechanisms. While this shift in focus from information known to the taxpayer to information known to the IRS may have been motivated by the IRS’ desire for unfettered discretion to pursue all taxpayers whose liability they would otherwise have discovered, because the new policy defines the

triggering events from the IRS’ perspective, rather than with reference to the taxpayer’s knowledge, it deprives taxpayers and their advisers of the certainty necessary to encourage utilization of the program.

Even the new policy’s clarification that a general investigation or a compliance project into a particular type of transaction — which might but has not yet led to an investigation of a particular taxpayer — will not constitute a triggering event for that taxpayer falls short of providing the desired level of certainty. While publicity surrounding a given enforcement priority, such as the IRS’ current focus on abusive tax shelters, should not, in and of itself, preclude a taxpayer who has participated in such targeted activity from coming forward, the IRS’ invitation to make disclosure in these circumstances should be regarded with some caution because the taxpayer has no way of knowing whether he has already been identified by the IRS.

In recent years, the IRS has pursued an investigative initiative of the use of offshore credit cards to avoid tax liabilities. In an effort to entice taxpayers who use such credit cards to participate in the Voluntary Disclosure Policy, on Tuesday the IRS unveiled a new Offshore Voluntary Compliance Initiative aimed at providing taxpayers who use offshore credit cards or other financial arrangements an opportunity to come back into compliance with the tax laws.<sup>4</sup> In order to qualify for this new initiative, the taxpayers must not only pay back taxes, interest and certain accuracy or delinquency penalties, but also provide information regarding the individuals who promoted the offshore scheme and the operation of the scheme itself. In exchange, the taxpayer will be offered the ability to avoid criminal prosecution and will be excused from paying civil fraud penalties. However, because this initiative is predicated upon the Voluntary Disclosure Policy, taxpayers seeking to take advantage of the initiative have no assurance that, after making the necessary disclosures, they will be granted protection from criminal sanctions.

The benefit to the IRS from precluding

taxpayers who are unaware of a pending investigation from taking advantage of the Voluntary Disclosure Policy is hard to fathom, particularly given the scant number of tax prosecutions commenced each year and the fact that the IRS may prosecute even those taxpayers who do qualify under its voluntary disclosure program. Indeed, even under the old policy, the IRS was able to challenge effectively a taxpayer's claim that his disclosure was voluntary where circumstances suggested otherwise. *United States v. Zuckerman*,<sup>5</sup> is a case in point. There, after the taxpayer was contacted by the IRS to obtain information about his employer, his accountant called the IRS and disclosed that the taxpayer had not filed returns for a number of years. The IRS commenced a criminal investigation of the taxpayer after he filed those returns and expressed his intention to submit a payment plan. The service contended that it had uncovered the delinquency by the time the accountant had contacted the IRS as a result of a computer search conducted in preparation for its interview of the taxpayer. Magistrate Judge E. Thomas Boyle of the Eastern District of New York rejected the taxpayer's contention that he made his disclosure without knowledge of that fact, finding that his argument "strains credulity." Magistrate Judge Boyle refused to accept that the taxpayer's accountant "spontaneously chose to call the IRS and disclose that [the taxpayer] had failed to file his tax returns for five years," the day after the IRS sought to contact the taxpayer.

### Other Requirements

The revised policy makes explicit for the first time that the voluntary disclosure practice is not available to taxpayers with illegal source income. It also reiterates the prior requirement that the taxpayer must be both willing and able to cooperate with the service in determining the correct tax liability. The new version replaces the previous requirements that taxpayers make bona fide arrangements to pay to the extent of their actual ability to pay<sup>6</sup> with a stark con-

dition that the taxpayer make "good faith arrangements with the IRS to pay, in full, the tax, interest, and any penalties determined by the IRS to be applicable," including the 75 percent penalty applicable in cases of fraud.

This more exacting language may have been motivated by the recent litigation in *United States v. Tenzer* in which a delinquent taxpayer offered to pay only a portion of his outstanding liability. The district court was initially persuaded by the taxpayer's argument that his offer of modest installment payments, although "laughable" given the extent of his liabilities, was not sufficient to disqualify him from the benefits of voluntary disclosure.<sup>7</sup> The U.S. Court of Appeals for the Second Circuit reversed the trial court's finding that the taxpayer was entitled to immunity under the voluntary disclosure program, finding that the policy's requirement of an "arrangement to pay" contemplates an actual agreement rather than a mere offer from the taxpayer.<sup>8</sup> The court did observe however, that "[w]hile the burden of making a bona fide arrangement rests principally on the taxpayer, ... [t]he government is obligated to negotiate in good faith with the taxpayer toward the end of achieving an arrangement to pay. ... [and] the IRS may not withhold its assent capriciously or in bad faith." Although the court found that the taxpayer's offer was inadequate to bring him within the terms of the voluntary disclosure policy, it subsequently held that the IRS conduct in prosecuting the defendant notwithstanding his efforts to reach a payment arrangement might constitute the type of mitigating circumstance warranting a downward sentencing departure.<sup>9</sup> Although Mr. Tenzer was ultimately convicted of the misdemeanor of failure to file his tax returns, the protracted litigation and pointed criticism the IRS received during that process appear to have caused it to tighten the requirements for making payment arrangements. It remains to be seen whether its obligation to negotiate in good faith with taxpayers seeking voluntary disclosure status will be affected by this revision.

### The Way to Go

As if the risks of voluntary disclosure were not already sufficient to deter most taxpayers from coming forward, in its illustrations accompanying the revised policy, the IRS makes clear that anonymous disclosures do not fall within the policy. Thus, an attorney cannot contact the IRS on behalf of an unidentified client in order to determine whether, if the taxpayer resolves his tax liability, he can avoid prosecution. As a practical matter, even the taxpayer who wishes to come clean may conclude that he has little to gain from a program that requires complete disclosure and complete payment before he learns his fate. Such taxpayers can still follow the procedure, currently recommended by the vast majority of experienced practitioners, of filing amended or delinquent returns with the service center, paying the tax and interest, and bypassing the voluntary disclosure process altogether. If the taxpayer has escaped the IRS' notice up to that point, it is highly unlikely that the service will opt to prosecute once the returns are filed and payment or arrangements to pay have been commenced.

(1) See John J. Tigue, Jr. and Jeremy H. Temkin, "State Tax Enforcement: The Carrot and the Stick," *New York Law Journal*, July 9, 2002.

(2) This policy was announced in 1961 and incorporated into the Internal Revenue Manual in 1973.

(3) I.R.M. CI Handbook [9.5] 3.3.1.2.1. (April 1999).

(4) See Rev. Proc. 2003-11; Release No. IR-2003-5.

(5) 88 FSupp2d 9 (E.D.N.Y. 2000).

(6) See I.R.M. §342.142(3)(e) (April 1993); IRS Chief Counsel's Directives Manual Part (31)330, §(4)(d) (December 1991).

(7) *United States v. Tenzer*, 950 FSupp 554 (S.D.N.Y. 1996).

(8) 127 F3d 222 (2d Cir. 1997). The court declined to reach the question of whether prosecution of a taxpayer who had complied with the voluntary disclosure policy was a violation of due process, relying instead on its finding that the taxpayer had not complied with the policy.

(9) 213 F3d 34 (2d Cir. 2000). Taxpayers prosecuted despite efforts to make a voluntary disclosure to the IRS might also invoke §5K2.16 of the sentencing guidelines, which authorizes a downward departure where the defendant has voluntarily disclosed an offense which was unlikely to have been otherwise discovered.

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