Welcome to Edition 15 of The Newsletter from Scott H. Novak, Attorney at Law. The Newsletter is designed to bring timely and interesting topics to accountants and attorneys. Comments and suggestions are always welcome. Feel free to call or write at any time.

Normally, this Newsletter covers two or more topics. This time, it is covering one important topic. While the New IRS Voluntary Disclosure Program was released last November, I find that there are many who are unfamiliar with it, so it remains a timely topic.

The New IRS Voluntary Disclosure Program

The IRS Voluntary Disclosure Program has been around for many years. However, the voluntary disclosure regime is getting much more attention as a result of the closing of the Offshore Voluntary Disclosure Initiative (OVDI) on September 28, 2018.

Under the voluntary program that existed prior to the OVDI, approaching the IRS with a potential voluntary disclosure was largely a "one-off" situation that occurred only after the taxpayer concluded that there really was no other option. Usually, the taxpayer making a traditional voluntary disclosure faced a rigorous civil audit to determine the true tax due and all deficiencies were subject to the civil fraud penalty.

On November 20, 2018, the IRS came out with a new voluntary disclosure regime, the stated objective of which is to "provide taxpayers concerned that their conduct is willful or fraudulent, and that may rise to the level of tax and tax-related criminal acts, with a means to come into compliance with the law and potentially avoid criminal prosecution."

So how does the new program work? It starts with a preclearance from the IRS Criminal Investigation Unit (CI). CI screens all voluntary disclosure requests, whether domestic, offshore or anything else, to determine if the taxpayer is eligible for the voluntary disclosure program. To get the process started, the taxpayer files a newly redesigned Form 14457.

Early on, the form asks you to briefly describe the issue. You must address whether you think the IRS is on to you. The form asks about related entities. If there is a partnership that you are a partner of, that's under investigation, for example, you may not get precleared. The form instructs you to list ALL noncompliant financial accounts.

The Internal Revenue Manual (IRM) at 9.5.11.9 serves as the basis to determine taxpayer eligibility for a voluntary disclosure. One part of the IRM basically states that amended returns submitted by an attorney with a letter from the attorney may in fact be an acceptable voluntary disclosure. It is a judgment call as to whether to use Form 14457 or amended returns. It is very clear that if your client has illegal source income, the client will be ineligible for a voluntary disclosure.

Assuming there is no current or pending criminal investigation involving the taxpayer or a related entity, preclearance is likely. Going back to form 14457, the last two pages are submitted only after you have been precleared. The fourth page, under "Narrative," requires you to set forth the facts from inception to present. You are then asked about the specific noncompliance, taxpayer background and professional advisors. You must include a complete discussion about Title 26 and Title 31 failure and explain all methods used to conceal your noncompliance. Taxpayer background must include all aspects of your personal and professional history. If your disclosure involves offshore issues, you must provide a complete story about your foreign financial assets. The form states that you must provide specific facts on this form providing a complete story *about your tax fraud and willful noncompliance*.

Once CI has received and preliminarily accepted the taxpayer's voluntary disclosure, CI will notify the taxpayer of preliminary acceptance by letter and forward the voluntary disclosure letter and attachments to Austin for case preparation before examination.

Once received in Austin, they route the case as appropriate. It goes out to the appropriate Business Operating Division and Exam function for civil examination. This is a *full* civil examination, not limited to verifying the numbers, as was done in the OVDI program. Full cooperation is expected. If full cooperation is not given, the taxpayer's preliminary acceptance for a voluntary disclosure could be revoked. This is quite a significant weapon, because at least in *theory*, a criminal investigation could be opened and the taxpayer has already given quite a bit of information that could be used against him. In *practice*, if word got out that this was happening, how many more people would come forward under the voluntary program? In any event, the Service expects that voluntary disclosures will be resolved by agreement with the full payment of taxes, interest and penalty.

Here is the general framework of how this works. The voluntary disclosure period will generally be the six most recent tax years (better than the 8 under OVDI). This may vary. If the voluntary disclosure cannot be resolved by agreement, the examiner has the discretion to expand the scope of the examination to ALL years of noncompliance and may assert the maximum penalties allowable under the law, provided there is management approval. In cases where the noncompliance is less than six years, all years will be up for examination. With the IRS's review and consent, cooperative taxpayers may expand the disclosure period beyond six years. Who would do this? Someone correcting tax issues with other governments that include the other years, correcting tax issues before the sale or acquisition of an entity, correcting tax issues relating to unreported taxable gifts in prior tax periods.

Examiners determine taxes, interest and penalties. On the topic of penalties, either the civil penalty for fraud or the civil penalty for the fraudulent failure to file income tax returns will apply to the one year with the highest tax liability. That's a 75% penalty. In limited circumstances, the examiner can apply the 75% penalty to more than one year, based on facts and circumstances (such as if there's no agreement as to the tax liability). The penalty can be applied past the six-year disclosure period if the taxpayer fails to cooperate and resolve the examination by agreement. They are really trying to force the taxpayer into coming to a settlement with the examiner. All bets are off if you do not.

The IRS indicates that in each of these voluntary disclosures, penalty consideration is important. Managers must ensure that penalties are applied consistently, fully developed and documented in all cases. But, penalty mitigation may occur, depending on a few factors. Mitigation occurs by focusing on a specific disclosure period, the discretion of the examiner based on all of the relevant facts and circumstances and MOST importantly, the full cooperation of the taxpayer during the civil examination of the voluntary disclosure. Now let's not gloss over that. If you are to do a voluntary disclosure, you have to come clean. There is no in-between, no massaging of the facts, no omissions because you think it best if the IRS doesn't know about something. If you are not ready to go that far, think twice about doing a voluntary disclosure.

If the taxpayer can provide convincing evidence of why mitigation should happen, he can request the 20% accuracy penalty in place of the 75% civil fraud penalty or the willful FBAR penalty. This is supposed to be the exception, not the rule.

Penalties for the failure to file information returns will not automatically be imposed. Examiner discretion calls for taking into account the application of other penalties to determine if these penalties should be imposed. This is a *good* thing, as, for example, the failure to file a form 5471 is $10,000 per return, which adds up quickly. Under the OVDI program, generally, if you got hit with the 27.5% penalty, you did *not* get hit with the information return penalties. That point is far less clear here. It is up to the discretion of the examiner. Penalties related to excise taxes, employment taxes, estate and gift tax, etc. will be handled on a case by case basis with the involvement of the subject matter experts. There remain appeal rights after a voluntary disclosure examination, but you start to see how the examiner can use the threat of large penalties to get things to go the way he or she wants them to go.

So a few thoughts on this. It is possible to get the 50% FBAR penalty and the 75% fraud penalty for the same year, or for more than one year. Non-cooperative taxpayers will face a more stringent penalty regime. If that is going to be your client, you might want to consider whether the cost of admission is worth it. A hallmark of voluntary disclosure is and has *always* been that the IRS must not already know about you. If they do, you will *not* get precleared. Again, you don't need the voluntary disclosure program if there was no criminal or fraudulent activity. Appeal is a funny thing here. The IRS says specifically that you are entitled to appeal (unlike the OVDI, where there were no appeal rights). But if you do appeal, you can be deemed to be uncooperative and higher penalties can be asserted.

Even though this new voluntary disclosure regime came out in a November 20th Treasury memorandum, there is still quite a bit that we don't know about the program. The thought process about whether or not to come forward under this program is complicated because of substantially higher penalties and what appears to be much more aggressive IRS civil review of all new voluntary disclosures.

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