Deal or No Deal: The Unknown Cost of the IRS's New Voluntary Disclosure Practice

By Zhanna A. Ziering and Arielle M. Borsos[1]

The Internal Revenue Service cannot detect and punish everyone who fails to comply with the tax law. Thus, it is essential for effective tax administration that such taxpayers have an acceptable mechanism to self-correct. For decades, a qualifying taxpayer with potential criminal tax exposure had an opportunity to resolve their tax issues with the IRS on their own initiative and avoid criminal prosecution through the IRS's long-standing voluntary disclosure practice as set forth in the Internal Revenue Manual ("IRM").[2] Under this practice, the taxpayer had to come forward in a timely[3] manner, cooperate with the IRS, submit truthful and complete amended or delinquent returns, and pay (or make good faith arrangements to pay) the related tax, interest, and penalties that the IRS determined to be applicable. In exchange, the IRS generally would not recommend the taxpayer for criminal prosecution. This voluntary disclosure practice was administered informally, without explicit guidelines beyond its relatively brief description in the IRM, and worked reasonably well for decades. There were no explicit understandings as to civil penalties.[4]

In 2009, in the aftermath of UBS's entry into a deferred prosecution agreement covering its decades-long practice of helping Americans hide money in Switzerland,[5] the IRS introduced the Offshore Voluntary Disclosure Program ("OVDP"), an issue-specific program for taxpayers with previously unreported offshore assets. Unlike the traditional voluntary disclosure practice, the OVDP established formal procedures for participation in the program, a uniform civil penalty structure, and an explicit promise of no criminal prosecution. Taxpayers who had potential criminal exposure relating to offshore issues were expected to utilize the OVDP to resolve their prior noncompliance. Although the IRS intended that the OVDP be temporary, the Service extended the program three times, in 2011, 2012, and 2014, concomitantly increasing the applicable civil penalties to encourage prompt participation and disclosure. But in 2018, the IRS announced it would no longer extend the OVDP, shuttering the program on September 28, 2018. The end of the

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[1] Zhanna A. Ziering is a Member of and Arielle M. Borsos is an Associate with Caplin & Drysdale, Chartered. Ms. Ziering practices in the firm's New York office and Ms. Borsos practices in the Washington, D.C. office. Both specialize in offshore and domestic criminal tax matters. The authors thank Scott D. Michel, a Member of Caplin & Drysdale, for contributing his insights and perspective to the article.

[2] I.R.M. 9.5.11.9

[3] A disclosure is timely if it is received before: the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination; the IRS has received information from a third party (e.g., informant, other governmental agency or the media) alerting the IRS to the specific taxpayer's noncompliance; the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer and; the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena). IRM 9.5.11.9.5.

[4] I.R.M. 9.5.11.9 (3).

[5] Press Release, U.S. Dep't of Justice, UBS Enters into Deferred Prosecution Agreement (Feb. 18, 2009), https://www.justice.gov/opa/pr/ubs-enters-deferred-prosecution-agreement.

OVDP left uncertainties about how taxpayers could effectively resolve their offshore noncompliance going forward.

Throughout the OVDP period, meanwhile, taxpayers whose prior non-compliance arose from non-offshore issues, such as the failure to report domestic-source income, relied on the traditional IRM voluntary disclosure practice, which the IRS tweaked in various ways to encourage more widespread participation.

On November 20, 2018, the IRS issued updated Voluntary Disclosure Practice ("VDP") procedures applicable to both offshore and domestic voluntary disclosures, filling the gap left in the absence of the OVDP *and* providing far more extensive procedural and substantive guidance than contained in the IRM's voluntary disclosure provision.[6] The updated VDP borrows heavily from the practice under the OVDP and the traditional voluntary disclosure practice, providing uniform procedures for both domestic and offshore voluntary disclosures and a flexible, but in comparison to the OVDP, more open-ended (and thus uncertain) penalty structure. The updated VDP applies to all voluntary disclosures submitted after September 28, 2018, and may, at the IRS's discretion, apply to unresolved domestic voluntary disclosures submitted on or before that date. Importantly, the VDP is available not just to resolve non-compliance with income taxes, but other types of tax non-compliance as well, including issues related to excise taxes, employment taxes, or estate and gift taxes.

The VDP Process

Similar to the OVDP, the new VDP provides formal procedures for participation in the program. Taxpayers wishing to make a voluntary disclosure must submit a preclearance request to the IRS Criminal Investigation Division to determine if their voluntary disclosure would be considered timely. The IRS will continue to look to its traditional criteria under the IRM to determine this criteria.

Upon pre-clearance, taxpayers must promptly submit their facts and circumstances, and, on Form 14457 (forthcoming), identify their assets, entities, related parties and any professional advisors involved in the prior noncompliance. The VDP covers a six-year disclosure period (shorter than the eight-year OVDP period), but allows a taxpayer to expand the disclosure period if desired.[7]

While the OVDP endeavored to resolve the vast majority of cases without submitting the taxpayer to a full examination, the VDP takes the opposite approach. Once preliminarily accepted to the VDP, IRS CI will forward the matter to an IRS unit in Austin, which will assign the cases for civil examination to occur following the submission of all amended and/or delinquent returns. All cases will follow standard examination procedures, focusing on the last six years. To comply with the VDP, participants must submit tax returns and make full payment of all taxes, penalties and interest for

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[6] IRS Interim Guidance Memorandum, LB&I-09-1118-014, Updated Voluntary Disclosure Practice (Nov. 20, 2018), https://www.irs.gov/pub/spder/lbi-09-1118-014.pdf. The terms of the VDP will be incorporated into the IRM by November 20, 2020.

[7] It may be in a taxpayer's interest to expand the disclosure period in circumstances that involve correcting tax issues with other governments, correcting tax issues before a sale or acquisition of an entity, closing an estate, or relating to unreported taxable gifts in prior periods.

the disclosure period.[8] At the completion of the IRS examination of the disclosure package, participants enter into a closing agreement with the IRS. Those who cannot reach an agreement on taxes and penalties have the right to appeal the results of the examination with the IRS Office of Appeals. Moreover, in an unagreed case, the IRS has the right to expand its examination beyond the six year period to include all the years of noncompliance; this often would provide a significant incentive to the taxpayer to accept the IRS's disposition on audit.

Penalty Regime

The VDP civil penalty regime differs from both the OVDP and the longstanding voluntary disclosure practice: it provides general penalty guidance to IRS examiners while still leaving them with substantial discretion. As a result, there is much uncertainty regarding the ultimate cost of participating in the VDP. While some of these uncertainties may be clarified in future IRS guidance, others may simply depend upon the discretion of the particular IRS agent.

According to the IRS's published guidelines,[9] taxpayers participating in the VDP should anticipate the following:

- A civil fraud penalty equal to 75% of the unpaid income tax on the noncompliant year with the highest income. Examiners retain discretion to impose a fraud penalty for other years, particularly "if the taxpayer fails to cooperate and agreement cannot be reached."[10]

- A willful "FBAR" penalty equal to 50% of undisclosed assets' value for taxpayer who failed to disclose reportable foreign financial accounts.

- The potential to present evidence to attempt to mitigate the fraud and willful FBAR penalties. However, because the VDP is geared towards taxpayers that have concerns about criminal liability, the guidelines make clear that a grant of such relief would "exceptional."

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[8] Taxpayers not able to pay the full liability are not ineligible under governing authorities if they make good faith arrangements to attempt to pay the liability through traditional IRS collection vehicles, such as offers in compromise following the submission of accurate and complete financial statements.

[9] Interim Guidance Memo LB&I-09-1118-014 (Nov. 20, 2018).

[10] It should be noted that the VDP guidelines are not clear as to whether a taxpayer's unwillingness to accept the IRS's proposed disposition constitutes a lack of "cooperation." It appears that even a good faith disagreement between the IRS and taxpayer can be viewed as a lack of cooperation. On December 14, 2018, at the ABA's National Institutes on Criminal Tax Fraud and Tax Controversies in Las Vegas, Nevada, an attorney with the IRS Office of Chief Counsel provided practitioners with a VDP hypothetical where the taxpayer and the IRS disagree in good faith on a technical issue. The hypothetical demonstrated that in such circumstances, the taxpayer will be assessed multiple year fraud penalties, which the IRS views as "a conservative, protective position in the absence of an agreement," rather than "retaliatory" as was viewed by many practitioners. Kristen A. Parillo, IRS Scenario Under Voluntary Disclosure Draws Jeers, 2018 WTD 242-8.

- Penalties for failure to file foreign information returns[11] will not be applied automatically. The amount of such penalties varies by return, and examiners retain discretion to assess any such penalties, taking into account other penalties that might be imposed.

- Penalties in connection with estate and gift taxes, employment taxes, and excise taxes based on the facts and circumstances of the particular case.

Notwithstanding this guidance, for now, tax advisors are unable to estimate with any reasonable certainty what further penalties their clients may face in the VDP or their ability to reach a final disposition with the IRS. For example:

- With a fraud penalty imposed on the highest year, will the other five years covered by the VDP be subject to other penalties (*i.e.*, accuracy-related, delinquency penalties)?

- With a willful civil FBAR penalty imposed for one year, will the other five years covered by the VDP be subject to non-willful FBAR penalties?

- If the IRS and the taxpayer have a good faith disagreement over a tax reporting position in one out of the six years, can the taxpayer close the five years by agreement and only appeal the one unagreed year to the IRS Office of Appeals?

Is the VDP a Good Deal?

The proposed penalty guidelines are just a starting point for a taxpayer's potential penalty exposure. The significant IRS discretion and uncertainty embedded in the VDP penalty regime may lead to much harsher results for the taxpayer. One major area of risk is the agent's discretion in assessing information return penalties, which could be exorbitant and assessed on the same assets as the FBAR penalty. More generally, the VDP gives agents wide leeway to impose multi-year fraud or FBAR penalties, or even expand the years at issue.

Without a set penalty regime, taxpayers considering participation in the VDP face a difficult choice. Participating in the VDP provides taxpayers, particularly those with criminal exposure, potential avoidance of criminal prosecution and finality with a binding closing agreement. Yet, the inability to quantify the cost of participation before entering the program creates obvious uncertainty. The IRS appears to bank on the proposition that taxpayer worried about a possible criminal conviction will bear a great deal of financial uncertainty in order to receive an assurance that no criminal prosecution will occur.

Taxpayers who have significant financial exposure, and their advisors will need to weigh the advantages of criminal protection against the open-ended possibility of confiscatory monetary penalties. A lot will hinge on the advisor's determination of the taxpayer's culpability and specific

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[11] Such returns are due, for example, to report a taxpayer's relationship with certain foreign corporations, partnerships or trusts, or the taxpayer's receipt of gifts or bequests from foreign persons.

intent under traditional criminal tax principles. For most clients (but, in our experience, not all), the greater the criminal risk, the less important the likely financial considerations. Taxpayers without criminal tax exposure do have other potentially viable options to rectify prior noncompliance, offshore or domestic, through other established IRS procedures, such as the Streamlined Filing Compliance Procedures, the Delinquent FBAR or International Information Returns Submission Procedures, or by simply filing amended or delinquent tax returns. Each of these approaches has its own attendant risks and benefits, but none provide criminal protection or the eventual finality of the updated VDP.

Ultimately, without additional guidance from the IRS clarifying some of the unknowns, the taxpayers considering VDP are asked to take a leap of faith and hope to reach an agreement with the IRS on the terms similar to those set forth in the published guidance. Undoubtedly tax practitioners will develop a "track record" over the coming months and years concerning how the IRS is approaching these cases. It is certainly in the IRS's interest to act reasonably in implementing the new VDP procedures and applying the relevant guidance in order to encourage greater participation among non-compliant taxpayers.
