

Voluntary disclosure and the avoidance of criminal prosecution

Dear Reader:

You recently asked what a taxpayer can do to reduce the possibility of criminal prosecution if he has had substantial return compliance problems in the past. Fortunately, IRS has a voluntary disclosure program under which the likelihood of prosecution for people who failed to meet filing requirements in the past is reduced if they disclose their problems voluntarily.

Under its voluntary disclosure program, IRS will consider voluntary disclosure along with all other factors in an investigation in determining whether criminal prosecution will be recommended. But, this practice creates no substantive or procedural rights for taxpayers, and taxpayers can't rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution. A voluntary disclosure will not automatically guarantee immunity from prosecution, but may result in prosecution not being recommended. These voluntary disclosure rules do not apply to taxpayers with illegal source income.

To qualify under IRS's voluntary disclosure program, a taxpayer's communication must be truthful, timely, and complete. The taxpayer must also show a willingness to cooperate (and actually cooperate) with IRS in determining his correct tax liability, and must make good faith arrangements with IRS to pay in full, the tax, interest on the tax, and any penalties that IRS determines to be applicable.

A disclosure is timely if it is received before IRS has:

- (1) initiated a civil examination or criminal investigation of the taxpayer, or notified the taxpayer that it intends to begin such an examination or investigation;
- (2) received information from a third party (e.g., informant, other governmental agency, or the media) alerting IRS to the specific taxpayer's noncompliance;
- (3) initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or
- (4) acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

A disclosure by an individual who failed to file tax returns qualifies as voluntary under the disclosure rules, even if it is made after the individual receives a notice stating that IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year. If the individual files complete and accurate returns and makes arrangements with IRS to pay the tax, interest, and any penalties determined by IRS to be applicable in full, this is a voluntary disclosure because IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so and because all other requirements above are met.

However, the voluntary disclosure program is not without defects from the taxpayer's point of view. Disclosure of the taxpayer's identity is a requirement for the program, and, as indicated above, there are no guarantees of immunity from prosecution. Although the rules governing IRS's current voluntary disclosure policy are fairly objective by historical standards, there is some uncertainty about some aspects of the program, such as what constitutes a good faith arrangement to pay the taxes.

IRS has a special program for offshore voluntary disclosures that offers a uniform penalty structure for taxpayers who voluntarily came forward. Under the program, which began on March 23, 2009 and that won't apply in its present form after September 23, 2009, taxpayers with undisclosed foreign accounts or entities can make a voluntary disclosure that enables them to become compliant, avoid substantial civil penalties, generally eliminate the risk of criminal prosecution and calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues. Participating taxpayers must pay back-taxes and interest for six years and either an accuracy related or delinquency penalty. But, in lieu of all other penalties that may apply, including FBAR and information return penalties, IRS will assess a penalty equal to 20% of the amount in foreign bank accounts or entities in the year with the highest aggregate account or asset value.

The Tax Division of the Justice Department also has a voluntary disclosure policy with less specific standards for determining what is a voluntary disclosure that qualifies for relief. Under this policy, there are two elements to a voluntary disclosure: (1) it must be made timely, and (2) the taxpayer must thereafter fully cooperate with the government. A disclosure is not timely if IRS has already initiated an inquiry that is likely to lead to the taxpayer and the taxpayer is reasonably thought to be aware of that activity, or if some event occurred before the disclosure which the taxpayer probably knew about and which would be likely to cause an audit into the taxpayer's liabilities. Until the IRS and Justice Department standards are brought into conformity, there may be some opportunity to convince the Justice Department that a voluntary disclosure that didn't meet IRS's standard was nevertheless sufficient under the Justice Department standard.

If you would like to know more about participating in this program or about other issues relating to your tax status, please give me a call.

