

IRS Provides Guidance on Updated Voluntary Disclosure Practice Following the Recent Closing of the Offshore Voluntary Disclosure Program

Tax Alert
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On November 20, 2018, the Internal Revenue Service's (IRS) Criminal Investigation Division (CI) issued a memorandum (the Updated Practice) providing significant guidance on voluntary disclosures (both domestic and offshore) for willful noncompliance going forward; however, the Updated Practice also leaves many questions unanswered.¹ The Updated Practice comes in the wake of the IRS's March 13, 2018, announcement that it would discontinue the 2014 Offshore Voluntary Disclosure Program (OVDP) effective September 28, 2018.² For 11 years, the OVDP and its predecessors gave taxpayers with willful tax violations an opportunity to avoid criminal prosecution and avail themselves of a reduced (but still significant) civil penalty structure.³ While other disclosure programs continue to be available for the time being for taxpayers who are not willfully noncompliant and who do not have criminal exposure – such as the Streamlined Filing Compliance Procedures (SFCP), the Delinquent International Information Return Submission Procedures (DIIRSP), and Delinquent FBAR Submission Procedures – the Updated Practice represents a major change to the way the IRS approaches disclosures that involve willful conduct.⁴

Overview of Updated Practice

The Updated Practice details what taxpayers must do to receive credit for a voluntary disclosure of willful noncompliance, outlines the examination procedures, and stipulates the civil penalty structure that applies. The Updated Practice's stated objective is to provide taxpayers who committed willful or fraudulent acts with a means to become compliant and, potentially, to avoid criminal prosecution. Although a voluntary disclosure does not guarantee immunity from prosecution, a voluntary disclosure by a taxpayer may result in the IRS not recommending criminal prosecution to the U.S. Department of Justice (DOJ) for any issue relating to the tax noncompliance, even if such violation arose from willful conduct.⁵ Unlike the OVDP, however, the Updated Practice does not explicitly state that the IRS will not refer a cooperative taxpayer's voluntary disclosure case to DOJ for criminal prosecution. As with the OVDP, the Updated Practice creates no substantive or procedural rights for taxpayers because it simply represents internal IRS practice.⁶

The Updated Practice covers both offshore and non-offshore disclosures received after September 28, 2018, and gives the IRS the discretion to apply the Updated Practice procedures to all non-offshore disclosures received on or before September 28, 2018.⁷ A taxpayer wishing to make a voluntary disclosure must submit a preclearance request to the IRS using a soon-to-be revised Form 14457 – entitled the "Offshore Voluntary Disclosure Letter" – to determine whether he or she is eligible for the Updated Practice.⁸ The purpose of the preclearance request is to determine if the taxpayer is eligible to participate in the Updated Practice; a taxpayer will not be eligible for the Updated Practice if the IRS has already initiated a civil or criminal investigation of the disclosing taxpayer for any year.⁹ Under the old OVDP, preclearance was available as an option, but it was not required, and taxpayers did not submit Form 14457 until later in the process.

If CI accepts the taxpayer's preclearance request, the taxpayer must then submit to CI all required voluntary disclosure documents using the soon-to-be revised Form 14457. Whether this Form is different than the one to be used for preclearance is not clear from the Updated Practice. However, the new Form 14457 will require a taxpayer to provide disclosure information and attachments, including a narrative detailing the facts and circumstances of his or her noncompliance (*e.g.*, assets, entities, related parties, and involvement of professional advisors), similar to the current iteration of the Form.¹⁰ Once CI has received and preliminarily accepted the taxpayer's voluntary disclosure, it will forward the "voluntary disclosure letter and attachments" (which presumably refers to the revised Form 14457 described above) to examiners (via the IRS's Large Business & International unit in Austin, Texas) to carry out a civil examination pursuant to standard examination procedures.¹¹ Under the OVDP, the Offshore

Voluntary Disclosure Letter was a list of questions to which the taxpayer had to respond detailing the circumstances of his or her noncompliance, while the attachments collected information about each offshore account or asset (*e.g.*, date opened, range of balance and income, advisors and contacts, etc.). It appears that the Updated Practice will require a similar submission, although the precise details are not yet clear.

Once a taxpayer's submission is routed to an examiner, the taxpayer must submit all required returns and reports for the disclosure period, which is generally the six most recent tax years.¹² The disclosure period can, however, be longer at the taxpayer's request or if the taxpayer fails to cooperate. The disclosure period will be shorter only if the taxpayer was noncompliant for less than the six most recent tax years.¹³ This six-year disclosure period is a two-year reduction from the OVDP's eight-year disclosure period.¹⁴

Like the OVDP, the IRS expects that disclosures under the Updated Practice will be resolved by agreement, including the full payment of taxes, interest, and penalties; the Updated Practice does not provide a taxpayer with any opportunity to negotiate these amounts.¹⁵ However, while the OVDP did not permit taxpayers to go to the IRS Office of Appeals to resolve disputes regarding the amount of tax or penalties due unless the taxpayer opted out of the OVDP,¹⁶ the Updated Practice states that a taxpayer "retain[s] the right to request an appeal with the Office of Appeals," but does not elaborate on the scope of this appeal option or the likelihood of its success.¹⁷

Participants in the Updated Practice are subject to a penalty structure which, in general, is more severe than those imposed under the OVDP. However, the Updated Practice gives more discretion to examiners by allowing them to vary the penalty structure based on the facts and circumstances of each case. The following penalties apply under the Updated Practice:

- In general, a "civil fraud penalty" under either section 6663¹⁸ or 6651(f)¹⁹ will apply to the tax year with the highest tax liability. Examiners may assess the lesser accuracy-related penalty under section 6662²⁰ in lieu of the civil fraud penalty at a taxpayer's request, but only in exceptional circumstances where the taxpayer supports his or her request with convincing evidence. Examiners also have the power to apply the civil fraud penalty to more than one year in the six-year period based on the facts and circumstances (*i.e.*, if no agreement is reached as to the tax liability) and can even apply the penalty beyond six years if the taxpayer fails to cooperate and resolve the examination by agreement.²¹
- Examiners may assert willful Report of Foreign Bank and Financial Accounts (FBAR) penalties – which are the greater of \$100,000 or 50 percent of the balance in the previously unreported offshore account at the time of the violation²² – in accordance with existing IRS penalty guidelines under IRM 4.26.16 and 4.26.17.²³ Under these guidelines, examiners will not impose a penalty if the violation was due to reasonable cause, and special rules apply to determine whether the taxpayer's conduct is willful.²⁴ A taxpayer may request non-willful FBAR penalties in lieu of willful FBAR penalties, but examiners are directed to grant such requests only in exceptional circumstances.²⁵
- Failure-to-file penalties with respect to information returns will not be imposed automatically, and in determining whether to impose them, examiners may take into account the other penalties being applied.²⁶
- Examiners will coordinate with appropriate subject matter experts when deciding whether to impose penalties relating to excise taxes, employment taxes, estate and gift tax, etc. based on the specific facts and circumstances.²⁷

By comparison, the OVDP required examiners to impose the following penalties:

- An accuracy-related penalty under section 6662.²⁸
- Any applicable failure-to-file penalties under section 6651(a)(1).²⁹
- Any applicable failure-to-pay penalties.³⁰
- In lieu of other applicable penalties (including FBAR penalties), an "offshore penalty" equal to 27.5 percent, or in some cases 50

percent (if the taxpayer has an account at a foreign financial institution that is under investigation, such as Credit Suisse AG),³¹ of the highest aggregate value of previously unreported offshore assets during the eight-year disclosure period.³²

Significantly, the willful FBAR penalty's high ceiling (the greater of \$100,000 or 50 percent of the highest aggregate value of the previously unreported offshore assets), means that the Updated Practice can trigger a penalty substantially higher than the OVDP's "offshore penalty" (which could be as low as 27.5 percent of the highest aggregate value of the previously unreported offshore assets). In addition, the Updated Practice allows for a civil fraud penalty as high as 75 percent of the underpayment, which exceeds the OVDP's accuracy-related penalty of only 20 percent of the underpayment.

Observations

Despite the high monetary cost of making a voluntary disclosure under the Updated Practice, taxpayers considering disclosure may find solace in the increased discretion the Updated Practice gives to examiners when imposing penalties, and – perhaps more importantly – the possibility of avoiding criminal prosecution after the closure of the OVDP (albeit with less certainty). Moving forward, case by case determinations will need to be made to determine which voluntary disclosure program, if any, is appropriate for a taxpayer seeking to come into compliance. Given the increased cost and emphasis on taxpayer cooperation, the Updated Practice will be a valid path forward for many taxpayers. Much will come down to whether their noncompliance is "willful or fraudulent" as the courts have interpreted those terms. If not, then one of the other programs (*e.g.*, SFCP) will be preferable. Taxpayers should also look to their advisors to work with examiners after entering the Updated Practice to ensure that the lowest possible civil penalties are imposed (including to advocate, with respect to FBARs, whether reasonable cause exists), because examiners now have significant discretion.

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¹See Kristen B. Weilobob, *Memorandum for Divisions Commissioners Chief, Criminal Investigation: Updated Voluntary Disclosure Practice* (Nov. 20, 2018), <https://www.irs.gov/pub/spder/lbi-09-1118-014.pdf>.

²See Dept. of the Treasury, IRS, *IRS to end offshore voluntary disclosure program; Taxpayers with undisclosed foreign assets urged to come forward now*, IR-2018-52 (March 2018), <https://www.irs.gov/newsroom/irs-to-end-offshore-voluntary-disclosure-program-taxpayers-with-undisclosed-foreign-assets-urged-to-come-forward-now>.

³See Dept. of the Treasury, IRS, *Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2014* (OVDP FAQ) (Nov. 9, 2018), <https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers-2012-revised>.

⁴Updated Practice at 1.

⁵See IRM 9.5.11.9 (Dec. 2, 2009); Updated Practice at 1 (citing IRM 9.5.11.9 (Dec. 2, 2009)).

⁶IRM 9.5.11.9. (Dec. 2, 2009).

⁷Updated Practice at 2.

⁸*Id.* IRM 9.5.11.9 will serve as the basis for determining taxpayer eligibility for the program as it did under the OVDP. *Id.*

⁹ See IRM 9.5.11.9 (Dec. 2, 2009).

¹⁰ See Form 14457; Updated Practice at 3.

¹¹ Updated Practice at 3.

¹² *Id.* at 4.

¹³ *Id.*

¹⁴ OVDP FAQ, FAQ 9.

¹⁵ See Updated Practice at 3; OVDP FAQ, FAQ 7.

¹⁶ OVDP FAQ, FAQ 49.

¹⁷ Updated Practice at 5.

¹⁸ See section 6663(a) (imposing a penalty of up to 75 percent of the portion of underpayment of tax required to be shown on the return which is due to fraud). All section references are to the Internal Revenue Code of 1986 as amended and currently in effect.

¹⁹ See section 6651(f) (increasing the fraudulent failure to file income tax return penalty under section 6651(a)(1) to 15 percent a month up to 75 percent of the amount of tax required to be shown on the return as tax).

²⁰ Section 6662(a) (imposing an accuracy-related penalty of 20 percent on underpayments described under section 6662(b)).

²¹ Updated Practice at 4.

²² 31 U.S.C. 5321(a)(5)(C).

²³ Updated Practice at 5.

²⁴ See IRM 4.2.16.6.5.1 (Nov. 6, 2015).

²⁵ Updated Practice at 5.

²⁶ *Id.*

²⁷ *Id.*

²⁸ Section 6662(a) (imposing an accuracy-related penalty of 20 percent on underpayments described under section 6662(b)).

²⁹ See section 6651(a)(1) (imposing a failure to file penalty of 5 percent per month up to 25 percent of the amount of tax required to be shown on the return as tax).

³⁰ See section 6651(a)(2) (failure to pay penalty of 0.5 percent per month up to 25 percent of the amount of tax required to be shown on the return as tax).

³¹ The 50 percent "offshore penalty" applies to all of the taxpayer's foreign financial assets if either a foreign financial institution at which the taxpayer has or had an account or a facilitator who helped the taxpayer establish or maintain an offshore arrangement has been publicly identified as being under investigation or as cooperating with a government investigation. OVDP FAQ, FAQ 1.1. A list of such financial institutions is available here: <https://www.irs.gov/businesses/international-businesses/foreign-financial-institutions-or-facilitators>.

³² OVDP FAQ, FAQ 7. Note that the OVDP still requires taxpayers to file FBARs for the past eight years and execute agreements with the IRS to extend the statute of limitations on assessing tax and FBAR penalties. *Id.*

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