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IRS Brings the Hammer Down on Those Who Waited

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By Memorandum dated November 20, 2018 from Kirsten B. Wielobob, Deputy Commissioner for Services and Enforcement (the ''Memorandum''), the Internal Revenue Service updated rules which will govern foreign and domestic voluntary disclosures following closing of the Offshore Voluntary Disclosure Program on September 28, 2018. The Memorandum embellishes voluntary disclosure practice described in Internal Revenue Manual (IRM) 9.5.11.9. The Memorandum explains the procedures by which the IRS will process voluntary disclosures, describes the civil penalties which taxpayers may expect, and confirms the existing procedures for those taxpayers whose noncompliance is not subject to criminal liability or substantial civil penalties will remain available, at least for now. The Memorandum is explicit that the updated procedures are available only to taxpayers that make ''timely voluntary disclosures and fully cooperate with the Service.''[1]

The Updated Voluntary Disclosure Process

The voluntary disclosure process will begin with submission of a preclearance request to IRS Criminal Investigation (CI) by the taxpayer who desires to make a voluntary disclosure using existing Form 14457 pending a promised forthcoming revision. The Memorandum confirms the standard set forth in IRM 9.5.11.9 will determine whether the taxpayer submitting the preclearance request is eligible to make a voluntary disclosure. In addition to the timeliness requirement set forth in the IRM, the taxpayer's communication must be ''truthful'' and ''complete'' and show a willingness to cooperate and actual cooperation with the IRS to determine the taxpayer's correct tax liability. Finally, the taxpayer must make good faith arrangements to pay tax, interest, and penalties in full as determined by the IRS.[2]

Once preclearance is granted, the taxpayer must ''promptly submit'' all the voluntary disclosure documents required by the revised Form 14457. These will include a narrative providing the facts and circumstances surrounding the taxpayer's non-compliance, and disclosure of assets, entities, related parties, and professional advisors involved in the non-compliance. Taxpayers will be notified of preliminary acceptance by correspondence from CI.

Those taxpayers determined to be eligible to make a voluntary disclosure will have their submissions forwarded to the Large Business and International unit in Houston, Texas, which will establish the most recent tax year for examination and forward the taxpayer's submission to ''the appropriate business operating division and exam function for civil examination.'' Voluntary disclosures will be subject to standard examination procedures, including gathering additional information regarding the taxpayer and the taxpayer's non-compliance. ''Taxpayers are required to promptly and fully cooperate during civil examinations.'' Failure to do so allows the examiner to request that CI revoke its preliminary acceptance.[3]

The Memorandum confirms the scope of the examination will include a six-year disclosure period. Tax-

[1] Under IRM 9.5.11.9, a disclosure is timely if received before initiation of a civil examination or criminal investigation of a taxpayer or the taxpayer's receipt of notice that such an examination or investigation will commence; before the IRS has received information from a third party regarding the specific taxpayer's noncompliance; before initiation of a civil examination or criminal investigation directly related to the specific liability of the taxpayer; and before the IRS has acquired information directly related to the specific liability of the taxpayer. IRM 9.5.11.9(4).

[2] IRM 9.5.11.9(3).

[3] Although the Memorandum cites IRM 9.5.11.9.4's discussion

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payers are required to submit all required tax and information returns for the disclosure period. The disclosure period can be expanded in the discretion of the examiner to include the ''full duration of the noncompliance'' for those taxpayers unable to reach agreement with the IRS. This is particularly problematic for U.S. citizens living abroad who stopped filing or never filed U.S. income tax returns. The pressure to reach agreement is increased by the threat that the IRS may assert ''maximum penalties.''

Penalties

Most noteworthy is the Memorandum's description of the penalties to which taxpayers who make a voluntary disclosure will be subject: either the 75% civil fraud penalty under §6663 or the 15% per month failure to file penalty (up to a maximum of 75% of the tax due) for fraudulent failures to file under §6651(f).[4] Somewhat mercifully, the Memorandum states that those penalties will apply only to the tax year with the highest tax liability. Again, the Memorandum follows with a threat: if no agreement is reached, the civil fraud penalties may be extended to additional years, but apparently no more than six years. However, for those taxpayers who are unable to reach agreement with the IRS and are determined to have failed to cooperate, the civil fraud penalties may be extended to more than six years.

Taxpayers making a voluntary disclosure under the updated procedures will also be subject to willful FBAR penalties asserted in accordance with the penalty guidelines found in IRM 4.26.16 and 4.26.17. The willful FBAR penalty is the greater of $100,000 or 50% of the account balance for each unreported account. The guidelines allow discretion as to whether the penalties will be applied for multiple years, but provide ''in most cases, the total penalty amount for all years under examination will be limited to 50% of the highest aggregate balance of all unreported foreign financial accounts during the years under examination.''[5]

Offering a glimmer of hope for taxpayers seeking mitigation, the Memorandum allows requests for nonwillful FBAR penalties and imposition of accuracy related penalties under §6662 in lieu of civil fraud penalties. However, granting those requests ''is expected to be exceptional,'' and a taxpayer must provide ''convincing evidence'' to justify assertion of lesser penalties. In a small concession, the Memorandum notes that customary penalties for failure to file information returns ''will not be automatically imposed.''

Quiet Disclosures

The most surprising aspect of the Memorandum is its apparent endorsement of quiet disclosures.[6] ''Taxpayers who did not commit any tax or tax-related crimes and do not need the voluntary disclosure practice to seek protection from potential criminal prosecution can continue to correct past mistakes using the procedures mentioned above [streamlined filings and delinquent FBAR and international information return procedures] or by filing an *amended* or past due return.'' (Emphasis supplied.)

Effective Date

The updated procedures for voluntary disclosures are effective for all voluntary disclosures, both foreign and domestic, received after September 28, 2018, the date on which the 2014 Offshore Voluntary Disclosure Program was closed. However, the Memorandum reserves discretion to apply the same procedures to domestic voluntary disclosures received on or before September 28, 2018, which remain unresolved. This also suggests a return to traditional voluntary disclosure practice which generally did not distinguish between domestic and foreign non-compliance until the 2009 Offshore Voluntary Disclosure Program.

Uncertainties

The Memorandum creates several uncertainties. One of the most significant is whether the failure to reach agreement in the examination will be viewed as a lack of cooperation exposing the taxpayer to extension of the civil fraud penalty beyond the six-year disclosure period or revocation of the taxpayer's acceptance to make a voluntary disclosure. The statement in the Memorandum that ''taxpayers retain the right to request an appeal with the Office of Appeals'' suggests this should not be the case. Other areas of uncertainty include whether taxpayers who filed joint returns must both make submissions, even if the conduct giving rise to concerns of criminal noncompliance or excessive civil penalties applies only to one spouse. Further, the discretion allowed examiners to determine the number of years to which willful FBAR penalties will apply leaves taxpayer who have

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of taxpayer's cooperation, that portion of the Internal Revenue Manual describes the information that CI personnel are to provide the taxpayer and largely reiterates the cooperation requirements of IRM 9.5.11.9. Notably, part of the information special agents are required to provide to taxpayers includes the warning that taxpayers who do not fully cooperate or provide materially false information may be referred for ''criminal investigation and/or imposition of civil sanctions.''

[4] All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise specified.

[5] IRM 4.26.16.6.5.3(2) (11-06-2015).

[6] Quiet disclosures were aggressively discouraged under the 2014 OVDP. *See* Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2014, Questions and Answers 2015 (Nov. 9, 2018).

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not timely filed FBARs with considerable uncertainty regarding the amount of penalties to which they may be exposed.

There were three prominent features of the Offshore Voluntary Disclosure Programs and Initiatives in 2009, 2011, 2012, and 2014 (the ''OVDP Programs'') which were beneficial to taxpayers: relief from criminal penalties, predictability regarding penalty amounts, and closure in the form of a Form 906 closing agreement. Presumably, closing agreements will remain a feature of the updated Voluntary Disclosure practice.[7] However, the other two taxpayer-friendly features of the OVDP Programs are gone. While the Memorandum describes a voluntary disclosure as a means to potentially avoid criminal prosecution, it provides no assurance such prosecution will not follow. This has long been the case with voluntary disclosures and the IRM continues to direct special agents to advise taxpayers that their voluntary disclosure ''will not automatically guarantee immunity from prosecution.''[8] Further, the discretion retained to apply FBAR penalties for multiple years and extend civil penalties to multiple years creates considerable uncertainty for taxpayers who make voluntary disclosures.

ABA Comments

In response to a Notice and Request for Comments published in the Federal Register on February 28, 2018 [9] the ABA Tax Section responded with comments on May 2, 2018 (the ''Comments'')[10] The Comments made several recommendations regarding the terms of a new offshore voluntary disclosure program. Many appear to have been adopted by the Memorandum. First, the Comments recommended the IRS ''establish a centralized examination unit staffed with Service personnel experienced in the programs and international issues.''[11] Processing through LB&I in Houston may accomplish this, although it remains to be seen how uniform practice and penalties will be among the business operating divisions conducting the examination function. Second, the Comments recommended the IRS expedite the preclearance process, noting considerable delays in receiving responses to pre-clearance requests and the need to make multiple submissions in many cases. Perhaps, the preclearance process described in the Memorandum will be more responsive and reliable than past experience. However, the Memorandum omits any time frame in which the IRS will respond to pre-clearance requests or procedure by which taxpayers may inquire regarding requests which languish without response. Third, the Comments recommended the disclosure period be limited to six years. Generally, this was done. However, the threat to expand years under examination in the case of taxpayers unable to reach agreement with the IRS may be used as a tool to compel agreement.

In contrast to the recommendations from the Comments which were potentially adopted by the IRS, at least two were disregarded. First, the Comments recommended limiting an increase in the offshore penalty to 30% and applying it solely to assets subject to FBAR and Form 8938 reporting.[12] While the Memorandum provides ''in most cases'' the total penalties will be capped by reference to a taxpayer's unreported foreign financial accounts, the ceiling is considerably higher: 50%, instead of 30%.[13] Second, the Memorandum suggested sending taxpayers identified through Foreign Account Tax Compliance Act (FATCA) disclosures a ''nudge letter'' as a last change for compliance at the cost of a slightly higher 32.5 % offshore penalty to incentivize voluntary disclosures. The greatest weakness to the new voluntary disclosure rules is the lack of any incentive for taxpayers to come forward voluntarily, other than the threat of enforcement.

Enforcement Will Be Key

The success of the OVDP Programs was measured by the dramatic increase in the number of voluntary disclosures. The lack of protection from criminal prosecution and lack of certainty regarding penalties makes it unlikely the updated voluntary disclosure procedures will have similar success. Nonetheless, enhanced enforcement could stimulate more voluntary disclosures. Based on the number of FBARs submitted annually, there are at least hundreds of thousands, if not millions, of U.S. citizens living abroad who are not filing FBARs and more likely not engaging in any form of U.S. tax compliance. For these taxpayers, there is no incentive to come forward voluntarily to become U.S. tax compliant unless they can qualify for participation in either (1) the Streamlined Filing Compliance Procedures because their non-compliance was

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[7] *See generally* Form 866, *Agreement as to Final Determination of Tax Liability*, and Form 906, *Closing Agreement on Final Determination Covering Specific Matters*.

[8] IRM 9.5.11.9.4(7) (12-02-2009). *See also* IRM 9.5.11.9(2) (12-02-2009).

[9] Collection; Comment Request on Information Collection Tools Relating to the Offshore Voluntary Disclosure Program (OVDP), 83 Fed. Reg. 40, 8734.

[10] *See* ABA Tax Section, ''Comments on the 2014 Offshore Voluntary Disclosure Program and the Streamlined Procedures'' (May 2, 2018).

[11] *Id.* at p. 14.

[12] Under the OVDP, the offshore penalty was imposed at a 20% rate in the 2009 OVDP, 25% in the 2011 OVDI, and 27.5% in the 2012 and 2014 OVDPs on all assets which were the subject or result of non-compliance.

[13] ABA Tax Section at p. 14.

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not willful, or (2) the Delinquent FBAR Submission Procedures or Delinquent International Information Return Submission Procedures because their compliance failures were due to reasonable cause. Absent some form of broad-based enforcement, there is no reason to expect the updated voluntary disclosure procedures to enhance compliance or participation in the U.S. tax system for U.S. persons who have chosen to ignore their U.S. tax compliance obligations. It is remarkable that more than three years after the United States began gathering information regarding U.S. persons with foreign accounts from foreign financial institutions that the IRS has not simply sent a letter to the individuals identified through those procedures inquiring about their U.S. income tax and information returns or FBAR filings. There is a growing consensus among U.S. citizens residing abroad and those who advise them that there is no consequence to remaining non-compliant because there is no enforcement.

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