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Understand the IRS' Voluntary Disclosure Program

by JOEL N. CROUCH

The federal tax system is a voluntary system that relies on taxpayers to file complete and accurate tax returns. However, the Internal Revenue Service released a study on Jan. 6, reporting that individuals and businesses underpay their taxes by an estimated 17 percent each year, resulting in almost $450 billion of lost tax revenues annually.

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Taxpayers who intentionally file inaccurate or incomplete tax returns risk exposure to significant criminal penalties. However, taxpayers can take steps to remedy the issue. Counsel can advise clients with a guilty conscience or second thoughts to participate in the IRS' voluntary disclosure program. The program allows taxpayers to reduce the chance of a criminal investigation or prosecution by voluntarily confessing their sins to the IRS and filing amended tax returns.

Counsel should also note that taxpayers who have not filed tax returns are eligible to participate in the IRS voluntary disclosure program. The IRS will require a delinquent taxpayer who makes a voluntary disclosure to file six years of back tax returns, unless there are indications that more returns should be filed.

Although an IRS voluntary disclosure does not automatically guarantee immunity from prosecution, as a matter of practice, the IRS does not pursue criminal charges against a taxpayer who meets the program's requirements. A voluntary disclosure occurs when a taxpayer timely, truthfully, completely and voluntarily notifies the IRS about an inaccurate tax return or other document filed with the IRS.

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Above all else, timeliness is the most important factor for a voluntary disclosure. A disclosure is timely only if the taxpayer makes the disclosure before the IRS initiates a civil examination or criminal investigation of the taxpayer or before the IRS notifies the taxpayer that it intends to do so.

In addition, the taxpayer must make the disclosure before a third party alerts the IRS to that taxpayer's noncompliance. A taxpayer concerned that a former spouse, disgruntled employee or former business partner may provide information to the IRS should consider making a voluntary disclosure before the third party provides information to the IRS. In these situations, establishing the day and even the time of a disclosure to the IRS can be critical.

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Noisy and Quiet

Counsel should explain to the client that a taxpayer can make a voluntary disclosure to the IRS by making a noisy disclosure or a quiet disclosure. But only the noisy disclosure triggers the protections of the voluntary disclosure program.

A noisy disclosurew occurs when the taxpayer or his attorney contacts the IRS and provides the taxpayer's name, Social Security number and date of birth. If the IRS determines that the disclosure is timely, i.e., before the IRS has started a civil examination or criminal investigation or received information from a third party, it notifies the taxpayer that it preliminarily is accepting him into the voluntary disclosure program. If the taxpayer then files complete and accurate amended tax returns, cooperates with the IRS in determining the correct tax liability, and makes good-faith arrangements with the IRS to pay in full any tax, interest and applicable penalties, the disclosure is complete, and the taxpayer will not face criminal prosecution.

A quiet disclosure occurs when the taxpayer quietly files an amended return, without first contacting the IRS. Because the taxpayer has not contacted the IRS, the taxpayer does not know if a civil or criminal investigation already has started or if the IRS has received information from a third party. As a result, a taxpayer making a quiet disclosure has continuing exposure to a criminal investigation and possible prosecution. Furthermore, the IRS has stated that it does not consider a "quiet disclosure" to be a voluntary disclosure as defined by the Internal Revenue Manual.

An example of what is not considered a voluntary disclosure is a letter from an attorney stating his or her client, who wishes to remain anonymous, wants to resolve his tax liability. This is not a voluntary disclosure until the client's identity is revealed.

In deciding whether a client should make a quiet or noisy disclosure, an attorney must consider the client's risk tolerance and the seriousness of the misstatement on the original return. A noisy disclosure is the safest and most conservative approach and should be used if there is any concern that the client has exposure to criminal tax penalties.

In 2009, the IRS introduced a special variation of its voluntary disclosure program, known as the Offshore Voluntary Disclosure Initiative (OVDI). The OVDI allows taxpayers who failed to disclose to the IRS their offshore activities such as bank accounts and interests in foreign entities the opportunity to provide this information to the IRS, avoid potential criminal penalties and pay reduced civil penalties.

Since the IRS started the OVDI, more than 30,000 taxpayers with bank accounts in more than 60 countries have come forward to participate, and the IRS has collected an estimated $4.4 billion in taxes, penalties and interest, according to a Jan. 9 press release from the IRS. The OVDI is still available, although the terms for participating have changed.

There is no doubt that foreign bank accounts will continue to be a priority for the IRS for the foreseeable future. The IRS has investigated and indicted numerous individuals and professional advisers, and it has negotiated nonprosecution agreements with many foreign banks. Under the terms of the nonprosecution agreements, foreign banks are turning over the identities of U.S. taxpayers with accounts.

A lawyer must be careful in handling any voluntary disclosure to the government, but this is particularly true in handling a voluntary disclosure to the IRS. It is critical for counsel to help his client analyze all the risks before deciding whether to make a voluntary disclosure and if so, whether it should be a noisy or quiet disclosure. TL

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