Voluntary Disclosure to the IRS:

A Viable Option

While failure to file returns or pay correct tax can subject clients to heavy penalties, taxpayers who come forward can sometimes receive a break.

by Stephen G. Huggard

Every once in a while, a client with a heavy heart visits a CPA. The client has not been paying what he or she owes Uncle Sam and wants or needs to come clean, but has no idea how to do so. The good news is that there are ways to help your client.

For more than 55 years, the IRS has had a policy that can allow such taxpayers to come forward and, in exchange for their truthfulness and cooperation, escape criminal prosecution. While the Service's forbearance under this voluntary disclosure policy is not ironclad or available under all circumstances, it can be determinative. "A true voluntary disclosure is usually the deciding factor in decisions about prosecution," said Shirley D. Peterson, former IRS commissioner, in a speech to the AICPA Tax Division.

The bad news is that inexpert advice can buy the client a lot of trouble, perhaps even a stay in a federal penitentiary. CPA tax practitioners who learn of an error in a taxpayer's return or the taxpayer's failure to file a required return should advise the taxpayer of the error and measures to be taken. In keeping with AICPA Statement on Standards for Tax Services (SSTS) no. 6, if it appears the taxpayer could be charged with fraud or other criminal misconduct, the taxpayer should be advised to consult legal counsel.

Criminal Penalties Potentially Severe

The U.S. punishes tax evasion more harshly than most countries. While anecdotal evidence suggests that many more people cheat on their taxes every year than are caught by the IRS, those who are caught can be punished far more severely than the public might realize. Federal sentencing guidelines call for someone who evades between $30,000 and $80,000 in taxes to be sentenced to between 15 and 21 months in prison, without benefit of parole. In addition, the taxpayer will still owe the back taxes, interest and penalties. Many Americans live with the fear that the IRS somehow will find out the truth about their tax returns. That fear can be paralyzing but need not prevent a client from addressing the issue head-on.

The IRS can be relatively forgiving if taxpayers voluntarily disclose that they have not reported all their income or have not filed all their tax returns. In fact, the Service's policy encourages people to voluntarily disclose their tax delinquencies in return for consideration from the IRS in determining whether criminal charges should be sought. The back taxes and interest, however, will have to be paid in full. This is good for the IRS, which after all is in the business of collecting money. Almost anything that encourages more people to pay more money is good for it.

But why would an individual ever make such disclosures? And what does "relatively forgiving" mean? In answer to the second question, a successful filing of a voluntary disclosure may result in criminal prosecution not being recommended, as long as it's not subsequently determined the taxpayer was untruthful or uncooperative.

Taxpayers may want to get right with Uncle Sam for several reasons. Some people are bothered by their consciences. Others are refinancing mortgages and need to show accurate tax returns to the lender. People may become embroiled in a nasty bit of litigation with someone who knows their secret, and they want to remove the leverage that such knowledge provides the opposing side. Maybe they are changing marital status. In any event, they have come to realize that a criminal prosecution is at least theoretically possible, and they want to eliminate the threat from their lives.

When Disclosure Is Voluntary

Unfortunately for such people, the IRS's voluntary disclosure policy contains some strict guidelines. The Internal Revenue Manual (IRM), which establishes policies and guidelines for IRS agents nationwide, makes it plain that the disclosure must be both voluntary and timely before the IRS will consider it favorably (IRM section 9.5.11.9). In addition, the taxpayer must show a willingness to cooperate with the IRS in determining his or her correct tax liability and make good-faith arrangements to pay all outstanding taxes, interest and applicable penalties. The taxpayer does not have to file complete returns and make full payments at the time of the voluntary disclosure; he or she just has to make the IRS comfortable that both will happen.

The disclosure must be made before the taxpayer has come to the attention of the IRS through independent means. If the taxpayer is the subject of a civil or criminal investigation by the IRS—even if the taxpayer does not know it—it is too late to make a voluntary disclosure to the IRS. If the taxpayer's tax issues have been brought to the attention of the IRS through a third party such as an informer or the media, it is too late. This category of "informants" includes the taxpayer's bank. If the taxpayer deals with large amounts of currency, the bank may well have filed Currency Transaction Reports or Suspicious Activity Reports with the IRS. The IRS considers these reports on a par with informants. Conversely, if the IRS is examining a widely promoted scheme in which the taxpayer participated but the taxpayer himself or herself has not yet come to the attention of the IRS, the disclosure still may be timely.

The voluntary disclosure should be made to the Criminal Investigation office of the IRS and is best made to a supervisory special agent, since it will be evaluated by a special agent. There are hazards. The IRS goes out of its way to underscore a lack of guarantees in this area. Specifically, there is no guarantee that, just because the taxpayer discloses to the IRS, that the IRS will not seek to prosecute the taxpayer. Therefore, before any disclosures are made, a representative must carefully debrief the taxpayer to ensure that there are no issues that the IRS will already have on its radar. This should be done by a qualified attorney, to cloak the conversation in the attorney-client privilege. Clients may well be

Executive Summary

- **Under its policy of voluntary disclosure,** the IRS can forbear from referring for criminal prosecution taxpayers who come forward to admit previously unreported tax liabilities. CPAs may be in a position to learn of clients' intentions to make such disclosures. Where disclosures could otherwise entail criminal penalties, CPAs should refer clients to a qualified attorney in keeping with AICPA Statement on Standards for Tax Services no. 6 and for the attorney-client privilege available.
- **Policies and guidelines for voluntary disclosure** are contained in Internal Revenue Manual section 9.5.11.9. To take advantage of them, taxpayers must be willing to cooperate with the IRS in determining correct tax liability, which they must arrange to pay, along with interest and penalties.
- **Voluntary disclosure treatment is not available** if the IRS has learned of the taxpayer's liability through the news media, an informant, bank reporting or the fruits of its own investigation. Also, voluntary disclosure does not protect a taxpayer whose unreported income was from an illegal source.
- **Despite its potential pitfalls, a properly managed voluntary disclosure** may be a valuable strategy for taxpayers who otherwise could face severe penalties that can in some instances include incarceration.

Stephen G. Huggard*, Esq., is a partner in the Securities, Government Enforcement & Corporate Governance Litigation practice group of the 550-attorney international law firm of Edwards Angell Palmer & Dodge. His e-mail address is shuggard@eapdlaw.com.*

loath to admit in a nonprivileged setting some aspects of their activities that have come to the Service's attention.

In the debriefing of the client, before any disclosures are made, counsel will best be able to determine whether the taxpayer has engaged in activities that are likely to be known to the IRS. If the IRS decides that the information is not new to it, agents will listen politely and then use that information against the taxpayer, who will have dug a hole from which he or she may never emerge.

Among other things, counsel must ensure that the unreported income was all "legal source" income—money made from lawful dealings. Dealers in illegal drugs, for example, cannot benefit from the voluntary disclosure policy. The taxpayer must also be willing to disclose all entities that are related to him or her. For example, if he or she owns a string of restaurants, each separately incorporated, the IRS will expect him or her to identify each and to make sure that each set of returns is up to date and accurate.

This is not the time to be cute with the IRS. If it decides that the taxpayer has been only partially forthcoming, it is likely to view him with suspicion and pursue any remedies it has, including criminal investigation. The IRS expects that people who seek shelter under the voluntary disclosure policy will be fully forthcoming. At the same time, the risks involved argue in favor of having the communications come through the taxpayer's counsel, and not from the taxpayer.

An "All-In" Proposition

Anonymous disclosures are counterproductive. The IRM explicitly states that anonymous disclosures are insufficient to warrant favorable consideration by the IRS. Moreover, the anonymous disclosures can prompt the IRS to begin an investigation, thus precluding the possibility of the taxpayer ever being able to voluntarily disclose his or her issues. The taxpayer will effectively have become a "third-party" informant against himself. Taxpayers who think they want to disclose to the IRS must understand that this is an "all-in" proposition; they do not get to stick their toe in the pool to test the waters. That being said, the representative might well want to have some exploratory talks with the IRS in which the situation is described to gauge the agents' reactions, with the understanding that until the taxpayer's identity is disclosed, nothing really has happened and no protections can be expected.

As with most policies, some gray areas in the voluntary disclosure policy should be explored with caution. For example, the IRM specifically states that the disclosure is not timely if the IRS has received information about the taxpayer through a criminal enforcement action such as a search warrant or grand jury subpoena. It also states that a disclosure is not voluntary when made by a taxpayer who is under grand jury investigation. The IRM does not specify that the grand jury investigation has to be tax-related to foreclose the disclosure. In fact, many grand jury investigations uncover tax issues that are never shared with the IRS.

Given the tenor of the IRM, that the disclosure is too late if the *IRS* already knows about the taxpayer's issues, the disclosure might (arguably) be considered timely and voluntary even if the taxpayer is a subject of a grand jury investigation being conducted by a different agency. This is not plain, however, and is a good example of the type of scenario counsel might want to present in a preliminary fashion before disclosing the taxpayer's identity.

Once the disclosure is made, a special agent will evaluate it. If the agent deems it to be truthful and complete, he or she will so indicate to the special agent in charge. According to the IRM, the evaluation should be completed within 10 working days from when it was received. The disclosure doesn't have to be communicated in any particular format, but processing it will require information outlined in IRM 9.5.11.9.6.

If the IRS accepts the disclosure, it is agreeing to take it into consideration in deciding whether to recommend prosecution by the Justice Department. If all other factors are met, the disclosure may result in prosecution not being recommended.

Hazards Manageable

For many CPA firms, apparent criminal exposure for their tax clients may come up seldom, if ever. "Thankfully, our firm does not have much experience with voluntary disclosure," said Patrick H. O'Brien, a CPA with O'Brien, Riley & Ryan PC in Westwood, Mass. "We require our clients to provide us with the information necessary to file complete and accurate returns. In situations where clients come forward with information indicating that they have been less than truthful in the past, it becomes necessary to carefully reconsider whether that client relationship still makes sense.

"If we decide to continue our relationship with the client, we first encourage that the client immediately retain legal counsel," O'Brien said. "After the client and his legal counsel have reviewed all their options, we do believe that the use of voluntary disclosure is a viable option that should be considered and could provide significant savings to the client. Most likely, we may use the voluntary disclosure with a new client or referral that is looking to get back on the right track."

There are generally few risks to the CPA if the client makes a properly counseled voluntary disclosure. If the IRS accepts the disclosure, it would not be very interested in the accountant's role in any prior filings. Of course, if the accountant knew of and participated in prior filings of false tax returns, it would be potentially problematic to have the client talking to the IRS. In most cases, however, any involvement by the accountant would be sufficiently innocent that the IRS would not take an interest.

Given the hazards built into the voluntary disclosure policy, is it ever wise to pursue a disclosure? These days, in particular, the answer is "yes." Law enforcement resources are stretched thin, and with the Justice Department focused on terrorism, the IRS is often happy to get a taxpayer back in the fold without having to launch an investigation. The taxpayer must simply be aware of the rules and be candid with counsel about his or her situation. While there are no guarantees, practice reveals that properly made voluntary disclosures are usually effective. As long as the taxpayer is careful, he or she likely will wind up poorer but still free, which definitely beats poorer and in jail. ❖

AICPA RESOURCES

Conferences

AICPA Practitioners Symposium, May 5–7, Las Vegas, "How to Negotiate Persuasively With the IRS," session on May 6

CPE

Dealing with the IRS, a CPE self-study course (#732263)

For more information or to register or make a purchase, go to **www.cpa2biz.com** or call the Institute at 888-777-7077.