The Tax Gap and Voluntary Disclosure

By Dennis N. Brager

Dennis N. Brager examines the elements of voluntary disclosures, illustrates how to make a voluntary disclosure and gives examples of defective voluntary disclosures.

Introduction

As anyone who has picked up a newspaper, watched TV, listened to the radio or surfed the Internet knows, Congress is obsessed with "closing the Tax Gap." In the Tax Gap, Congress has discovered the Holy Grail of tax policy. If the Tax Gap can be closed, then Republicans will be happy because taxes do not need to be raised, and Democrats will be equally pleased since spending will not need to be cut.[1] In response to Congressional pressure, the IRS is pledging to ratchet up its tax collection machinery. As part of this effort, the IRS has indicated that a key component of closing the Tax Gap is increasing criminal investigations. Given this reality, it is a good time to take a look at what advice should be given to a taxpayer who has made reporting errors of a significant, and possibly intentional, nature and is now reconsidering the wisdom of his or her reporting position. Similar issues arise in the case of a taxpayer who has simply failed to file tax returns.

For many, many years, the IRS has had a "policy" of giving special consideration to those taxpayers who voluntarily come forward and confess their tax crimes without any prior prompting either from the IRS or third parties. Between 1934 and 1952, the IRS had a written policy that precluded prosecution of taxpayers who made voluntary disclosures.[2] After that date, the IRS had an informal "practice" that it would take a voluntary disclosure into account in deciding whether criminal prosecution would be forthcoming.[3] As of 1999, the Criminal Investigation Division's manual provided that "voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended."[4] In 2002 the IRS formally adopted and publicly announced its voluntary disclosure practice.[5] The practice is contained in the INTERNAL REVENUE MANUAL at §9.5.11.9 (September 9, 2004). It states as follows:

> It is currently the practice of the IRS that a voluntary disclosure will be considered along with all other factors in the investigation in determining whether criminal prosecution will be recommended. This voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided solely for guidance to IRS personnel. Taxpayers cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution.

Thus, just because a voluntary disclosure is made does not guarantee that a criminal prosecution will not occur, but it may result in a criminal prosecution not being recommended. For that reason, careful consideration must be given to whether or not a voluntary disclosure should be made taking into account all of the facts and circumstances. It is also important to remember that the policy does not apply to illegal source income.[6] Thus, the client who makes his or her money through narcotics or prostitution will not

Dennis N. Brager is an attorney with Brager Tax Law Group, APC, a tax litigation and tax controversy law firm with offices in Los Angeles and Woodland Hills, California.

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be able to take advantage of the policy. The same rule would apply to a taxpayer who failed to report income from embezzlement, Medicare fraud or other white collar crimes.

Elements of a Voluntary Disclosure

In order to qualify as a true voluntary disclosure, the communication to the IRS must be truthful, timely and complete. In addition, the taxpayer must show a willingness to cooperate with the IRS, and must in fact cooperate with the IRS in determining his or her correct tax liability. The taxpayer must also pay the liability in full, or make good faith arrangements with the IRS to make full payment of tax, interest and penalties.[7]

Perhaps the easiest way to make a defective voluntary disclosure is for it to be untimely. For a disclosure to be timely, it must be received before the IRS has:

- initiated a civil or criminal investigation, or has notified the taxpayer that it intends to begin an exam;
- received information from a third party such as an informant, the media or other government agency alerting it to the specific taxpayer's noncompliance;
- initiated a civil examination or a criminal investigation that is directly related to the specific liability of the taxpayer; or
- acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action such as a search warrant, or grand jury subpoena.[8]

IRM §9.5.11.9(6) provides the following examples of voluntary disclosures:

- A disclosure made by an individual who has not filed tax returns after the individual has received a notice stating that the IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year
- A disclosure made by a taxpayer of omitted income facilitated through a widely promoted scheme regarding which the IRS has begun a civil compliance project and already obtained information which might lead to an examination of the taxpayer; however, the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so
- A disclosure made by a taxpayer of omitted income facilitated through a barter exchange after the IRS has announced that it has begun a civil compliance project targeting barter exchanges but before it has commenced an examination or investigation of the taxpayer or notified the taxpayer of its intention to do so

In all three examples, the IRS notes that there is a voluntary disclosure because although the IRS project may lead to an investigation of the taxpayer, the project does not yet directly relate to the specific liability of the taxpayer. Each example assumes that the taxpayer either pays the full tax, interest and penalty or makes arrangements to do so.

Making the Disclosure

There are two schools of thought regarding how to make a voluntary disclosure. The first is that it should be done quietly. Send in new or amended tax returns, with a check, and hope that it gets processed without every hearing from the Criminal Investigation Division ("CI"). This is a very tempting method because due to the large volume of returns the IRS processes there is a likelihood that a return with a check will never be audited. What makes this method problematic is that if the IRS has begun an investigation, but the taxpayer is not aware that this has occurred, the disclosure is not voluntary. The amended return becomes an admission of the amount by which the tax liability was understated on the original return. The amended return will be used by the IRS to meet its burden of proof if it decides to prosecute. Nor does the amended return even have the minimal benefit of starting the running of the three-year statute of limitations period for civil tax assessments with regard to an earlier fraudulent tax return for which there was an unlimited statute of limitations.[9] An original correct return will start the civil statute of limitations running, but is still an admission that a return was due, and the amount of each item that was required to be set forth on the return.

The second approach is that a meeting should be arranged with CI to discuss whether or not the taxpayer's facts and circumstances meet the terms of the IRS voluntary disclosure policy, and whether or not the IRS has already begun an investigation of the

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taxpayer of which the taxpayer is unaware.[10] It is safe to say that there is no agreement on which method works better, and different factual situations will call for different tactics.

A taxpayer contemplating a voluntary disclosure should consult with an attorney to discuss all of the circumstances surrounding the errors on the tax return, or the failure to file a tax return. The reason for consulting with an attorney is to prevent the information which the client discusses (including his state of mind) from coming into the possession of the IRS unnecessarily or prematurely. Willfulness is a key element of the government's criminal case, or for that matter its civil fraud case. One easy way for the IRS to establish willfulness is to subpoena the tax preparer to testify regarding the client's conversations. Those conversations usually include statements from the taxpayer to the effect that he did not file the returns because he was occupied with other weighty matters; sometimes taxpayers will tell their accountants that they did not include certain income items because they did not think the IRS could/would find out. Needless to say, these statements can be devastating to the client's case.

Although clients may also have privileged communications with their CPAs and enrolled agents, the privilege can not be asserted in a criminal matter[11]; nor does the privilege apply to written communications regarding tax shelters.[12] Thus, the so-called federally authorized tax practitioner privilege is a leaky one. Once an attorney has been consulted, the attorney can engage an accountant to assist him in the calculation of the correct tax, and communications between the client and the accountant should, if properly handled, be cloaked with the attorney-client privilege.[13] It is of course crucial that any amended returns or delinquent returns are entirely accurate. Filing false or delinquent returns may run the risk of prosecution and starting anew the six-year criminal statute of limitations.

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Examples of Defective Voluntary Disclosures

A failure to pay or make arrangements to pay will result in a defective disclosure. In *J.L. Tenzer,*[14] the taxpayer filed late returns and submitted an offer in compromise, which was ultimately not accepted. The court determined that the taxpayer must have actually made arrangements, not merely offered to make arrangements for the policy to apply. *Tenzer* is a very disturbing case for the taxpayer who cannot afford to pay up front since anyone who has even a passing acquantance with the IRS offer program knows that whether or not the IRS will accept any particular offer can be difficult to predict. The fact pattern in *Tenzer*, however, involved a situation where the taxpayer failed to stay current on estimated tax payments, and then proceeded to file a return with over $100,000 in tax due after having been advised by the IRS that he needed to stay current if the offer in compromise was to be considered. It probably did not help that Tenzer was an accountant and a tax attorney. Still, it serves as a sobering reminder that merely filing delinquent returns does not necessarily insulate one from criminal prosecution.

Other examples set forth in IRM §9.5.11.9 (7) of what are not voluntary disclosures include the following:

- A letter from an attorney stating his or her client, who wishes to remain anonymous, wants to resolve his or her tax liability
- A disclosure made by a taxpayer who is under grand jury investigation
- A disclosure made by a taxpayer after an employee has contacted the IRS regarding the taxpayer's double set of books; this is not a voluntary disclosure even if the taxpayer was unaware that the informant had contacted the IRS
- A disclosure made by a taxpayer, who is not currently under examination or investigation, of omitted gross receipts from a partnership, whose partner is already under investigation for omitted income that was skimmed from the partnership. According to the IRS, this is not a voluntary disclosure since the IRS already initiated an audit directly related to the specific liability of the taxpayer.
- A disclosure made by a taxpayer, who is not currently under examination or investigation, of omitted constructive dividends received from a corporation which is currently under examination. Again the IRS concluded that the corporate exam is directly related to the specific liability of this taxpayer.

Conclusion

It is no doubt true that taxpayers file delinquent and amended returns on a regular basis and suffer no adverse consequences other than the assessment of additional tax, interest and penalty. On the other hand, the taxpayer who has not filed tax returns for several years failing to report large amounts of income may be at risk of criminal prosecution. For these taxpayers, a careful look at the IRS voluntary compliance program before simply filing returns with little thought about the consequences is vital.

ENDNOTES

[1] Depending upon the program, and who is being taxed, feel free to swap "Democrat" for "Republican."

[2] *See R. Hebel*, CA-8, 82-1 USTC ¶9162, 668 F2d 995, at 997.

[3] *Id.*, at 999, *citing* the U.S. Department of Justice Manual for Criminal Tax Trials, Ch.1, at 5 (as it was in effect during 1973).

[4] IRM §9.5.3.3.1.2.1, as cited in COMISKY, TAX FRAUD AND EVASION 4-18, note 97 (2007).

[5] IR 2002-135 (Dec. 11, 2002).

[6] IRM §9.5.11.9(2).

[7] IRM §9.5.11.9(3).

[8] IRM §9.5.11.9(4).

[9] *E. Badaracco, Sr.*, SCt, 84-1 USTC ¶9150, 464 US 386.

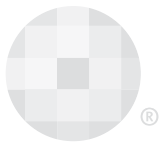
[10] *J. Crystal,* CA-9, 99-1 USTC ¶50,464, 172 F3d 1141.

[11] Code Sec. 7525(a).

[12] Code Sec. 7525(b).

[13] *See L. Kovel,* CA-2, 62-1 USTC ¶9111, 296 F2d 918.

[14] *J.L. Tenzer,* CA-2, 97-2 USTC ¶50,689, 127 F3d 222.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