

A Primer on the IRS's New Voluntary Disclosure Practice: A TAXPAYER'S SECRET WEAPON

By Jason B. Freeman, JD, CPA, and
Matthew L. Roberts, JD, LLM

The United States' system of federal taxation is a voluntary one. As such, taxpayers are generally required to voluntarily file an annual income tax return and pay any associated tax liabilities.ⁱ

Generally, this system has worked well. But, as with any voluntary tax system, there are inevitably instances in which taxpayers attempt to circumvent the system, such as through non-filing, non-reporting or the non-payment of tax. Willful instances of these latter reporting deficiencies can present risks of serious civil penalties and, in some instances, even risks of criminal prosecution.

However, the IRS offers several administrative programs that in some situations may reduce, or even eliminate, criminal and civil penalty exposure for noncompliant taxpayers.ⁱⁱ Perhaps the oldest and most widely known is the IRS's voluntary disclosure practice.

Although the practice and its requirements have varied over time, its basic premise has remained the same: noncompliant taxpayers may come forward voluntarily to resolve their outstanding tax issues – and, in the process, reduce their risk of criminal prosecution – provided they disclose the noncompliance, cooperate and otherwise meet the requirements of the program. The taxpayer must, however, come forward in a "timely" manner; that is, before they are on the IRS's radar.



Because the IRS's current voluntary disclosure practice has undergone significant changes in the last few years, this article provides an overview of the practice as it currently stands.

The November 20, 2018 Memorandum

From 2009 through 2018, the IRS effectively maintained a dual voluntary disclosure system. Taxpayers with foreign tax compliance issues were generally eligible to take advantage of the IRS's formal Offshore Voluntary Disclosure Program (OVDP). Taxpayers with only domestic issues were generally eligible for the IRS's domestic voluntary disclosure practice.

The OVDP, a widely successful program, was terminated on September 28, 2018.ⁱⁱⁱ With the end of the OVDP, and having drawn nearly a decade of insights from the OVDP and its predecessors, the IRS coordinated a significant overhaul and standardization of its voluntary disclosure practice. As part of that effort, on November 20, 2018, the IRS issued a Memorandum announcing updates to its voluntary disclosure practice (the Memorandum).^{iv} Significantly, the Memorandum applies to all voluntary disclosures, whether domestic or offshore, submitted to the IRS after September 28, 2018.^v

The Memorandum sets out significant new guidance for the voluntary disclosure practice going forward. For example, the Memorandum requires that taxpayers submit a voluntary disclosure using a redesigned Form



14457^{vi} Form 14457, which can be submitted to IRS Criminal Investigation (IRS-CI) either by fax or mail, provides IRS-CI with significant identifying information, helping them determine whether a taxpayer's submission is "timely" and whether to grant the taxpayer "preclearance" to move forward with the disclosure process.^{vii}

If preclearance is granted, the Memorandum instructs the taxpayer to submit additional information regarding the noncompliance on a subsequent section of the same Form 14457 to determine whether the taxpayer will be "preliminarily accepted" into the program.^{viii} After preliminary acceptance, the taxpayer is advised that IRS-CI will forward the voluntary disclosure letter and any attachments to IRS LB&I in Austin, Texas for case preparation and examination.^{ix}

For penalties, the Memorandum instructs IRS examiners to generally impose one fraud penalty under I.R.C. § 6663 or one civil penalty under I.R.C. § 6651(f) for fraudulent failure to file for the tax year with the highest tax liability.^x However, the IRS examiner also has the discretion to impose either of these fraud penalties for more than one year "based on the facts and circumstances of the case."^{xi}

For example, the Memorandum indicates that the IRS could impose more than one fraud penalty if there is no

agreement between the IRS and the taxpayer as to the proper tax liability.^{xii} Moreover, for willful FBAR penalties, the IRS indicates that it will continue to utilize the existing penalty structure under I.R.M. pt. 4.26.16 and I.R.M. pt. 4.26.17.^{xiii}

In addition, the Memorandum indicates that penalties for failure to file information returns (e.g., Forms 5471, 8938, 8865) will not automatically be imposed; however, the Memorandum also indicates that the IRS examiner will have the discretion to take into account the applicability of other penalties in making this determination.^{xiv}

Revised Form 14457 and Voluntary Disclosure Program Process

In April 2020, the IRS released a revised version of the Form 14457, Voluntary Disclosure Practice Preclearance Request and Application. The revised Form 14457 also includes extensive instructions, most of which incorporate the guidance contained in the Memorandum.



Requirements to Make a Voluntary Disclosure

The instructions to the Form 14457, read in conjunction with the IRS's Internal Revenue Manual (IRM), provide taxpayers with guidance on the requirements to make a voluntary disclosure. Thus, tax practitioners should have a thorough understanding of these requirements prior to attempting to submit a voluntary disclosure.

Consistent with its historical voluntary disclosure practice, the instructions and IRM indicate that the IRS will only accept a voluntary disclosure if the disclosure is truthful, timely and complete.^{xv} The truthful concept requires little in the way of explanation. However, the concepts of a timely and complete disclosure are discussed below.



Revisions to the Internal Revenue Manual

Only recently, the IRS revised its IRM to take into account changes to the voluntary disclosure program.^{xliii} Many of these changes were made to incorporate the Memorandum and revised Form 14457 and instructions, which have been discussed in this article. However, tax practitioners should take caution of the IRM's reminder that the voluntary disclosure program provides no substantive or procedural rights to taxpayers.^{xliv}

The IRM also reminds taxpayers that they are unable to rely on the fact that similarly situated taxpayers may not have been recommended for criminal prosecution. Any IRS-CI determinations, including determinations concerning timeliness, completeness, truthfulness, rejection and revocation decisions, are not subject to any administrative or judicial review or appeals process.^{xlv}

Under the instructions to the Form 14457 and the IRM, a disclosure is considered timely if the taxpayer submits it before the IRS has:

- Commenced a civil examination or criminal investigation;
- Received information from a third party (e.g., informant, other governmental agency, John Doe summons, etc.) alerting the IRS to the noncompliance; or
- Acquired information directly related to the specific noncompliance from a criminal enforcement action (e.g., search warrant, grand jury subpoena, etc.).^{xvi}

Stated differently, if the IRS is already in possession of information that has revealed the tax noncompliance, the taxpayer will not be able to make a voluntary disclosure under the timeliness requirement.

The instructions to the Form 14457 and the IRM also provide additional clarity on the meaning of a complete disclosure. Significantly, the Form 14457 itself cautions taxpayers to "[c]omplete all fields" and in the event a field cannot be completed, the taxpayer is further warned to attach a statement explaining why.^{xvii} In addition, the IRM provides that a disclosure will not be considered complete if the willful noncompliance narrative portion of Part II of the Form 14457 does not contain all of the elements addressed in the instructions to the Form 14457.^{xviii} Accordingly, taxpayers are generally advised to disclose as much information as possible to avoid having the disclosure deemed incomplete.

The instructions to the Form 14457 and the IRM further communicate to the taxpayer that a successful disclosure requires the taxpayer to cooperate with the IRS in several material respects during the disclosure process. For example, the taxpayer must cooperate with the IRS in determining the proper tax liability and compliance reporting requirements.^{xix} Moreover, the taxpayer must cooperate with the IRS in investigating any professional enablers who aided in the noncompliance.^{xx}

In addition, the taxpayer must submit all required returns, information returns and reports for the disclosure period.^{xxi} Finally, the taxpayer must make good faith arrangements with the IRS to pay in full the tax, interest and any penalties determined by the IRS to be applicable.^{xxii}

The instructions and the IRM caution taxpayers that the IRS will not accept a voluntary disclosure if the taxpayer has illegal source income.^{xxiii} For these purposes, income is considered illegal even if it is legal under state law, provided it is illegal under federal laws.^{xxiv}

Preparation and Submission of Part I of Form 14457

The first step to submit a voluntary disclosure is to obtain preclearance from IRS-CI.^{xxv} To do so, the taxpayer must prepare and submit Part I of Form 14457.^{xxvi} The primary purpose of preparing and submitting Part I of the Form 14457 to IRS-CI is to assist IRS-CI in determining whether the taxpayer meets the initial requirements of the voluntary disclosure program.^{xxvii}

Generally, Part I can be broken down into three segments. First, Part I asks for identifying information of the taxpayer and related parties, including any entities. More specifically, Part I asks the taxpayer to identify all entities (corporations, partnerships, etc.) that were in any way related to the noncompliance during the disclosure period at issue. In addition, Part I asks the taxpayer to identify all entities owned or controlled (or beneficially owned) by the taxpayer during the disclosure period, either directly or indirectly.

Second, Part I asks the taxpayer to provide essentially "yes" or "no" answers to whether the taxpayer or related party has been notified of any intent to commence a civil or criminal investigation, either by the IRS or another government authority.^{xxviii} Moreover, Part I asks the taxpayer to answer "yes" or "no" as to whether the taxpayer has information to believe the IRS has obtained information concerning the taxpayer's tax liability and also whether the taxpayer or any related party has income from illegal sources.

Third, Part I asks the taxpayer to list all domestic and foreign noncompliant financial accounts owned or controlled (beneficial or otherwise) by the taxpayer for the relevant disclosure period. This includes the account number and the date the account was opened and closed. Generally, the IRS's determination to preclear a taxpayer to make a voluntary disclosure can take a minimum of 30 days but in some instances may take longer.^{xxix}

Preparation and Submission of Part II of Form 14457

After IRS-CI reviews Part I of the Form 14457 and indicates to the taxpayer that the taxpayer has been precleared, the taxpayer has 45 days to complete Part II of Form 14457.^{xxx} However, if the taxpayer needs additional time, the taxpayer can generally request an

additional 45-day extension.^{xxxi} To complete Part II of the Form 14457, the taxpayer will need the case control number, which is provided by IRS-CI after submission of Part I of the Form 14457.^{xxxii}

Part II of the Form 14457 asks the taxpayer to submit essentially three parts of information:

- An estimated total annual unreported income amount and the highest aggregate account or asset values of offshore accounts or assets, if applicable, for the disclosure period;
- Information on any professional advisors' involvement in the noncompliance; and
- A noncompliance narrative.

Because the disclosure must be truthful and complete and because the taxpayer must sign this part under penalties of perjury, Part II requires careful attention, particularly with respect to the willful narrative.

For the willful narrative, the taxpayer must provide a thorough discussion of all Title 26 and Title 31 willful failures to report income, pay tax, and submit all required information returns and reports. The taxpayer must also provide in this narrative an explanation of the roles the professional advisors had in the noncompliance. As indicated above, a failure to complete the narrative in

Contact Us

813 Oak Street 10A #298
Conway, AR 72032

Office - 866.260.2793
Kathy Cell - 501.514.4928
Christy Cell - 501.499.4357

kathy@accountingbizbrokers.com
christy@accountingbizbrokers.com
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accordance with the instructions to the Form 14457 may result in the disclosure being deemed incomplete.

In signing Part II under penalties of perjury, the taxpayer also agrees that he/she will continue to cooperate with the IRS, including in assessing any income tax liabilities and making good faith arrangements to pay any tax, interest and penalties associated with the voluntary disclosure.^{xxxiii} The instructions to Form 14457 also explain that cooperation may include:

- Promptly and fully responding to all information document requests;
- Submitting to interviews and providing access to related party witnesses;
- Providing statute extensions or waivers as necessary for tax and tax-related issues;
- Providing delinquent or amended returns, information returns, supporting documents, workpapers, etc.;
- Providing bank secrecy waivers for offshore cases; and
- Resolving all compliance matters covered by the disclosure by agreement.^{xxxiv}

If the taxpayer believes that he/she is unable to pay the tax in full, the instructions to the Form 14457 advise the taxpayer to disclose this on the form and to also submit a proposed payment arrangement and completed Collection Information Statement with the form.^{xxxv} The IRS cautions that the burden is on the taxpayer to establish inability to pay, to the satisfaction of the IRS, based on full disclosure of all assets and income, domestic and foreign, under the taxpayer's control.^{xxxvi}

Should the taxpayer fail to fully cooperate with the IRS examiner, the instructions further warn that the examiner may request IRS-CI to revoke the taxpayer's preliminary acceptance.^{xxxvii} Moreover, in these instances, examiners can expand the scope of the examination to include all tax years involving willful tax noncompliance, resulting in the assertion of all applicable penalties to the maximum extent permitted under the law.^{xxxviii}

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IRS Examination

The instructions to Form 14457 communicate to the taxpayer that in the event preliminary acceptance of the disclosure is granted (i.e., successful review of Part II), then IRS-CI will forward the taxpayer's case to civil examination.^{xxxix} Accordingly, an IRS examiner assigned to the case will contact the taxpayer with an initial contact letter.^{xl}

Generally, at this stage, the examiner will request from the taxpayer any delinquent or amended returns and information returns in addition to any other substantiation and records related to the returns.^{xli}

The instructions caution taxpayers that the voluntary disclosure process is not complete until taxpayers have come into compliance and made good faith arrangements with the IRS to pay the full tax, interest and penalties.^{xlii}

Consider the Facts and Circumstances

The IRS's revised voluntary disclosure program provides opportunities for tax practitioners to assist their noncompliant clients in avoiding criminal prosecution. Accordingly, the wise tax practitioner will carefully explore whether a potentially eligible taxpayer meets all the requirements of the voluntary disclosure program and whether the program is a good fit for the client.

In order to make these decisions, tax practitioners should carefully consider the facts and circumstances of the taxpayer's individual case. CPAs should, however, always remain mindful that the accountant privilege does not apply in the criminal context. Given that discussions with clients about a possible voluntary disclosure often involve

potentially incriminating facts, CPAs should almost always seek to involve legal counsel when the privilege is an important consideration.

ABOUT THE AUTHORS:

Jason B. Freeman, JD, CPA, is the founding and managing member of Freeman Law, PLLC, and is TXCPA's chairman-elect. He is a dual-credentialed attorney-CPA, author, law professor and trial attorney. He can be contacted at Jason@freemanlaw.com.

Matthew L. Roberts, JD, LLM, is a principal of Freeman Law, PLLC. He devotes a substantial portion of his legal practice to helping his clients successfully navigate and resolve their federal tax disputes, either administratively or, if necessary, through litigation. He can be contacted at mroberts@freemanlaw.com.

FOOTNOTES

ⁱ I.R.C. § 6012.

ⁱⁱ Currently, these programs include the Streamlined Filing Compliance Procedures, the Delinquent FBAR Submission Procedures and the Delinquent International Information Return Submission Procedures.

ⁱⁱⁱ IR-2018-176, available at <https://www.irs.gov/newsroom/irs-offshore-voluntary-compliance-program-to-end-sept-28>.

^{iv} IRS Memorandum for Division Commissioners, Nov. 20, 2018.

^v Id. at 2.

^{vi} Id. at 2-3.

^{vii} Id. at 3.

^{viii} and ^{ix} Id.

^x Id. Taxpayers would not be precluded from requesting a reduced accuracy-related penalty under I.R.C. § 6662 instead of the fraud penalty, but the Memorandum

indicated that the granting of such requests would be "exceptional."

^{xi, xii} Id.

^{xiii} Id. Generally, the willful FBAR penalty will be limited to 50% of the highest aggregate balance of all unreported foreign financial accounts during the disclosure period. See IRM pt. 4.26.16.6.5.3 (Nov. 6, 2015). IRS examiners are given discretion to increase or reduce the penalty.

^{xiv} Form 14457, at 7.

^{xv} Id.

^{xvi} Id.; also see IRM pt. 9.5.11.9(7) (Sept. 17, 2020).

^{xvii} Form 14457, at 3.

^{xviii} IRM pt. 9.5.11.9.1(5). The IRM also cautions taxpayers that if they fail to complete the narrative successfully, they will not be given an opportunity to supplement their submissions. See id.

^{xix}, ^{xx}, ^{xxi}, ^{xxii} Form 14457, at 3; IRM pt. 9.5.11.9(6).

^{xxiii, xxiv} Form 14457, at 3; IRM pt. 9.5.11.9(5).

^{xxv} IRM pt. 9.5.11.9.1(2) (Sept. 17, 2020).

^{xxvi} Id.

^{xxvii} Id.

^{xxviii} The IRM refers to any "yes" response as a potentially "disqualifying factor." See IRM pt. 9.5.11.9.4 (Sept. 17, 2020).

^{xxix} Form 14457, at 11.

^{xxx} Id. at 13; also see IRM pt. 9.5.11.9.1(4) (Sept. 17, 2020).

^{xxxi} Form 14457, at 13; also see IRM pt. 9.5.11.9.1(4).

^{xxxii} Form 14457, at 3.

^{xxxiii} Id. at 5.

^{xxxiv} Id. at 9.

^{xxxv} Id. at 10.

^{xxxvi} Id.

^{xxxvii} Id. at 11.

^{xxxviii} Id.

^{xxxix} Id. at 7.

^{xl, xli, xlii} Id.

^{xliii} IRM pt. 9.5.11.9 (Sept. 17, 2020).

^{xliv} IRM pt. 9.5.11.9(4) (Sept. 17, 2020).

^{xlv} Id.

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