

## PRACTICE STRATEGY

## Avoiding Criminal Tax Prosecution: The Newly Revised IRS Voluntary Disclosure Policy

By Justin A. Thornton

The distraught new client, a respected, wealthy, well-dressed businesswoman, looks at you anxiously from across your desk. "Can you help me avoid going to jail?" Several years ago, while vacationing in the Caribbean, Jane opened an account at a bank located on Grand Cayman Island. The bank issued her credit and debit cards linked to her offshore account. Jane's federal income tax returns in recent years failed to disclose the offshore account or report the interest earned on it.

Jane has heard news reports that the Internal Revenue Service is gathering information about thousands of U.S. taxpayers with credit and debit cards issued by banks in the Caribbean. Although she has yet to receive any contact from the IRS, she fears it may be just a matter of time.

You remember reading about a voluntary disclosure policy of the IRS and wonder whether Jane qualifies, since she knew from considerable media coverage that the IRS was going after offshore bank accounts in general and offshore debit and credit cards in particular. Would an approach to the IRS be too late to keep her out of jail? Should amended returns be prepared and filed? How do you advise her?

This is not a rare scenario for private practitioners who represent taxpayers subjected to ever-increasing IRS scrutiny of offshore financial transactions. To serve properly your client's needs, you must understand the seriousness of the situation, especially in view of current IRS and

Department of Justice enforcement priorities, practices, procedures and policies.

### The Ongoing IRS Hunt for Foreign Account Records

During the past two years the IRS has issued "John Doe" summonses to American Express, MasterCard, and Visa to obtain the names, addresses, telephone numbers, Social Security numbers, and other pertinent information relating to holders of debit and credit card accounts with banks located in 30

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countries, 20 of which the U.S. government considers to be tax havens (e.g., Antigua, the Bahamas, Barbuda, the Cayman Islands, Isle of Man, Hong Kong, Liechtenstein, and Switzerland). (Business Crimes Bulletin, September 2002.) The government has estimated that there are 1 million to 2 million taxpayers with offshore debit and credit cards, and that only 10 percent report their foreign accounts. In an effort to determine which of those potential tax cases should be pursued civilly or criminally, a special unit within the IRS (reportedly to which approximately 1,400 revenue agents ultimately will be assigned) has been formed to evaluate responses to the "John Doe" summonses.

Since the investigation began, many private tax practitioners have asked the IRS about the effect of general publicity regarding the investiga-

tion upon the timeliness requirement for voluntary disclosure by a holder of such an offshore account. After all, how could the IRS, with its limited resources, prosecute up to 2 million tax cases? Couldn't the IRS articulate a policy that would allow offshore account holders to pay up, get right with the "taxman" and avoid criminal prosecution?

Although the IRS' early responses were less than clear and reassuring, the agency, to its credit, has now revised its voluntary disclosure policy, reportedly in response to the private bar's repeated requests for clarification.

### Recent Revisions to IRS' Voluntary Disclosure Policy

On Dec. 11, the IRS announced that it had revised and updated a key practice that assists its investigators in determining whether a tax case is recommended for criminal prosecution. While a taxpayer's timely, voluntary disclosure of a substantial unreported tax liability had long been an important factor in determining whether the taxpayer's case would be referred for criminal prosecution, the IRS says its practice has been modernized to let more taxpayers correct past omissions voluntarily and to reduce uncertainty over what constitutes a "timely" disclosure. The IRS press release gave examples to illustrate the new standards of timeliness and reduce confusion. Most notably, the release explained that general publicity regarding enforcement and compliance efforts will not necessarily bar a taxpayer from the benefits of voluntary disclosure.

The IRS qualified its announcement, however, by noting that the practice still requires the taxpayer to make good-faith arrangements with the agency to pay in full the tax, interest and applicable civil penalties as determined by the IRS. See *U.S. v. Tenzer*, 127 F.3d 222 (2d Cir., 1997). Narcotics traffickers, gamblers and others with illegal sources of income need not apply.

The revised practice continues to be a matter of internal IRS use, creating no substantive or procedural

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## Revised IRS Policy

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rights for the taxpayer, and it is not a means of obtaining an automatic guarantee of immunity from prosecution. See IRS News Release of December 11, 2002 (Release No: IR-2002-135).

### 'New and Improved' IRS Voluntary Disclosure Policy

While the revisions arguably are a step forward, their application is not without ambiguity for private practitioners and their clients.

The newly revised policy states in pertinent part that a voluntary disclosure occurs when the communication is truthful, timely, and complete, and the taxpayer cooperates with the IRS and arranges to pay in full all applicable taxes, interest and civil penalties. The disclosure is "timely" if it is received before the IRS has:

- initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer of its intention to commence such an audit or investigation;
- received information from an informant, another government agency, the media, or other third party of the specific taxpayer's noncompliance;
- begun an audit or investigation that is directly related to the specific tax liability of the taxpayer; or,
- obtained information from a search warrant, grand jury subpoena or other criminal enforcement action, that is directly related to the specific tax liability of the taxpayer.

IRS Criminal Investigation is charged with the responsibility of evaluating all voluntary disclosures that are attempted by taxpayers or their representatives. A voluntary disclosure will still not guarantee a taxpayer's immunity from prosecution, and a taxpayer cannot rely on the fact that others in similar situations were not prosecuted. See Internal Revenue Manual § (31)330(1)(b).

### What's a Voluntary Disclosure?

The press release gave four specific examples to show that disclosures qualify under IRS's newly revised policy when:

(1) A letter from an attorney encloses complete and accurate amended returns and offers to pay applicable taxes, interest and penalties as determined by the IRS;

(2) A disclosure by a taxpayer of omitted income facilitated through a barter exchange after announcement by the IRS that it has begun a civil compliance project targeted at barter exchanges, but before any contact by the IRS and before the commencement of any IRS audit or investigation of the taxpayer;

(3) A disclosure of omitted income facilitated through a widely promoted scheme about which the IRS has begun a civil compliance project that might lead to an examination of the taxpayer, but before the initiation of an audit or investigation of the taxpayer; and

(4) A disclosure by a nonfiler who has received a notice that the IRS has no record of having received a tax return from them for a particular year and asking whether such a return was filed, who then files complete and accurate returns prior to the commencement of an IRS audit or investigation, or notification by the IRS of its intent to initiate same. The taxpayer must not have any income derived from illegal sources.

### What's Not a Voluntary Disclosure?

The IRS also gave five examples of attempted disclosures that would fail to qualify:

(1) A letter from counsel stating that their client, whose identity counsel does not disclose because the client wishes to remain anonymous, wants to settle his or her tax liability;

(2) A disclosure by a taxpayer who is already under grand jury investigation, regardless of whether they knew of the existence of the pending criminal investigation;

(3) A disclosure by a taxpayer whose business partner is already under IRS investigation for omitted income skimmed from the partner-

ship, regardless of whether the taxpayer knew of the ongoing investigation;

(4) A disclosure by a taxpayer of omitted constructive dividends received from a corporation that is currently under IRS examination, regardless of whether the taxpayer knew of the ongoing audit; and

(5) A disclosure by a taxpayer after an employee has informed the IRS of the taxpayer's double set of books, regardless of whether the taxpayer knew of the informant's contact with the IRS.

### Ambiguity and Unanswered Questions

Despite the IRS' laudable goals of clarity and better understanding by taxpayers and tax professionals, ambiguity still surrounds the voluntary disclosure policy and important questions remain unanswered.

For instance, absent any actual notice by the IRS, how can the taxpayer know whether an audit or investigation has commenced, and whether an attempted voluntary disclosure would pass the timeliness requirement?

As for taxpayers who have not received any contact from the IRS that they are, or about to be, under civil audit or criminal investigation, and whose incomes are derived only from legal sources, but who have failed to file returns or have filed false returns, wouldn't it be wiser policy for the IRS to announce that those individuals might come forward without fear of criminal prosecution if they file true and accurate delinquent or amended tax returns as the case may be, and make good-faith arrangements with the IRS to pay all applicable taxes, interest and penalties?

### Clients Must Still Be Wary

The revisions to the IRS voluntary disclosure policy are a step in the right direction. Nevertheless, the taxpayer who has had no notice of an impending audit or IRS investigation must still proceed with extreme caution when attempting to satisfy the timeliness requirement for a voluntary disclosure. To do otherwise may be akin to helping the hangman knot the noose.