

Cleaning Up the Client's Mess: Voluntary Disclosure

QUINNIPIAC UNIVERSITY SCHOOL OF LAW

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Agenda

- What is a voluntary disclosure and who should use the IRS's practice?
- IRS Updated Voluntary Disclosure Practice
 - Significant recent changes to the submission process
 - Post-submission: what to expect
 - Penalty framework
 - Case resolution and revocation
- Ongoing areas of uncertainty
 - Timeliness
 - Cryptocurrency reporting

Review of Voluntary Disclosures

A voluntary disclosure is made when the communication is *truthful, timely, and complete*. The practice also requires taxpayers to:

1. Cooperate with the IRS in determining their tax liability and compliance reporting requirements,
2. Cooperate with the IRS in investigating any professional enablers who aided in the noncompliance,
3. Submit all required returns, information returns, and reports for the disclosure period, and
4. Make good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.

Who should use the Voluntary Disclosure Practice?

Revised IRM 9.5.11.9 - updated September 17, 2020

- Focus on the willfulness of the tax or tax-related violation
- If noncompliance was not willful, use another compliance option

9.5.11.9
(09-17-2020)

Voluntary Disclosure Practice

- (1) The Voluntary Disclosure Practice is a long-standing practice of the IRS that provides taxpayers with criminal exposure a means to come into tax compliance and potentially avoid criminal prosecution.
- (2) The Voluntary Disclosure Practice is a compliance option for taxpayers who have committed tax or tax-related crimes and have criminal exposure due to their willful violation of the law. If the violation of the law was not willful, taxpayers should consider other options including correcting past mistakes by filing amended or past due returns.
- (3) A voluntary disclosure will be considered along with all other factors in determining whether criminal prosecution will be recommended. A voluntary disclosure does not guarantee immunity from prosecution.

Who should use the Voluntary Disclosure Practice?

Revised Instructions to Form 14457 (Feb. 2022):

Who **Should** Make a Voluntary Disclosure

You should consider applying for the IRS-CI Voluntary Disclosure Practice if you engaged in willful noncompliance that exposes you to criminal liability for tax and tax-related crimes, you meet the eligibility requirements (discussed next), and you wish to come into tax compliance and avoid potential criminal prosecution. The IRS-CI Voluntary Disclosure Practice is available to individuals (U.S. Citizens, Green Card Holders, Non-Resident Aliens, Expatriates, etc.) and business entities (Corporations, Partnerships, LLCs, Trusts, Estates).

A voluntary disclosure will not automatically guarantee immunity from prosecution. A voluntary disclosure will be considered along with all other facts and circumstances in determining whether criminal prosecution will be recommended for tax and tax related crimes covering the disclosure period.

Who **Should Not** Make a Voluntary Disclosure

You should not use the IRS-CI Voluntary Disclosure Practice if the source of the unreported income is from any illegal source. You should not use the IRS-CI Voluntary Disclosure Practice if you did not commit any acts that rise to the level of tax or tax-related crimes. The purpose of the IRS-CI Voluntary Disclosure Practice is to provide protection from potential criminal tax and tax-related prosecution. You can correct less serious non-compliance by filing amended or past due tax returns. If your less serious noncompliance involves unreported offshore income or delinquent international information returns, see “Other Compliance Options” later in this section.

Other Compliance Options

- Revised Instructions to Form 14457 (Feb. 2022):

Other Compliance Options

If you did not commit any tax or tax-related crimes and wish to correct mistakes or file delinquent returns, it is recommended that you consider the alternatives below:

1. If you made a mistake on your income tax return, you can file an amended return. For more information go to <https://www.irs.gov/faqs/irs-procedures/amended-returns-form-1040x/amended-returns-form-1040x>
2. If you failed to file one or more income tax returns, file the delinquent returns as soon as possible. For more information go to <https://www.irs.gov/businesses/small-businesses-self-employed/filing-past-due-tax-returns>
3. If you non-willfully failed to report foreign financial assets and pay all tax due in respect of those assets, you may be able to use the Streamlined Filing Compliance Procedures. For more information go to <https://www.irs.gov/streamlined>
4. If you reported all income and paid all tax but failed to file FBARs, consider the delinquent FBAR submission procedures, go to <https://www.irs.gov/individuals/international-taxpayers/delinquent-fbar-submission-procedures>
5. If you reported all income and paid all tax but failed to file international information returns, consider the delinquent international information return procedures, go to <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures>

The Streamlined Filing Compliance Procedures may be discontinued at any time.

A Client Calls With a Problem



- Understand the situation: what happened; what is the issue; magnitude of noncompliance; effect on other taxpayers; objectives and desirable (but realistic) end result.
- Options for addressing the issues: VDP? Other?
- How does VDP work: requirements; timing; cost and exposure.

MUST CLEAN UP ALL THE MESS!

Current Voluntary Disclosure Practice

- Intended only for taxpayers with criminal exposure
- Returns must be corrected for last 6 years
- Agree to penalties, *e.g.*:
 - A 75% civil fraud penalty on the highest balance year;
 - Willful FBAR penalties of 50% are the norm (see IRM 4.26.16);
 - Information return penalties are not automatic – case-by-case.
- Use IRS Form 14457
 - Part I for pre-clearance,
 - Part II for disclosure once cleared within 45 days

See IRM 9.5.11.9 (revised 9-17-20); Instructions to IRS Form 14457.

Submission Process

- The IRS-CI Voluntary Disclosure Practice is centralized.
- Taxpayers must provide all pertinent information using the latest version of Form 14457.
 - Last updated in February 2022 – see: <https://www.irs.gov/pub/irs-pdf/f14457.pdf>
- Preclearance by IRS-CI is mandatory.
- To request preclearance, a taxpayer must submit Part I of Form 14457.
- Taxpayers are required to provide a narrative statement of facts detailing their willful conduct in Part II of Form 14457.
- Effective for all voluntary disclosures made after September 28, 2018.

NOTE: *Interim Guidance Memo (IGM) LB&I-09-1118-014 (published November 20, 2018) expired November 20, 2020. IRM and Form 14457 reflect the current voluntary disclosure practice.*

Upfront Disclosure of Key Noncompliance Information

Part I – Preclearance

- Disclosure of entities, financial institutions, and virtual currency among other elements relating to noncompliance

Part II – Preliminary Acceptance

- Detailed narrative description of the reasons for the taxpayer's noncompliance
- Signed by taxpayer under penalty of perjury
- Failure to provide complete Information and narrative is disqualifying; no correction allowed
- No assurance that narrative will not be used against taxpayer if application is rejected
 - Instructions specifically state that “[i]nformation provided to the IRS may be utilized in civil and criminal investigations.”

See also: Comments of the ABA Tax Section Concerning the Voluntary Disclosure Practice and the Streamlined Filing Compliance Procedures (Sept. 24, 2021); IRS Supporting Statement, Voluntary Disclosure Practice and Streamlined Filing Compliance Procedures, OMB Control No. 1545-2241

Special Situations

Instructions to IRS Form 14457 provide welcome guidance on common situations:

- Inability to pay must be disclosed in Part II, along with collection information and a payment plan
 - This occurs very early in the VDP stages, is it premature is situations change?
- Joint returns where one spouse is at fault – IRS encourages a joint submission with allocation of responsibility in the narrative description
- Estates – generally should not use voluntary disclosure unless the conduct of related parties (e.g., executors) gives rise to criminal exposure

Post-Preliminary Acceptance: What to Expect

- CI will forward the submission to an examining agent, who will send an initial contact letter
- Taxpayers should hold any delinquent/amended returns and payments until contacted by specific examiner
 - See IRM 4.63.3.26.6(3) Note and Instructions to Form 14457
- Voluntary disclosures will be assigned for examination and follow standard examination procedures
 - See IRM 4.63.3.26.6(5)

Post-Preliminary Acceptance: What to Expect

- Instructions to Form 14457 – be prepared to provide the following:

Documentation requested may include, but is not limited to:

- Delinquent/amended tax returns and information returns
- Statute extensions for all applicable income tax and FBAR years
- Accounting books and records
- Bank statements and related account opening documents
- Advice provided by professionals
- Any materials related to a promoter, enabler, or other facilitator of tax noncompliance
- Payment for tax, interest, and penalties

A civil examiner may require that you submit to an interview under oath to explain the facts provided in your voluntary disclosure, answer questions about return positions, provide information about promoters, and answer any other questions the civil examiner determines are relevant.

Penalties: Income Tax

- A civil fraud penalty or fraudulent failure to file penalty for at least one year is in lieu of accuracy-related penalties and delinquency penalties
 - Not in lieu of penalty for failure to make estimated tax payments under I.R.C. § 6654
 - Specific examples are in IRM 4.63.3.26.2(5) and instructions
- Exceptions to the penalty framework will be considered “in rare and extraordinary cases” based upon “clear and convincing evidence” – see IRM 4.63.3.26.2(10)
 - Requires elevation and approval from Voluntary Disclosure Practice Counsel
 - “We anticipate deviation from the penalty structure to be exceedingly rare”

Penalties: Fraud Penalty for Taxable Entity and Individual

Taxable Entity and Individual Fraud. When a voluntary disclosure involves fraud by a taxable entity (most commonly a subchapter C corporation) and by an individual related to the entity, a civil fraud penalty or a fraudulent failure to file penalty, sections 6663 or 6651(f), respectively, will apply to at least one year of the voluntary disclosure at both the corporate and individual levels. This penalty structure applies whether the entity submits a separate Form 14457 or not. The following example illustrates this:

- Individual taxpayer was the sole shareholder of a subchapter C corporation, and the corporation fraudulently understated income by paying personal expenses of the individual taxpayer and deducting them as business expenses. Individual taxpayer submits six years of amended returns, Forms 1040X, and the corporation submits six years of amended returns, Forms 1120X. One fraud penalty will apply to the year with the highest tax liability at the individual level and at the corporate level and no accuracy-related penalties will apply for the other five years.

Revised Instructions to Form 14457 (Feb. 2022)

Penalties: Estate Tax and Gift Tax

- Estate tax:

- Civil fraud penalty applies to the deficiency, but at a 50% rate rather than the usual 75% rate

- Gift tax and GST tax:

- If the fraudulent activity involves multiple tax years, the 6-year lookback period is inapplicable
 - All past gift tax returns must be amended/filed
 - Single civil fraud penalty is assessed on highest year with highest liability at 75% rate in lieu of all other accuracy-related penalties
 - If only one year is involved, civil fraud penalty applies at the reduced 50% rate

Penalties: Information Return and FBAR Penalties

- Information Return Penalties:

- Not automatically imposed. Application of other penalties are within the discretion of examining agent.

- FBAR Penalties:

- Willful FBAR penalties apply to all cases with offshore noncompliance where facts and law support the assertion of a willful penalty
 - Computed in accordance with IRS penalty guidelines under IRM 4.26.16 and 4.26.17

Penalties: Employment Tax

- Single civil fraud penalty applies to the tax quarter of the disclosure period with the highest employment tax liability
 - In lieu of accuracy-related and delinquency penalties
- Failure-to-deposit penalty under section 6656 still applies
- Calculation of employment tax liability will be made without regard to 3509(a) or (b) rates
- Supplemental income tax withholding rate applies for failure to deduct and withhold tax from wages
- Suspension of interest under 6205 does not apply
- Still required to file Forms W-2 and W-2c with the SSA
- Further employment-tax specific guidance and examples are in the Instructions

Penalties: Employment Tax

- Tax and penalty consequences can be severe in a relatively common situation
- For the last number of years an S-Corp is in a business where a significant portion is paid in cash. Some employees are paid partially in cash, some fully. In addition, all shareholders and other executives are paid in cash. There is no withholding of tax on cash payments
- Potential Penalties:
 - Fraud penalty for unreported income for S-Corp and each shareholder on increased liability
 - One fraud penalty on the tax quarter with the highest employment tax penalty
 - Failure to deposit penalty for all periods
 - Supplemental income tax withholding rate – currently 22% --increases the amount of fraud penalty and failure to deposit penalty significantly
 - No suspension of interest
 - May be additional penalties for delinquent or amended W-2 and W-2C

VDP Case Resolution

- Most VDP cases are resolved via Closing Agreement
 - Agreements are reviewed at national level and are based on a standard template
 - Fraud penalty should be specifically referenced in agreements
 - Agreements typically include waiver of CDP and other collection rights, so collections should be addressed with the examining agent

VDP Acceptance Revocation

- Full cooperation with the exam is required, and VDP acceptance can be revoked
 - Procedures for revocation are outlined in IRM 9.5.11.9.7
 - Taxpayers should receive a written warning from the examiner
 - Examiner asks CI to revoke acceptance into VDP, and CI makes the decision
 - Taxpayer will receive notice of revocation, and criminal referral is possible

Taxpayers must comply with U.S. law for all tax periods after the disclosure period and file returns according to standard filing procedures. Failure to remain in compliance for all tax periods after the disclosure period may result in the revocation of preliminary acceptance and possible criminal prosecution.

Revised Instructions to Form 14457 (Feb. 2022)

Prompt and Full Cooperation with Exam

- Prompt and full cooperation with the exam is required
- Instructions to Form 14457 provide further guidance on what is meant by full cooperation

Cooperation includes but is not limited to:

- 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 unrestricted instructions to foreign banks to provide full and complete records (for offshore cases)
- resolving all compliance matters covered by the disclosure by agreement
- full payment of all determined taxes, additions to tax, interest and penalties, or entering into a payment arrangement acceptable to the IRS

- Lack of cooperation: example given in IRM is making “any false statement as to any material matter” in VDP submissions

Ongoing Areas of Uncertainty - Timeliness

A disclosure is timely if it is received before:

1. The IRS has commenced a civil examination or criminal investigation of the taxpayer or has notified the taxpayer that it intends to commence such an examination or investigation.
2. The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the taxpayer's noncompliance.
3. The IRS has acquired information directly related to the noncompliance of the taxpayer from an enforcement action (e.g., search warrant, summons, grand jury subpoena).

IRM 9.5.11.9(7) (revised 9-17-20).

Is the voluntary disclosure “timely”?

Timeliness is Critical. In order to make a voluntary disclosure, you must come forward before the IRS has information about your noncompliance. You are not timely and cannot make a voluntary disclosure if:

The IRS has commenced a civil examination or criminal investigation,

The IRS has received information from a third party (e.g., informant, other governmental agency, John Doe summons, etc.) alerting the IRS to your noncompliance, or

The IRS has acquired information directly related to your specific noncompliance from a criminal enforcement action (e.g., search warrant, grand jury subpoena, etc.)

Is the voluntary disclosure “timely”?

Instructions to IRS Form 14457 (Rev. Feb. 2022).

- Lines 8, 9, 10 and 11: “you, your spouse or any related entities”
- Offer opportunity to explain. Not all automatic disqualifiers

Definition of Related Entity. Related entity means any and all entities (such as corporations, partnerships, associations, limited liability companies, trusts, estates, escrows, charitable foundations, insurance companies, international business companies, etc.) whether foreign or domestic, which a person (defined broadly to include natural persons and entities), personally or through any other person, owns, controls, or in any way has the ability to exercise authority over, either directly or indirectly. The concept of related entities goes beyond constructive ownership and attribution rules and should be interpreted broadly.

Changes to Definitions of Timeliness

- Definitions in IRM and in IRS Form 14457 are slightly different
- Both definitions make clear that information from a civil enforcement action (e.g., John Doe summonses) “may” disqualify a taxpayer
- Both definitions reflect that information obtained from a third party or a “related” party can disqualify a taxpayer
- Less certainty for taxpayers – is the disclosure timely?
- “Disqualifying Factors” – see IRM 9.5.11.9.4
 - Expressly contemplates successive voluntary disclosures – “enhanced review”
 - Illegal-source income remains disqualifying
 - Example: activity legal under state law but illegal under federal law

Ongoing Areas of Uncertainty - Cryptocurrency

- Inconsistency in definitions among the following:
 - IRS Notice 2014-21
 - IRS Virtual Currency Transactions FAQs, specifically A1 and A3
 - Instructions to Form 14457
- What is a noncompliant virtual currency for purposes of preparing Part I of the Form 14457?
 - How should these be listed? Each individual virtual coin? Each wallet? Each virtual currency transaction?
- For the narrative required by Part II of Form 14457, are the facts and circumstances of every virtual coin required?
- In light of the IRS's strict stance on correction and completeness of the Part II narrative, as well as the potential for criminal referral/revocation of VDP acceptance, further guidance is urgently needed

Ongoing Areas of Uncertainty - Cryptocurrency

- Inconsistency in definitions among the following:
 - IRS Notice 2014-21 -- a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.
 - IRS Virtual Currency Transactions FAQs, specifically A1 and A3
 - A1: Virtual currency is a digital representation of value, other than a representation of the U.S. dollar or a foreign currency (“real currency”), that functions as a unit of account, a store of value, and a medium of exchange. Some virtual currencies are convertible, which means that they have an equivalent value in real currency or act as a substitute for real currency. The IRS uses the term “virtual currency” in these FAQs to describe the various types of convertible virtual currency that are used as a medium of exchange, such as digital currency and cryptocurrency. Regardless of the label applied, if a particular asset has the characteristics of virtual currency, it will be treated as virtual currency for Federal income tax purposes.
 - A3: Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. A transaction involving cryptocurrency that is recorded on a distributed ledger is referred to as an “on-chain” transaction; a transaction that is not recorded on the distributed ledger is referred to as an “off-chain” transaction.

Ongoing Areas of Uncertainty – Cryptocurrency (cont.)

Instructions to Form 14457:

- Line 12: Definition of Financial Account. The definition of financial account should be interpreted broadly to also include any type of relationship with a third party established to provide or engage in deposit-type services or other financial services; this includes virtual currency, gambling accounts, and other deposit-type arrangements that function like a financial account regardless of who provides the arrangement. To avoid duplicative reporting, Virtual Currency accounts should be reported under Line 13.
- Line 13: “Virtual Currency” is a dynamic area, and for purposes of this form the term encompasses assets beyond what many define as virtual currencies.” References FAQ’s for definition. “Provide details for all noncompliant virtual currency you owned or controlled or were the beneficial owner of, either directly or indirectly. The listings must cover the entire disclosure period, including assets acquired or disposed of during the disclosure period and including those held through entities. Additionally, if you used a “mixer” or “tumbler” in connection with your virtual currency or any virtual currency transaction, identify the mixer or tumbler used and explain why you used it. For purposes of preclearance, a noncompliant virtual currency is an asset that should have been reported on a federal income tax return or other required federal information return and was not previously reported. Each virtual currency should be listed once; the form is designed to expand to accommodate additional virtual currencies, as applicable, by clicking the Add Virtual Currency button. Jointly held assets should be identified as such and only listed once. Asset holders must match the disclosing taxpayer(s) from lines 4 and 5, or an entity named on line 7.
- Mere ownership of currency would not trigger its reporting on income tax return.

Ongoing Areas of Uncertainty - Cryptocurrency

13. Schedule of virtual currency

- List ALL domestic and foreign noncompliant virtual currency you owned or controlled or were the beneficial owner of, either directly or indirectly.
 - The listings must cover the entire disclosure period as outlined in the instructions below.
 - This includes assets acquired or disposed of during the disclosure period.
 - This includes assets held through entities you owned or controlled or were the beneficial owner of, either directly or indirectly.
Note: The entities will be further identified in Part II of this application.
- Click “Add Virtual Currency” button below for additional assets.

Virtual Currency 1

Name of virtual currency

Identifying number or other designation (<i>see instructions</i>)	Date asset acquired	Date asset disposed	Check appropriate box <input type="checkbox"/> Domestic <input type="checkbox"/> Offshore
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Account holders

Add Virtual Currency

Ongoing Areas of Uncertainty - Cryptocurrency

- What is a noncompliant virtual currency for purposes of preparing Part I of the Form 14457?
 - How should these be listed?
 - Each individual virtual coin each time it is acquired?
 - Each wallet?
 - Each virtual currency transaction that would trigger reporting on 1040?
- For the narrative required by Part II of Form 14457 are the facts and circumstances of every virtual coin required?

Noncompliance (Virtual Currency). If your voluntary disclosure involves virtual currency, whether domestic or offshore, explain in the narrative the noncompliance:

- How the assets were acquired (kiosk, centralized online, peer-to-peer platform operator, exchange payment processor, custodial broker, etc., including alternative methods of acquisition such as air drop, mined, gift, traded).
- How the assets were held (exchange, hosted wallet, private wallet, etc.). When multiple virtual currencies are held, please reference each asset by "Identifying Number or Other Designation" as described in Part I line 13.
- Names of virtual currencies acquired
- Outline your acquisition of virtual currency and provide at least rough estimates of total virtual currency transactions by year.

Reminders:

Make sure to included virtual currencies in combined tax noncompliance and the asset fair market values required in Part II Line 4 and Line 5 (if applicable).

Be prepared to provide examiners with specific information relating to virtual currency noncompliance such as number of units, cost basis, and other specifics relating to transactions.

Ongoing Areas of Uncertainty - Cryptocurrency

In light of the IRS's strict stance on correction and completeness of Part I and Part II narrative, as well as the potential for criminal referral/revocation of VDP acceptance, further guidance on disclosure of virtual currency, including reconciling definitions, and identifying how to correctly and completely respond to Line 13, is urgently needed.

Questions?

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