

## Addressing Foreign Non-Compliance in a Post-OVDI Landscape

*By Mary E. Wood, J.D.  
and Joel N. Crouch, J.D.*

The IRS's continued focus on undisclosed foreign bank accounts and activities makes it more crucial than ever for non-compliant taxpayers to take measures to remedy compliance issues. The Department of Justice recently announced it had started investigations of an additional nine foreign banks and their activities with US depositors. Since it is likely that the resolution of the investigations will result in the disclosure of cus-



tomers' identifications, resolving non-compliance is very important.

In light of these growing risks, what should you do if your client informs you that he or she has undisclosed foreign activities? If you learned this information prior to September 9, 2011, the options were much clearer as the taxpayer could have participated in the 2011 Offshore Voluntary Disclosure Initiative ("OVDI"). Similar to the 2009 program, the 2011 OVDI allowed taxpayers to disclose foreign non-compliance to the IRS thereby avoiding criminal penalties and reducing civil penalties. Now that the 2011 program has closed, practitioners must determine how to address foreign non-compliance

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## The Next Wave of Voluntary Disclosure Initiatives: Worker Classification

*By Kathryn W. Lyles, J.D., LL.M.*

The overwhelming success of the offshore voluntary disclosure program has led the IRS to launch a new initiative, the Voluntary Classification Settlement Program ("VCSPP"). This program is targeted at businesses that have misclassified their employees as independent contractors. Businesses that participate in the program may voluntarily reclassify

workers as employees for federal employment tax purposes with limited tax liability for the past nonemployee treatment.

Whether a worker is an independent contractor or employee is primarily determined by whether the business has the right to control and direct how the worker's job is accomplished. The IRS generally follows a 20-factor test

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in a post-OVDI landscape. While the answers are not as easy or clear, there are still a number of options available. First, the taxpayer can still make a voluntary disclosure through the IRS's ongoing voluntary disclosure practice which is outlined in the Internal Revenue Manual. Although an IRS voluntary disclosure does not automatically guarantee immunity from prosecution, historically the IRS has not pursued criminal charges against taxpayers who meet the requirements of the voluntary disclosure practice. A voluntary disclosure occurs when a taxpayer truthfully, timely and completely notifies the IRS of issues on tax returns or other documents filed with the IRS. In addition, a taxpayer must agree to cooperate with the IRS in determining his or her correct tax liability and make good faith arrangements with the IRS to pay in full any tax, interest and penalties determined by the IRS to be applicable. This type of disclosure is referred to as a "noisy disclosure" as the taxpayer is overtly alerting the IRS of the non-compliance and agreeing to take steps to satisfy any resulting deficiency.

Timeliness is the most important factor for a noisy voluntary disclosure. A disclosure is timely if it is made before the IRS has initiated a civil examination or criminal investigation of the taxpayer, or before the IRS has notified the taxpayer that it intends to commence a

civil examination or criminal investigation. A disclosure is not timely if it is made after the IRS receives information from either a third party alerting the IRS to the taxpayer's noncompliance or a criminal enforcement action, such as a search warrant or grand jury subpoena. If the taxpayer does not qualify for the



ongoing voluntary disclosure practice or if he does not want to make a noisy disclosure for other reasons, he can elect to make a "quiet disclosure" by filing amended returns to remedy any non-compliance. The IRS has publicly announced, however, that it does not

consider a quiet disclosure to be a voluntary disclosure as defined by the Internal Revenue Manual because the taxpayer does not notify the IRS or agree to cooperate and pay any resulting tax, penalty and interest in full. As a result, a taxpayer making a quiet disclosure risks exposure to a criminal investigation and possible prosecution.

Finally, the taxpayer can choose the "sin-no-more" approach, which requires compliance on a going-forward basis without addressing any past compliance issues. It is important to note, however, that the filing of correct returns for future tax years may alert the IRS of the past non-compliance. Furthermore, because the taxpayer takes no action to correct past compliance issues, this alternative creates the highest risk for criminal investigation and prosecution.

There is no doubt that the IRS will continue its focus on foreign activities and attempts to identify taxpayers that are not in compliance with foreign reporting obligations. It has already investigated and prosecuted more than 30 cases and obtained indictments and guilty pleas from taxpayers that did not participate in the 2009 OVDI. With the new bank investigations, a similar uptick in criminal proceedings is expected for taxpayers that did not participate in the 2011 OVDI. Moreover, the Foreign Account Tax Compliance Act (FACTA) enacted in

# Out with the Old: IRS Abandons 2-year Limitation on Innocent Spouse Claims

By Mary E. Wood, J.D.

In July of 2011, the IRS announced a much-anticipated removal of the two-year limitation that had precluded many taxpayers' eligibility for equitable "innocent spouse" relief. The two-year deadline was formally eliminated amid staunch criticism from practitioners, legislators and activists who felt that the deadline created an injustice for many taxpayers who would otherwise qualify for innocent spouse relief.

## About Innocent Spouse Relief

Typically, married individuals that file a joint income tax return are deemed jointly and severally liable for any tax shown due on the return and/or any additional tax later assessed by the IRS. This joint and several liability allows the IRS to collect the entire amount of the tax liability from either spouse individually.

A taxpayer seeking to avoid joint and several liability can seek relief under the innocent spouse provisions embodied in I.R.C. §6015. Section 6015 contains three categories for relief:

**1. "Classic" innocent spouse relief** — applicable if the understatement was caused by the erroneous item of the other spouse, the requesting spouse did not know or have

reason to know of the understatement, and based on the facts and circumstances it would be unfair to hold the requesting spouse liable for the understatement.

**2. Separation of liability** — allows the IRS to separate a tax liability



between the requesting spouse and his or her former spouse if they have been divorced or separated for a 12-month period. Eligibility for this relief is contingent upon proving that the requesting spouse did not have actual knowledge of the incorrect item.

**3. Equitable relief** — this catch-all provision applies only if the first two categories of relief are not available and the IRS determines

that based on the facts and circumstances it would be "inequitable" to hold the requesting spouse liable for any understatement of tax. The catch-all provision is the only provision that allows for relief from an underpayment of tax.

## Applicability of the 2-year limitation

Prior to the recent amendment, I.R.C. § 6015 mandated that individuals requesting relief under the "classic" innocent spouse or separation of liability provisions apply for relief no later than two years after the first IRS collection activity. The statute did not impose the same two-year deadline for claims falling under the equitable relief provision. The IRS, however, issued treasury regulations which extended the two-year requirement to equitable claims.

Many criticized the two-year deadline's application to equitable claims because a large number of the requesting spouses were not aware of the collection activity prior to the expiration of the two-year period. Furthermore, requesting spouses that had been in abusive relationships were often too frightened to come forward during the two-year window. In light of these scenarios, which produced harsh results for taxpayers that



2010 creates even more stringent foreign disclosure obligations for taxpayers beginning with the 2011 tax year. As a result, it is imperative that taxpayers fully disclose any foreign activities and take proactive steps to address any past foreign compliance issues prior to an IRS civil or criminal investigation.



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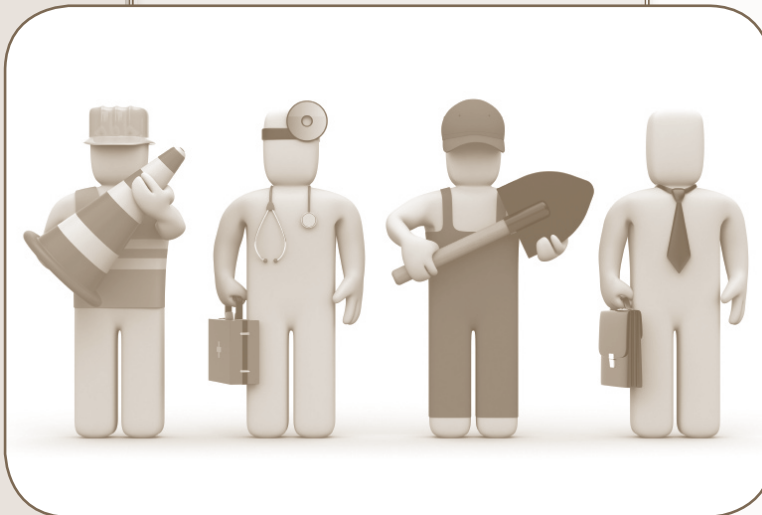
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based on common law rules to help determine the degree of control that is sufficient to establish an employer-employee relationship. There's no magic number of relevant evidentiary facts. Instead, all of the facts must be weighed in determining the extent of the business's right to direct and control the worker.

To be eligible to participate in the VCSP, a business must have consistently treated its workers as nonemployees and filed all required Forms 1099 for the workers for the previous three years. In addition, the business must not be under audit by the IRS or under audit concerning the classification of the workers by the Department of Labor or state agency. If the business meets these eligibility requirements, it

may participate in the VCSP by applying to the program and entering into a closing agreement with the IRS.

Businesses accepted into the program



must agree to treat misclassified workers as employees for future tax periods. The business must also pay 10% of the employment tax liability that may have been due on compensation paid

to misclassified workers for the most recent tax year, determined under the reduced rates of Section 3509. A participating business must further agree

to extend the statute of limitations on assessment of employment taxes for three years for the first, second and third calendar years beginning after the date on which the business has agreed under the VCSP to treat its workers as employees. In exchange, businesses will not be liable for interest or penalties on the tax liability, and will also not be subject to an employment tax audit

with respect to the worker classification of the workers for prior years.

The VCSP is part of a broader effort to end the misclassification of employees. On September 19, 2011, the IRS and

Department of Labor signed a Memorandum of Understanding that will allow the Department of Labor to share information and coordinate law enforcement efforts with the IRS to address the misclassification issue. In announcing the new agreement, Secretary of Labor Hilda Solis declared, "We're standing united to end the practice of misclassifying employees. We are taking important steps toward making sure that the American dream is still available for all employees and responsible employers alike." Likewise, IRS

Commissioner Doug Shulman was quoted saying that, "[t]his agreement takes the partnership between the IRS and Department of Labor to a new level." As regulators begin to coordinate their efforts to be more vigilant in preventing and detecting employee misclassification, businesses with concerns over misclassification should give serious consideration to participating in the VCSP and seek the counsel of tax professionals.



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were denied relief, the National Taxpayer Advocate, practitioners and legislators had been lobbying for repeal of the regulation.

### **Removal of 2-year limitation for equitable claims**

The IRS quelled rising opposition in Notice 2011-70 (July 25, 2011), where it announced it would no longer apply the two-year rule to equitable claims for innocent spouse relief. The IRS further explained that the expansion of the time period to file innocent spouse claims would be retroactive. As such, if a requesting spouse's equitable relief claim was previously denied solely due to the two-year limitation, the individual can reapply for relief by filing a Form 8857 Request for Innocent Spouse Relief as long as the 10-year statute of limitations on collection has not expired. Future requests and

requests that are currently pending will not be subject to the two-year rule.

Notably, any claims for relief under the classic innocent spouse or separation

spouse or former spouse and taxpayers whose requests for equitable innocent spouse relief have been denied as untimely should contact an attorney to determine whether they may qualify for innocent spouse relief under the new rules.



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of liability provisions remain subject to the two-year limitation. Taxpayers facing potential tax liability attributable to a

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Corpus Christi, TX

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Midland Memorial Foundation and Midland College Foundation  
Annual Estate Planning Seminar  
Midland, TX

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North American Petroleum Accounting Conference (NAPAC)  
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welcomes

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Ms. Hermesen received her B.S.B.A., Business Administration in Accounting, Minors in Economics and Mathematics, *With Highest Distinction*, from the University of Nebraska-Lincoln in 2007. She was a Chancellor's Scholar at the University of Nebraska-Lincoln. She received her M.P.A., Professional Accounting, with a focus in taxation, from The University of Texas in 2008. She attended Harvard Law School and received her J.D., *cum laude*, in 2011. She was the Business Manager and Executive Editor of the *Harvard Journal of Law & Public Policy* in 2010-2011.

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