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SPECIAL REPORTS

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On June 30 the U.S. Department of Justice filed an ex parte petition for leave to serve a John Doe summons in the U.S. District Court for the Southern District of Florida. The next day the court issued an order approving the issuance of a summons to force Swiss banking behemoth UBS AG to disclose to the IRS detailed account information on U.S. taxpayers who allegedly use UBS AG offshore accounts to conceal assets and avoid reporting income related to those assets for the purpose of evading U.S. taxation.[1]

Under the court's order, UBS must produce specified documentation and records to identify designated U.S. taxpayers who fall within the ascertainable group or class of persons covered by the John Doe summons. As UBS considers how to deal with this compelled U.S. discovery mandate, a crucial foreign legal issue is how the matter would be treated under Swiss law, which, generally speaking, makes production of banking documents and records a criminal violation in the absence of client consent to produce the same.[2]

From a U.S. tax law perspective, the most important issue is what remedial action can be taken by U.S. taxpayers affected by the summons order. The central focus of this issue is the IRS voluntary disclosure program, and specifically whether and to what extent the program is still available for U.S. taxpayers affected by the U.S. district court's John Doe summons order.

This article provides an overview of the U.S. voluntary disclosure program and ties that overview into the practical steps U.S. tax counsel should consider in evaluating a noncompliant U.S. taxpayer's case. It addresses the impact of the UBS summons case on affected U.S. taxpayers' potential use of the IRS voluntary disclosure program.

In this context, this article also provides commentary on the relevant complex and intertwined issues and provides suggestions to U.S. tax counsel engaged in evaluating these issues on behalf of affected U.S. taxpayers. This commentary derives from the authors' experience representing clients affected by the UBS AG summons case as well as other Swiss and non-Swiss offshore voluntary disclosure cases.

Further, observations are provided on the conundrum triggered by the UBS AG John Doe summons and conflicting Swiss bank secrecy law considerations.

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[1] *In the Matter of the Tax Liabilities of John Doe et al.*, U.S. District Court for the Southern District of Florida, Case No. 08-21864-MC-Lenard/Garber Order July 1, 2008. For a more extensive discussion of the UBS case, see B. Zagaris, ''U.S. Court Approves John Doe Summons in UBS Case,'' 24 *Int'l Enforcement Law Rep.* 9 (Aug. 2008) (hereinafter referred to as Zagaris). As summarized in Zagaris, the IRS has alleged that UBS AG failed to obtain Forms W-9 from its U.S. clients, failed to file Forms 1099, and failed to adhere to the 2001 qualified intermediary agreement entered into between the U.S. and Switzerland. As Zagaris explains, this is the first John Doe summons order directed to a non-U.S. bank. *See* Zagaris at 2; *see also* Department of Justice, ''U.S. Justice Department Release on Offshore Credit Card Record Summons,'' *Doc 2002-7826* or *2002 WTD 63-20*.

[2] *See* article 47 of Switzerland's Federal Banking Act. SR 952.0 provides that any person who discloses a secret entrusted to him as a bank employee is punishable by a prison term of up to six months and a fine of up to CHF 50,000.

Given the fluid status of the developing UBS AG summons case, no fixed guidelines exist. Therefore, this article attempts to provide both practical advice as well as technical commentary on how the tension between U.S. tax law and Swiss bank secrecy law might play out, including commentary based on the authors' informal discussions with senior IRS representatives.

Finally, it must be kept in mind that the current UBS AG summons proceeding appears to be material in light of the reported offshore tax abuse that purportedly has been going on for years on behalf of U.S. taxpayers. For example, the use of offshore tax havens to secrete funds in tax havens has been estimated to cost the U.S. government at least $70 billion annually.[3] Given that the UBS AG John Doe summons proceeding has elicited testimony and evidence to support IRS allegations that approximately 19,000 U.S. taxpayers hold undeclared Swiss accounts with UBS AG, and those accounts hold over $20 billion in assets,[4] no question exists as to the materiality of the UBS AG John Doe summons proceedings.

I. Voluntary Disclosure Program

Under the IRS voluntary disclosure program, noncompliant taxpayers may initiate contact with the IRS to practically — but not theoretically — eliminate the risk of criminal tax exposure and to resolve all civil tax issues, including tax deficiencies and penalties. The reason for this hedge (of the practical but not theoretical elimination of the risk of criminal tax exposure) is that the courts have uniformly held that voluntarily approaching the IRS won't insulate the taxpayer from criminal prosecution.[5]

The IRS will consider several factors on whether to recommend criminal tax prosecution regarding a voluntary disclosure submission. Those factors include whether a dual or successive prosecution exists, as well as the detailed facts and circumstances of a case, such as the health, age, and mental condition of the taxpayer and whether solicitation of tax returns has occurred.[6]

From the perspective of practitioners who have been heavily involved in the voluntary disclosure process (not only the authors of this article, but also several tax attorneys and practitioners with whom the authors have collaborated on voluntary disclosure cases over the years), this threshold determination on criminal tax exposure usually will be resolved on the basis of several factors, as noted above, as well as other key factors: the nature and extent of unreported income, the duration and history of the noncompliance, the motive and intention of the noncompliant taxpayer for engaging in the historical noncompliant activities and for coming clean, and any equitable or mitigating factors.

Mitigating factors include the fact pattern in which a noncompliant taxpayer inherits funds from a nonresident alien taxpayer or when the noncompliant taxpayer has been advised by a U.S. tax professional that offshore activity is not reportable or taxable in the United States. Some nonmitigating factors need to be taken into account, including a noncompliant taxpayer's intentional nondisclosure of the offshore activities to his return preparer and his attorney.

The voluntary disclosure program is by no means an amnesty program.[7] Although the IRS warns that the program is a matter of privilege and does not create substantive taxpayer rights, and thus is not definitively binding on the IRS, assuming the process is completed in such a manner as to enter into a closing agreement,[8] the noncompliant taxpayer can practically, if not effectively, bring closure to all civil and criminal tax exposure for noncompliant years.

Under the IRS voluntary disclosure program, the accepted processing of a case is premised on several requirements having been satisfied:

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[3] *See* William M. Sharp Sr., William T. Harrison III, and Scott A. Harty, ''Post-11 September Use of Offshore Tax Havens: The Dos and Don'ts,'' *Tax Notes Int'l*, Apr. 22, 2002, p. 351, *Doc 2002-9471*, or *2002 WTD 77-21* (hereinafter referred to as Sharp et al.). *See also* Scott D. Michael, ''Advising a Client with Secret Offshore Accounts — Current Filing and Reporting Problems,'' 91 *J. Int'l Tax'n* 158 (1999).

[4] On June 19, 2008, former UBS AG private banker and U.S. citizen Bradley Birkenfeld pleaded guilty to conspiring to defraud the IRS by assisting UBS AG U.S. clients in avoiding U.S. reporting requirements on income earned from UBS AG bank accounts. The $20 billion amount is based on Birkenfeld's testimony and has been widely reported by news media and even echoed by the headline in the June 30, 2008, Department of Justice press release: ''Bank Records Could Identify Those Who Use Swiss Accounts to Evade Income Taxes; Former Employee Estimates $20 Billion in Assets in Undeclared Accounts for U.S. Citizens,'' *available at* http://www.usdoj.gov/tax/txdv08579.htm (accessed Aug. 21, 2008). *See also* Zagaris, *supra* note 1, at 3.

[5] *See*, *e.g.*, *United States v. Hebel*, 668 F.2d 995 (8th Cir. 1982); *United States v. Choate*, 619 F.2d 21 (9th Circ. 1980); *United States v. Adams*, 832 F.Supp. 1138 (W.D. Tenn. 1993), *aff'd* 38 F.3d 1217 (6th Cir. 1994) *see also* Sharp et al., *supra* note 3, at 358.

[6] Internal Revenue Manual (hereinafter cited as IRM) 38.3.1.3(2) (Aug. 11, 2004).

[7] Nor was the voluntary disclosure program of the offshore voluntary compliance initiative, Rev. Proc. 2003-11, 2003-1 C.B. 311, a blanket amnesty program, and at best this was a limited amnesty program.

[8] Section 7121 says: ''The Secretary of the United States Department of the Treasury is authorized to enter into a written agreement with any person regarding the liability of an internal revenue tax. Such an agreement shall be final with the exception of a showing of fraud, malfeasance or the misrepresentation of a material fact.'' In appropriate cases, the IRS will contractually agree not to refer the matter concerned in a closing agreement for criminal prosecution, but will not go so far as to contractually immunize the taxpayer from criminal prosecution.

- First and foremost, the taxpayer's disclosure must be truthful, accurate, and complete; all bets are off if the disclosure falls short of these standards (even if a closing agreement is obtained).
- The taxpayer must be willing to cooperate (and does cooperate) with the IRS in determining the correct tax liability.
- 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.
- Of crucial importance, the income-producing and related activities pertaining to such income, including the source of funds, must be associated with legal sources, as opposed to illegal activities or conducts.
- Most important in light of the UBS AG John Doe summons case, the disclosure by the taxpayer must be timely. Timely means the disclosure must be received before the IRS has initiated an inquiry that is likely to lead to the taxpayer, as discussed below.[9]

In IRS Information Release 2002-135 (IR 2002-135), the IRS revised the voluntary disclosure policy on the timeliness condition as follows:

- The disclosure must be tendered to the IRS before the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation.
- The timeliness condition will be met only if the submission is made before the IRS has received information from a third party, such as another governmental agency or even the media, alerting the IRS to the taxpayer's noncompliance.
- The timeliness condition will be satisfied if the IRS has not initiated a civil examination or a criminal investigation that is directly related to the specific liability of the taxpayer.
- The timeliness condition will be met assuming the IRS has not 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.[10]

II. Timeliness and the John Doe Summons

In the context of the UBS AG John Doe summons, the most critical voluntary disclosure issue is whether a noncompliant U.S. taxpayer caught in Justice Department and UBS AG crossfire may now proffer a ''timely'' voluntary disclosure submission.

None of the timeliness guidelines, as set forth in IR 2002-135 above, specifically deal with the fact pattern regarding the issuance of a John Doe summons, such as in the UBS AG case. However, analyzing the examples set forth in IR 2002-135 sheds some light on this issue, as do recent informal discussions with senior IRS officials on this point.

Regarding the examples set forth in IR 2002-135, in section (6)c the fact pattern involves a disclosure made by a taxpayer of omitted income facilitated through a widely promoted scheme on which the IRS has begun a civil compliance project and has already obtained information that might lead to an examination of the taxpayer. However, in this scenario, the IRS has not yet commenced an examination or investigation of the taxpayer at issue or notified the taxpayer of its intent to conduct an examination or investigation.

It would appear the John Doe summons order has not yet eliminated the ability for a noncompliant U.S. taxpayer to meet the timeliness condition.

Under this fact pattern, the example says that assuming the taxpayer files ''complete and accurate'' returns and arranges with the IRS to pay in full the tax, interest, and any penalties determined to be applicable, then the submission would be treated as a voluntary disclosure because the civil compliance project involving the scheme does not yet directly relate to the specific liability of the noncompliant taxpayer.[11]

Based on this example, it is relatively clear that the UBS AG summons proceeding falls within the realm of a civil compliance project that has in its pathway the eventual obtaining of information, which in turn might lead to the examination of a specific UBS AG noncompliant U.S. taxpayer. However, assuming the IRS has yet to commence an examination or investigation of that taxpayer, then under this example the timeliness requirement should be satisfied.

The conclusions in this example and other examples in section (6)d are predicated on the IRS initiating action regarding a specific taxpayer and regarding that taxpayer's liability. In other words, the IRS must have

[9] *See* IRM 38.3.1.3.1.2 (Aug. 11, 2004).

[10] IR 2002-135 modified IRM 9.5.3.3.1.2.1.

[11] This conclusion in the example, of course, assumes that all other conditions as discussed above are met (that is, the disclosure is truthful, timely, complete, and so forth) as discussed in the text of note 9 *supra*.

particular knowledge of a taxpayer. It would appear, therefore, that the U.S. district court's John Doe summons order has not yet eliminated the ability for a noncompliant U.S. taxpayer to meet the voluntary disclosure program's timeliness condition.

In reviewing the examples in section (7)c under IR 2002-135 as to what factors do not constitute a valid voluntary disclosure, it appears the possible identification of UBS AG U.S. taxpayers to the IRS, such as the proceeding involving *Birkenfeld*,[12] lacks sufficient legal linkage with nonidentified noncompliant U.S. taxpayers to render voluntary disclosure treatment unavailable for such nonidentified U.S. taxpayers.

This legal linkage exists, however, in the case of a partnership example in section (6)c in which one partner with omitted gross receipts is already under examination, and the other partner has yet to be targeted by the IRS but attempts to make a voluntary disclosure. In this case, the attempted disclosure is not timely presumably because of the close legal nexus between the targeted partner and the partnership's other nontargeted partner.

The other examples in section (7) under IR 2002-135 also require some legal linkage or relationship — for example, employer-employee relationship — to neuter the timeliness condition for the taxpayer seeking to submit a voluntary disclosure. For example, in section (7)d, the timeliness requirement would not be satisfied when a corporation's omitted constructive dividends to its shareholders were not reported by those shareholders while the corporation was under IRS examination. Similarly, in example (7)e, the timeliness requirement is not met when the employee of the taxpayer has been contacted regarding the taxpayer's double set of books, and the taxpayer then attempts to initiate a voluntary disclosure.

Based on the authors' handling of various UBS AG cases, including several calls and meetings with various IRS representatives, it appears that, postissuance of the John Doe summons, UBS AG voluntary disclosure cases will be handled similarly to non-UBS AG cases with one exception: The IRS apparently has a specific list of identified UBS AG clients whom the Criminal Investigation division either is investigating or will likely investigate soon.[13] Bradley Birkenfeld, the U.S. citizen who served as a private banker with UBS AG for approximately six years and entered into a plea agreement on June 18, 2008,[14] may have provided this list, although the IRS has not officially confirmed the source.

With as many as 19,000 noncompliant UBS AG U.S. taxpayers that have not been disclosed to the IRS,[15] it is important to note that the purported list may contain the names of only a few of them. Given that CI investigated 4,211 cases for fiscal 2007, up approximately 8 percent from the 3,907 investigated cases in 2006,[16] CI would be hard-pressed to criminally investigate all 19,000 noncompliant UBS AG U.S. taxpayers.

If a UBS AG U.S. client who is on the list submits a voluntary disclosure case, once CI verifies that the taxpayer's name is on the list, the voluntary disclosure would most likely be rejected because of being untimely. Depending on the status of the CI investigation regarding the taxpayer, the submission would be untimely because the IRS has initiated a civil or criminal investigation or has notified the taxpayer that it intends to commence such an examination.[17] Even if CI has not yet started a criminal investigation regarding that taxpayer who appears on the list, the authors have been informally advised by CI that the knowledge of the taxpayer's name from the list would neuter the timeliness condition, and the voluntary disclosure could be rejected.[18]

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[12]As discussed in note 4 *supra,* Bradley Birkenfeld is the former UBS AG employee who recently pleaded guilty to conspiring to assist U.S. taxpayer Igor Olenicoff evade $7.2 million in U.S. taxes by helping him conceal $200 million in assets. *United States v. Birkenfeld*, U.S. District Court for the Southern District of Florida, Case No. 08-60099-CR-ZLOCH/SNOW; *USA v. Olenicoff*, U.S. District Court for the Southern District of California, Case No. SA CR No. 07-227-CJC.

[13]This information comes from several recent informal statements made by senior IRS representatives to the authors and is consistent with statements and information reflected in the press.

[14]*See supra* note 4.

[15]*See* U.S. Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, ''Tax Havens and U.S. Tax Compliance,'' staff report (July 17, 2008), at 84, citing the subcommittee interview with UBS on July 14, 2008.

[16]Treasury Inspector General for Tax Administration, ''Statistical Portrayal of the Criminal Investigation Division's Enforcement Activities for Fiscal Years 2000 through 2007'' (July 9, 2008), *available at* http://www.treas.gov/tigta/auditreports/2008reports/200810133fr.pdf (last accessed Sept. 8, 2008).

[17]*See* IR 2002-135 (4)a. Further, possession of the list by the IRS could also be interpreted as the IRS having received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the taxpayer's noncompliance, and thus the voluntary disclosure would not be timely. *See* IR 2002-135 (4)b. The acquisition and possession of the list by the IRS also could be interpreted as initiating a criminal investigation that is directly related to the specific liability of the taxpayer, and thus the voluntary disclosure would be rejected for being untimely. *See* IR 2002-135(4)a. Finally, the list could be interpreted as acquired information directly related to the specific liability from a specific enforcement action, which could also result in the rejection of the voluntary disclosure list as untimely. *See* IR 2002-135 (4)d.

[18]Despite this result, CI also has informally advised the authors that an IRS criminal investigation may not necessarily follow, as this could depend on the facts and circumstances of the listed taxpayer. Moreover, CI noted that if a U.S. taxpayer is on

(Footnote continued on next page.)

The use of a specific UBS AG list is still in keeping with the general IRS voluntary disclosure policy. No submission of a voluntary disclosure will be considered complete until the taxpayer's name is given to the IRS. In a no-name submission, described below, this is customarily done after the issuance of a clearance letter from CI and after a successful no-name presentation by the taxpayer's counsel. However, the clearance letter's recommendation of no prosecution is subject to CI verifying the taxpayer's name against the governmental databases to ensure the taxpayer is not the subject of an investigation or is otherwise disqualified for failing the timeliness requirement. The difference between UBS AG and other non-UBS AG voluntary disclosure cases is that, as discussed above, the IRS apparently already has a specific, albeit small and targeted, list of allegedly noncompliant UBS AG U.S. taxpayers whose voluntary disclosure submissions would be deemed untimely and would therefore be rejected by the IRS.

III. Voluntary Disclosure Submissions

Assuming the noncompliant U.S. taxpayer can satisfy the timeliness conditions of the IRS voluntary disclosure policy as described above, the next issue is what is the most advisable procedural method in which to submit the voluntary disclosure. In light of the lack of published guidance or precedent on this issue, most practitioners usually pursue a voluntary disclosure under either of two methods — a negotiated walk-through or a service center filing.[19] In the context of the UBS AG cases, perhaps the most advisable approach for pursuing a voluntary disclosure is the negotiated walk-through because of the certainty and binding nature of that method as opposed to a service center filing.

Perhaps the most advisable approach for pursuing a voluntary disclosure is the negotiated walk-through.

In a negotiated walk-through, taxpayers through legal counsel approach the IRS on a no-name basis with the goal of obtaining written legal assurances[20] that the IRS won't refer the matter for criminal investigation or prosecution or impose maximum civil fraud, Report of Foreign Bank and Financial Accounts (FBAR), and nonfraud penalties. In this form of voluntary disclosure, the relevant civil tax issues are also resolved, including all tax liabilities and tax penalty exposure items that are discussed and incorporated into a final and binding closing agreement.[21]

In the alternative approach, commonly referred to as a service center filing voluntary disclosure, taxpayers file an amended or dilatory but truthful, accurate, and complete amended Form 1040X, ''U.S. Individual Income Tax Return,'' for each of the noncompliant years, as well as other relevant returns and forms, such as Form 5471, ''Information Return of U.S. Persons With Respect to Certain Foreign Corporations''; Form 3520-A, ''Annual Information Return of Foreign Trust With a U.S. Owner''; Form 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts''; and Form TD F 90-22.1, ''Report of Foreign Bank and Financial Accounts,'' with the appropriate IRS service center to report previously omitted income and to address all applicable issues of noncompliance.[22]

A. Negotiated Walk-Through: Overview

In a negotiated walk-through, after completing due diligence and what the authors refer to as a legal audit, legal counsel along with counsel's engaged *Kovel* accountant[23] for the taxpayer meet with IRS senior representatives — usually a territory manager, IRS legal counsel, sometimes an IRS technical specialist and an IRS international specialist, and a representative from the IRS Criminal Investigation division (usually the special agent in charge).[24]

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the list, the taxpayer would be investigated sooner or later, and the fact that a good-faith voluntary disclosure was attempted would only help the taxpayer's case.

[19]*See* Sharp et al., *supra* note 3, at 358.

[20]Typically in the form of a binding closing agreement, as discussed in note 8 *supra*.

[21]*Id*.

[22]*See* IR 2002-135, which illustrates an example of a service center filing at section (6)a in which an attorney sends on behalf of his client a letter to the IRS that meets the timeliness condition of the voluntary disclosure program and includes 1) complete and accurate amended returns and 2) an offer to pay in full the tax, interest, and penalties determined by the IRS to be applicable. The IRS would consider this a voluntary disclosure because the taxpayer has met all the required elements of the voluntary disclosure program.

[23]An accountant is engaged under a *Kovel* agreement based on the well-known case, *United States v. Kovel,* 296 F. 2d 918 (2d. Cir. 1961), which held that ''if the lawyer has directed the client, either in the specific case or generally, to tell his story in the first instance to an accountant engaged by the lawyer, who is then to interpret it so that the lawyer may better give legal advice, communications related to that purpose ought to fall within the scope of privilege.'' *Id*. at 922.

[24]IRS voluntary disclosure practices may vary from one IRS area to another. *See* Sharp et al., *supra* note 3, at 359. The authors have directed most of their cases through the Plantation, Fla., offices of the IRS, and senior IRS officials have informally

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During this initial presentation, legal counsel (usually accompanied by counsel's *Kovel* accountant) for the taxpayer does not reveal the taxpayer's name or identifying information. The presentation is delivered anonymously. Legal counsel discloses the material facts regarding all the issues surrounding the taxpayer's noncompliance. This disclosure must be comprehensive and usually is orally communicated, but is supplemented with a written outline summarizing the relevant no-name facts, redacted diagrams, and exhibits. It may be appropriate to prepare all amended returns, FBARs, and supplemental disclosures in redacted form (perhaps even with a redacted closing agreement or outline thereof), along with all redacted supporting schedules and exhibits.

The taxpayer's name and identifying information are not revealed until CI issues a clearance letter and the taxpayer's legal counsel has negotiated a preliminary oral understanding with the IRS civil exam representatives.[25] If CI were to indicate that the case would likely commence an IRS criminal investigation, the taxpayer's legal counsel would terminate all discussions and proceed no further with the negotiated walk-through process.

Most IRS offices are receptive to a negotiated walk-through because the IRS acknowledges that taxpayers are unwilling to identify themselves until the substantive facts of the case are reviewed first by CI and then by the Civil Examination Division. It is important to note that the entire process is not anonymous, because for the voluntary disclosure to be complete, the taxpayer's identity eventually must be revealed.

However, before CI may consider the case, any jurisdictional issues between the IRS office in the taxpayer's home jurisdiction and the IRS office in the jurisdiction where the taxpayer begins the negotiated walk-through voluntary disclosure must be cleared.

After the CI clearance letter is issued, the taxpayer's identity is revealed and the Civil Examination Division conducts a computerized background systems check for any active investigations. If the IRS determines that it has already initiated a civil or criminal tax investigation of the taxpayer, the timeliness requirement would not be met and the submission would not be considered a voluntary disclosure. If the systems check uncovers tax compliance issues that legal counsel did not disclose, the IRS would likely reject the voluntary disclosure offer and terminate all discussions, and possibly refer the matter back to CI.

Assuming CI determines that the taxpayer's case does not warrant a referral for IRS criminal investigation and possible prosecution, as evidenced by issuance of a clearance letter, the case would be handled as an IRS civil tax matter. At that point, the remaining steps for obtaining a closing agreement would be to complete review and negotiations of all substantive tax law issues, including resolving the tax deficiencies for the years at issue and negotiating any civil penalty exposure.

As an administrative practice, in a negotiated walk-through the IRS prefers to address the prior six years (or up to the earliest tax year that is open for criminal tax purposes under the applicable statute of limitations). Usually, the substantive tax issues, tax deficiencies, and penalty exposure can be initially but informally discussed during the initial walk-through meeting with the IRS. When the CI review is completed, the taxpayer's legal counsel can begin preparation of the closing agreement outline based on the terms and conditions orally agreed on in the walk-through meeting and any follow-up discussions.

When legal counsel reaches an agreement for the appropriate tax treatment of the case with the IRS, the closing agreement is drafted and finalized. The closing agreement conclusively resolves, as a binding contractual matter, the income tax liability and penalty matters for each year at issue.[26] The closing agreement would resolve the penalties for failure to file Form 5471, ''Information Return of U.S. Persons With Respect to Certain Foreign Corporations''; Form 3520-A, ''Annual Information Return of Foreign Trust With a U.S. Owner''; Form 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts''; and Form TD F 90-22.1, ''Report of Foreign Bank and Financial Accounts.''

The penalty exposure for a negotiated walk-through is not determinable in a definitive or formulaic sense,

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informed the authors that more than half of all voluntary disclosure cases in the U.S. are handled out of this Florida office.

[25]In some cases this understanding may be discussed and preliminarily resolved in the initial walk-through meeting. Although the language of a clearance letter may vary from one IRS area to another, following is a redacted version of such a letter:

> We have reviewed the information you provided on behalf of your client. A voluntary disclosure is considered made when, among other requirements, the identity of the client is fully disclosed to the Service. At this time, your client's identity is unknown. However, based on the information provided, a criminal investigation will not be initiated at this time. This matter will be forwarded to the Small-Business Self-Employed Division (SB/SE).
>
> A voluntary disclosure is contingent on the continued cooperation and truthfulness of the taxpayer. If evidence is developed that the taxpayer has not fully cooperated or provided materially false information, this matter may be sent back to Criminal Investigation for further evaluation.
>
> I note that the aforementioned items were not the only issues addressed at our meeting on [DATE REDACTED], and that my determination is a result of careful consideration of all information presented and represented.

[26]*See* section 7121(b).

because resolution of each case is fact-sensitive and determined in light of the facts and issues. However, because of the voluntary nature of the disclosure, generally a good opportunity exists to negotiate all penalties except for the substantial understatement penalty.[27]

In most qualifying voluntary disclosure cases, the taxpayer's legal counsel can achieve a result that is no worse and is generally more favorable than another IRS examination program known as the Last Chance Compliance Initiative (LCCI). LCCI proceedings typically are less favorable to the taxpayer than the voluntary disclosure proceeding because in the former, the taxpayer has already been ''tagged'' by the IRS, and in the latter, the taxpayer has voluntarily approached the IRS. LCCI cases typically involve a Form TD F 90.22-1 penalty equal to one year's assessment and a tax penalty equal to the major civil fraud penalty for the most significant year of income omission.

B. IRS Service Center Filing: Overview

The alternative method for pursuing an IRS voluntary disclosure involves preparing amended Form 1040 and other relevant returns and forms for the years at issue, along with penalty abatement and reasonable cause statements. Such relevant forms could include Form 5471, ''Information Return of U.S. Persons With Respect to Certain Foreign Corporations''; Form 3520-A, ''Annual Information Return of Foreign Trust With a U.S. Owner''; Form 3520, ''Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts''; and Form TD F 90-22.1, ''Report of Foreign Bank and Financial Accounts.''[28]

A service center filing is appropriate if a voluntary disclosure matter requires determination of material factual issues. In other words, if a number of factual issues are involved, a walk-through voluntary disclosure presentation is not as practical because the IRS tribunal to which the presentation is made lacks the time and resources to engage in material factual determinations. In that case, the service center filing is more appropriate.

The service center filing is also commonly referred to as a stealth filing because the submission may be made without alerting the IRS to the prior years of noncompliance.[29] Other tactics can be implemented, including filing the amended tax returns over a couple of weeks to help reduce the risk of undue IRS scrutiny.

The primary disadvantage of using the service center voluntary disclosure filing is that the issues remain open in the sense that the IRS may audit the amended returns, subject to the statute of limitations, for up to three years after the date of submission of the amended returns (and sometimes may extend up to six years and possibly even earlier).[30] Also, the service center approach does not result in the negotiation and finalization of a closing agreement, so the prior years' issues still remain open in the sense that the IRS can easily examine them. In contrast, when a closing agreement has been negotiated, the IRS is restricted from revisiting the prior years so long as the voluntary disclosure meets the conditions described above.[31]

The service center filing is commonly referred to as a stealth filing.

Another disadvantage to a service center filing is that submitting to the IRS service center amended and/or untimely Forms 1040, 3520, 5471, and TD F 90-22.1 creates a risk that the returns will trigger a civil examination or even a criminal referral. However, since the revised IRS voluntary disclosure policy was issued in December 2002, the policy of the IRS has usually been not to pursue criminal tax violations against the filing taxpayer, provided the requirements of the voluntary disclosure policy otherwise have been met. The service center may impose civil penalties, even if the submitted forms are accepted as filed, but various remedies are available to protest (and perhaps mitigate or eliminate) asserted civil penalties.

In contrast, the primary advantage of a service center filing method is that it takes less time and is thus

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[27] *See* section 6662, providing in pertinent part that a 20 percent penalty of the underpayment of a required tax will be imposed if the underpayment is attributable to any substantial underpayment of income tax.

[28] Although note that Form TD F 90-22.1 is not filed at the Service Center, but at the Treasury Department office in Detroit.

[29] *See* IR 2002-135, example (6)a, which describes a letter from an attorney sent to the IRS. The letter includes a client's amended returns, which are complete and accurate (reporting legal source income omitted from the original returns). Further, the letter offers to pay in full all the tax, interest, and penalties determined by the IRS to be applicable. This would be considered a voluntary disclosure because all three essential elements have been met. The letter was 1) truthful, timely, and complete; 2) the taxpayer showed a willingness to cooperate with the IRS in determining his tax liabilities; and 3) the taxpayer was making good-faith arrangements with the IRS to pay in full that tax, interest, and penalties as determined by the IRS.

(Footnote continued in next column.)

[30] *See* section 6501(a), which provides that the IRS is required to assess a taxpayer's tax liability within three years after the tax return was filed with the IRS. *See also* section 6501(e), which provides that the statute of limitations is six years if the taxpayer omits additional gross income in excess of 25 percent of the amount of gross income stated in the tax return filed with the IRS. However, under section 6501(c)(1) the statute of limitations does not apply in the case of a false tax return or fraudulent tax return filed with the IRS with the intent to evade tax.

[31] *See* section 7121(b).

less expensive in terms of legal, accounting, and related fees and costs. Also, the service center filing does not flag the taxpayer like a negotiated walk-through (hence the ''stealth'' description). Once a service center filing type of disclosure submission is completed, the ball is in the IRS's court and the taxpayer and its legal counsel must simply wait and see what happens.

IV. Pursuing a Negotiated Walk-Through

Subject to reviewing and analyzing the facts and circumstances of a case, generally it is more legally prudent to pursue a negotiated walk-through in the context of a UBS AG case involving a noncompliant U.S. taxpayer. Besides resolving the case in the form of a final and binding closing agreement, which provides more assurances and certainty in resolution of the key issues, it also avoids the surprises that could emerge from a service center filing (for example, a postfiling IRS examination or possibly even an IRS criminal investigation).

Although the IRS voluntary disclosure policy states that completing a successful voluntary disclosure does not protect the taxpayer from criminal prosecution, the practical experience of the authors indicates that resolving a matter through a closing agreement practically, if not virtually, eliminates the emergence of IRS examination and potential criminal investigation for the years covered by the closing agreement, so long as the terms and conditions of the agreement are satisfied.[32]

It is also the view of the authors that assuming the closing agreement is properly drafted, the predicate conditions for the closing agreement are satisfied, and the agreement properly documents attainment of those conditions, it would arguably result in a breach of the closing agreement for the U.S. government to pursue a legal action regarding the matters covered in the closing agreement. In discussing this topic with practitioners over the years, the consensus seems to point in this direction, but again, because of the lack of statutory, regulatory, and judicial guidance, no firm conclusions may be drawn.

Accordingly, given that no names have been — and may never be — released under the U.S. district court's John Doe summons decision, but also given UBS AG's decision to close all U.S. client accounts with UBS AG by 2010 (unless, as some sources indicate, this timeframe is accelerated), then affected U.S. taxpayers have a window of opportunity to an IRS voluntary disclosure.

V. How Will Conflict Be Resolved?

Even though a noncompliant UBS AG-affected U.S. taxpayer should still qualify under the timeliness requirement unless his name is on the list, and thus should be able to submit a qualifying voluntary disclosure in a timely manner despite the recent UBS AG John Doe summons, the question still remains what course of action UBS AG will pursue in light of the July 1, 2008, decision by the U.S. district court to approve the IRS's serving of the John Doe summons. Complying with the U.S. district court order would result in the disclosure of up to 19,000 potentially noncompliant U.S. taxpayers holding unreported UBS AG financial accounts.

Thus, in light of the Swiss bank secrecy laws, the appropriate course of action for UBS AG to pursue has been the subject of debate and discussion both in the media and the legal press. Generally speaking, in the absence of a mutual legal assistance treaty[33] proceeding and an order issued thereunder,[34] Swiss banking law prohibits a bank from disclosing confidential banking information about private individuals or companies to any third party.[35]

Under Swiss law, disclosure without the consent of the account party would result in a criminal violation

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[32]Despite the IRM's commentary that a voluntary disclosure will not immunize a taxpayer from civil prosecution, it is the authors' position that if a closing agreement properly addresses this point, the IRS could be prohibited from instituting such an action. For example, the closing agreement might contain an agreement point stating:

> The taxpayers have substantially satisfied the requirements for a voluntary disclosure and the Internal Revenue Service will not refer the Taxpayers for prosecution for any violation of Section 7201, Section 7203, Section 7206, Section 7207 of the Internal Revenue Code (or any other provisions of Title 26), Title 18 U.S.C. Section 371 et seq. (or any other provision of Title 18) or Title 31 U.S.C. Section 5322 et. seq. (or any other provision of Title 31) which may have occurred with respect to the matters covered in this closing agreement for the tax years.

[33]*See* Switzerland-U.S. Treaty on Mutual Assistance in Criminal Matters, entered into force Jan. 23, 1977, 27 UST 2019, TIAS 8302.

[34]According to Zagaris, the U.S. has already required IRS assistance for some crucial cases under the mutual legal assistance treaty. *See* Zagaris, *supra* note 1, at 3.

[35]*See supra* note 2, and article 47 of Switzerland's Federal Banking Act, SR 952.0. Generally, only three instances would result in a lifting of Swiss bank secrecy in terms of a nonresident alien client:

- If the Swiss authorities grant legal assistance in criminal matters (*see supra* note 33). While tax fraud may be a criminal matter in Switzerland, simple tax avoidance or evasion is not and therefore would not be a predicate to a legal assistance proceeding from the Swiss.
- If the Swiss tax authorities grant administrative assistance under a double tax treaty (for example, under article 26 of the Switzerland-U.S. tax treaty, exchange of information may take place ''for the prevention of fraud or the like''). *See also* Mutual Agreement of January 23, 2003, Regarding the Administration of Article 26 (Exchange of Information) of the Switzerland-U.S. Income Tax Convention of October 2, 1966.

(Footnote continued on next page.)

to the disclosing bank and/or its bankers.[36] On the other hand, UBS AG may find itself between a rock and a hard place regarding making such disclosures, because failure to honor the John Doe summons could result in severe fines and penalties, a suspension of all U.S. activities of UBS, or even worse, legal action.[37]

In light of the above, and in discussing this issue with Swiss counsel as well as with other U.S. tax practitioners, the general school of thought appears to be that UBS AG might well release disclosure of identifying information of specific noncompliant U.S. taxpayers who have engaged in conduct that would be considered a criminal violation under Swiss law. For example, based on the authors' discussion with Swiss legal counsel, if a noncompliant U.S. taxpayer has engaged in conduct that constituted fraud under Swiss law, such as forgery of an official document — for example, improperly completing Form A (the cornerstone document in any Swiss banking file that identifies the underlying beneficial owner of a Swiss financial account) — that action could be viewed by the Swiss authorities as a violation of Swiss criminal law and could justify a disclosure under the mutual legal assistance treaty proceeding. How such a release would occur under the John Doe summons proceeding is another issue, but this is a topic that will be subject to debate and negotiation between UBS AG and the United States, with, of course, the Swiss government looking over everyone's shoulder.

VI. Conclusion

Although the IRS voluntary disclosure program has been a useful vehicle for decades, the recent UBS AG case has heightened the potential use and importance of this process for U.S. taxpayers maintaining undisclosed accounts with UBS AG. As the U.S. and Swiss governments seek to protect and uphold their laws, the situation creates uncertainty for taxpayers whose identities may be subject to disclosure. Although the IRS already has apparently obtained a limited list of names associated with the UBS AG accounts, it is far from clear whether the names of U.S. account holders for the remaining accounts will be disclosed to the IRS. Regardless, UBS AG has given a timeframe of approximately two years for all U.S. taxpayers to close their UBS AG accounts (although it is rumored that this timeframe will be shortened considerably). Should a noncompliant U.S. taxpayer move his UBS AG funds before becoming U.S. tax compliant, however, this action may further subject the taxpayer to additional civil and criminal legal exposure.

A window of opportunity exists for these taxpayers to come clean through the voluntary disclosure process, thereby limiting the criminal liability exposure and potentially reducing the overall penalty exposure associated with past years' noncompliant conduct. Although the situation with UBS AG raises interesting technical issues concerning the timeliness requirement for a voluntary disclosure, the pending UBS AG proceeding generally should not preclude a taxpayer from taking advantage of the voluntary disclosure process. If, however, a taxpayer's name were on the list of account names already obtained by the IRS, the voluntary disclosure would likely be rejected on the basis that it is untimely. Even then, however, the taxpayer is likely no worse off, because the IRS already has the taxpayer's name and surely will ultimately initiate an investigation. In fact, the taxpayer may still receive some benefit from contacting the IRS before the IRS is required to hunt down the taxpayer.

Practitioners representing U.S. taxpayers with undisclosed UBS AG accounts should carefully review the voluntary disclosure policy and consider whether the process is in the best interests of their clients. Further, practitioners must advise their clients as to the method best suited to the client for coming forward in a voluntary disclosure context. Through a properly planned and executed voluntary disclosure, U.S. taxpayers may effectively avoid criminal tax liability and minimize potential tax penalties. ◆

- If the Swiss authorities, as a matter of Swiss domestic law, mandate disclosure under the International Mutual Legal Assistance Act of 1983, commonly referred to as the ''I.R.S.G.''

[36] *See* note 16, *supra*.

[37] *See* Zagaris, *supra* note 1, at 3. And as further discussed in Zagaris, several other countries are pursuing tax violations in Switzerland as well as other targeted tax haven countries, such as Liechtenstein. *Id*.