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The State's New Voluntary Disclosure Program May Not Drive Delinquent Taxpayers to the Tax Rolls

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One of the most delicate problems faced by tax professionals is how to deal with individuals and businesses who have not complied with prior tax reporting and payment obligations. Such persons fall into a variety of categories. Some honestly were unaware of their obligations (such as out of state individuals and companies who did not believe they had nexus to New York or were unaware of the statutory residency provisions of the Personal Income Tax). Others knew to some degree or another that they had not complied but did not think they could afford to pay the tax when it arose or thought that they could get away with noncompliance (sometimes on the theory that “everyone does it”).

Eventually, many of these individuals and companies want a way to clean up these situations. Sometimes, the knowledge that they could be found out creates psychological strains on them; other times their income or prominence has increased to the point where the risk of being caught has grown.

In analyzing these cases, a tax professional and the individual or business are faced with difficult problems. Particularly when there has been noncompliance for many years, the potential

liability, including interest and penalties, can be overwhelming. This problem is often compounded because records for prior years are often missing or inadequate to determine the tax liability.

The New York State and City Tax Departments have a problem as well. Despite periodic declarations that they have bolstered their audit and investigation staffs and are making every effort to track down tax evaders, it is extremely difficult and expensive to track down nonfilers and others out of compliance. Thus, the departments are constantly looking for cost-effective ways to convince taxpayers to “get on the rolls”. Thus, for example, New York and other states periodically enact amnesty programs which eliminate penalties and sometimes interest for persons who come forward.¹ Although they can generate significant revenues, such programs tend to create a disincentive for persons to comply on their own.

More commonly tax departments rely on voluntary compliance programs. Both the New York State Department of Taxation and Finance (the “Department”) and the New York City Department of Finance (the “Finance Department”) have encouraged persons to disclose voluntarily their obligations and negotiate a resolution of prior periods.

Historically, New York State has not followed an established procedure

in granting requests for a voluntary disclosure. Rather, practitioners representing non-filers made contact with the Department and negotiated the terms of a voluntary disclosure agreement under an informal procedure described below. This informal procedure has been replaced with a new program referred to as the “Voluntary Disclosure and Compliance Program” (or the “VDCP”) as a result of the 2008-2009 New York State Budget legislation enacted in April of this year.²

As discussed below, the VDCP is far less attractive than the prior informal program. It is also doubtful that the State and City’s “unified procedure,” currently outlined in a New York City Finance Department Statement of Audit Procedure (PP-2008-24)³, can be carried out in a manner consistent with the new law.

Historical State Voluntary Disclosure Procedure

Under the prior informal procedure, nonfilers and others with noncompliance issues would typically retain a tax representative to contact the Department to negotiate agreements that would limit their financial liability.⁴ The initial correspondence and discussions with the Department would be done on a “no name” basis. Tax professionals would typically describe the client in such a manner as to make the De-

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partment unable to identify the particular business or individual. The representative would often request waiver of penalties for noncompliance and a limitation of the client's tax liability to a certain period of time, for example a "look-back period" of three or four years from the date of voluntarily coming forward to the State. After an agreement suitable to both parties has been reached, the taxpayer's representative would reveal the name of the taxpayer and would submit tax returns for the periods covered by the agreement.

To be eligible for a voluntary compliance agreement, the taxpayer generally had to affirm that the Department had not contacted the taxpayer with regard to the liability they were disclosing. Other important facts typically considered by the Department were: 1) how long the delinquency existed; 2) how likely it was that the Department would eventually identify the delinquent taxpayer; 3) was there a history of noncompliance in other areas and, 4) how much is potentially owed and how much is offered as a settlement amount.

If an agreement was reached, the Department would generally include several conditions in the agreement: 1) an agreement for future compliance; 2) a statement of reasonable cause for failure to file upon which an abatement of penalty could be based; and, 3) a representation that the taxpayer was not under criminal investigation.

New State Voluntary Disclosure and Compliance Program

The 2008 Budget legislation adopted significant provisions increasing the State Tax Department's enforcement powers and resources. The VDCP provisions were enacted, purportedly as giving taxpayers a last chance before they would be caught in the widening net of enforcement. Provided the taxpayer does not intentionally fail to pay the taxes, plus interest required under the Disclosure and Compliance Agreement, certain civil penalties (including additional interest under N.Y. Tax Law §1145) for failure to pay the tax liability, failure to file a return and failure to pay estimated tax would be waived.⁵

1. Eligibility

Taxpayers who are eligible for the VDCP include any person subject to a New York State tax or local tax administered by the State Tax Department (such as New York City's resident income tax and local sales and use taxes) who satisfies all of the following four conditions: 1) is not currently under audit by the Department; 2) is voluntarily disclosing a New York tax liability that the Department has not determined, calculated, researched or identified at the time of the disclosure; 3) is not currently a party to any criminal investigation being conducted by an agency of the state or any political subdivision thereof; and, 4) is not seeking to disclose participation in a tax avoidance transaction that is a federal or New York State reportable or listed transaction.⁶

The initial legislation proposed by former Governor Elliot Spitzer, provided that the taxpayer had to certify, that to the best of the taxpayer's knowledge, the taxpayer is not under criminal investigation, and the Commissioner was required to inform the New York State Attorney General and District Attorney before entering into an agreement that the taxpayer had applied to participate in this program and provide those parties with an opportunity to report whether the taxpayer is currently under criminal investigation.⁷ Since these provisions were rejected by the State Legislature, it is unclear how the Department will determine whether a taxpayer is currently a party to any criminal investigation and whether the Department has the authority to contact law enforcement parties in this regard. It is also unclear what it means for the Department to have "determined, calculated, researched or identified" the tax liability that is the subject of the disclosure. One concern would be if the Department had access to third party records. For example, with respect to use tax, could the Department determine that none of the customers of a particular jewelry store are eligible for the VDCP because the Department had

identified the store and would eventually have access to all of its sales records even if the Department failed to take any action prior to the taxpayer voluntarily disclosing its obligation to the State?

2. Applying for the VDCP

A taxpayer must apply by submitting a disclosure statement in the form and manner to be prescribed by the Department. The disclosure statement, which has not yet been released, shall contain all of the information that the Commissioner reasonably deems necessary to effectively administer the program.⁸ The opportunity to negotiate the terms of the voluntary disclosure agreement, in particular a look-back period, is not expressly provided in the statute and the Department indicated that taxpayers could not apply on an anonymous basis and no agreed-to look-back period would be available. An interesting aspect of the new law is that an application will not be denied "solely because the taxpayer has admitted that the delinquency was the result of willful or fraudulent conduct."⁹

3. The Disclosure and Compliance Agreement

If the taxpayer intentionally provides false information or omits information, or attempts to intentionally defeat or evade a tax due pursuant to the voluntary disclosure and compliance agreement (the "Disclosure and Compliance Agreement") or intentionally fails to comply with the terms of the Disclosure and Compliance Agreement, such Disclosure and Compliance Agreement shall be deemed rescinded.¹⁰

4. Avoidance of Criminal Prosecution

State tax officials have argued that a significant feature of the State's new VDCP is the clear statutory authority precluding criminal actions or proceedings against the delinquent taxpayer,¹¹ use of the taxpayer's disclosure as evidence in any proceeding, and disclosure of such information to any law enforcement or other agency,¹² upon the execution of a Disclosure and Compliance

Agreement. While this feature may alleviate prior concerns by taxpayers and their practitioners, several provisions of the VDCP invalidate the grant of criminal immunity if the taxpayer fails to comply with any of the terms of the agreement.¹³ This means that if the taxpayer is delinquent in its taxes ten years from the date that it enters into a Disclosure and Compliance Agreement the Department has the statutory authority to initiate criminal action against the taxpayer with respect to the ten-year past obligation, including disclosure to the District Attorney's office.

Although future compliance was an aspect of the State's prior program, the new legislation makes clear that the focus of the VDCP is future compliance and imposition of penalties through enforcement actions by the Department for any non-compliance.¹⁴ Accordingly, taxpayers should keep in mind that there could be significant future consequences by going the route of voluntary disclosure.

Unified City and State Voluntary Disclosure Procedure

The Finance Department recently updated many of its Statement of Audit Procedures to more accurately reflect changes in law, regulations, policies and procedures, including the Voluntary Disclosure SAP.¹⁵ However, the portion of the SAP that describes a

unified procedure to be used by taxpayers to jointly become compliant with the State and City seems to be somewhat inconsistent with the new VDCP inasmuch as the procedure provides that a taxpayer

- (1) may come forward through any State or City employee on an *anonymous* basis;
- (2) may communicate conditions for disclosure (i.e. a look-back period);
- (3) shall be offered comparable terms and conditions upon completion of the unified process as established jointly by the State and City; and,
- (4) will not be provided an avenue to avoid civil or criminal sanctions for any intentional failure to comply with the tax laws.¹⁶

Since the City Finance Department is not bound by the terms and conditions offered to the taxpayer by the State when taxpayers opt to pursue a separate disclosure process for each jurisdiction, it may be prudent for taxpayers to decline the unified procedure until the State provides further guidance about the VDCP.¹⁷

Tax Professionals' Reactions

Tax professionals have expressed to the State Tax Department officials significant objections to the replace-

ment of the prior informal program with the VDCP as set forth in the statute. The objections focus on two aspects; first, the inability to negotiate an agreement on an anonymous basis and second, the inability to cap the liability by limiting the look-back period. In combination, these provisions make it far more expensive for a client to come forward to remedy past due obligations and as a result discourages future compliance. Tax professionals, including the authors and others, have advised the Department that very few, if any, persons will use the VDCP unless it is either changed or the Department agrees to a parallel informal procedure similar to that used previously. The Department's attempt to persuade tax professionals that the statutory elimination of criminal penalties is a significant advancement has fell flat since, as a practical matter, prosecutors have not shown any inclination to move forward criminally against persons who have already come forward voluntarily.

Conclusion

We believe that the Department is reconsidering the VDCP in response to these objections and revisions are likely.

¹ Tax amnesties are programs adopted by legislatures to turn a backlog of taxes due into cash by offering delinquent taxpayers an opportunity to pay tax obligations with a waiver or reduction of penalties and interest. The last general tax amnesty in New York occurred in 2003. See 2002 N.Y. Laws Ch. 85. As discussed in a previous article, a limited New York State amnesty program will begin November 1, 2008. In most states, each amnesty is enacted with an emphatic announcement that it will be the LAST amnesty. These announcements are received with increasing levels of skepticism as legislatures enact additional general or limited amnesties at subsequent dates to further raise revenue.

² S.6807--C, A.9807--C (hereinafter the "Budget Bill"). The legislation constitutes Chapter 57 of the Laws of 2008. Part CC-1 of the Budget Bill amends the Tax Law by adding a new Article 36, entitled "Compliance and Enforcement Initiatives." Section 1700 of Article 36 of the N.Y. Tax Law contains the Voluntary Disclosure and Compliance Program statutory provisions.

³ The City of New York, Department of Finance, Statement of Audit Procedure (SAP PP-2008-24), *Voluntary Disclosure*, April 15, 2008 (the "Voluntary Disclosure SAP"). Statements of Audit Procedure are issued by the Finance Department for use by its audit staff as guidance on audit-related matters. The City's Voluntary Disclosure SAP is discussed further within the text of the article and footnotes 13 to 15.

⁴ The informal procedure outlined above is based on the author's personal experience with negotiating voluntary disclosure agreements with the State prior to the changes made by the Budget Bill.

⁵ N.Y. Tax Law §1700.3.

⁶ N.Y. Tax Law §1700.2.

⁷ See S.9810, A.9810, Part Z, Section 1.

⁸ N.Y. Tax Law §1700.4.

⁹ *Id.*

¹⁰ N.Y. Tax Law §1700.5(b).

¹¹ N.Y. Tax Law §1700.3 & .6.

¹² N.Y. Tax Law §1700.4.

¹³ N.Y. Tax Law §1700.3, .4,& .5(B).

¹⁴ See N.Y.S. Dept. Tax'n & Fin., *Tax Provisions in the New York State 2008-09 Budget*, Slide Show, Slide 5 available at <http://www.tax.state.ny.us> (stating "compliance agreement includes terms to require future compliance and penalties if agreement is intentionally violated"); N.Y.S. Dept. Tax'n & Fin., Office of Tax Policy Analysis, *Summary of Tax Provisions in SFY 2008-09 Budget*, p.5, available at <http://www.tax.state.ny.us> (describing the program as the "Voluntary Compliance and Disclosure Program," rather than the statutorily created "Voluntary Disclosure and Compliance Program").

¹⁵ See generally Summary of Statements of Audit Procedure, New York City Dept of Finance, available at http://www.nyc.gov/html/pub/pub_guidance_saps.shtml.

¹⁶ Voluntary Disclosure SAP, supra note 3, at p.1 & 4-7.

¹⁷ *Id.* at p.4.

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