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An Analysis of the IRS's Voluntary Disclosure Policy

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He that takes the procedural sword shall perish with that sword.[1]

I. INTRODUCTION

A. *The Voluntary Disclosure Policy*

You have a friend that has not paid income taxes for a few years. Since you are an attorney, tax consultant, or accountant, she calls you because she realizes that she probably should become current on her tax liability. She has heard that the Internal Revenue Service has a Voluntary Disclosure Policy that provides protection for a taxpayer who comes forward to the Service and updates her tax liabilities.[2] Do you advise her to walk down to the IRS service center tomorrow and disclose her delinquency? In theory, she should be able to approach the Service safely, make a voluntary disclosure, and expect to be free from prosecution. In practice, however, recent cases highlight problems that can arise in the process.

Since 1919, the Service has been attempting to balance the obvious benefits of having a voluntary disclosure policy with the problem of allowing tax misconduct to go unpunished.[3] Taxpayers gain a "clear conscience"[4] and the opportunity to "put [the] problem behind them and get on with their lives."[5] The obvious benefit to the Service is that if a taxpayer voluntarily comes forward, the Service does not have to spend any money to locate, investigate, and institute collection proceedings against the delinquent taxpayer.[6] However, history has shown that taxpayers often abuse the opportunity to obtain protection from

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[1]Vitarelli v. Seaton, 359 U.S. 535, 547 (1959) (Frankfurter, J., dissenting).

[2]Sometimes referred to as the "Policy."

[3]*See* Leo P. Martinez, *Federal Tax Amnesty: Crime and Punishment Revisited*, 10 VA. TAX REV. 535 n.54 (1991).

[4]*See Spring Meeting of the Tax Division American Institute of Certified Public Accountants*, IR-News Rel., 1992-71 (June 18, 1992).

[5]*See IRS Reaches Out To Bring Nonfilers Back Into the Tax System*, IR-News Rel., 1992-94 (September 30, 1992).

[6]*See* Shotwell Mfg. Co. v. United States, 371 U.S. 341, 349 n.7 (1963) (citing Address by J. P. Wenchel, Chief Counsel of the Bureau of Internal Revenue, to the Tax Executives Institute, May 14, 1947 for the proposition that "the basic reason for the [voluntary disclosure] policy [is] . . . 'to produce the revenue called for by the law with the minimum of cost of investigation'") [hereinafter *Shotwell II*]; United States v. Knottnerus, 139 F.3d 558, 559 (7th Cir. 1998) (noting that the Voluntary Disclosure Program "is designed to reduce enforcement costs and maximize tax revenue") [hereinafter *Knottnerus*].

prosecution.[7] As a result, recently the voluntary disclosure process has become much riskier due to the enormous amount of discretion courts have afforded the government.

In section II, this Article discusses the history of the Voluntary Disclosure Policy, including litigation that prompted various changes. Section III provides the legal framework for determining when an agency is required to follow its own rules. Section IV highlights some recent cases and their effect. In particular, section IV focuses on a recent Second Circuit Court of Appeals decision, *United States v. Tenzer*.[8]

This Article argues that recent decisions have removed some of the certainty that taxpayers should be able to expect from the Voluntary Disclosure Policy, but concludes that change is unlikely. Change is unlikely because there are competing considerations and it appears that the government has settled on how to balance them.

B. *United States v. Tenzer*

In September 1997, the Second Circuit reinstated a criminal Information against a tax lawyer named James Tenzer.[9] The Southern District of New York had dismissed the Information one year earlier on the grounds that the Service failed to follow its Voluntary Disclosure Policy.[10] The facts surrounding the case illustrate the nature of voluntary disclosure.

Mr. Tenzer failed to file timely tax returns for the years 1976 through 1991, with the exception of 1983, 1984, and 1985.[11] When the Service became aware of Mr. Tenzer's delinquency, it treated the case as a civil, rather than criminal, matter.[12] In 1991, Mr. Tenzer retained legal counsel to help him become current on his tax liabilities.[13] With this assistance, Mr. Tenzer attempted to take advantage of the Voluntary Disclosure Policy by filing tax returns for the years for which he owed taxes.[14] Because he did not have enough money to pay the full liability of about $1.3 million, his lawyers initiated negotiations in 1993 for an Offer in Compromise.[15] Mr. Tenzer's team made an Offer in Compromise for between 20 and 25% of his total liability.[16] Had the Service accepted the offer, Mr. Tenzer would have made a valid voluntary disclosure and, thus, may have avoided criminal prosecution.

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[7]*See generally Knottnerus*, 139 F.3d at 558; United States v. Hebel, 668 F.2d 995 (8th Cir. 1982); United States v. Choate, 619 F.2d 21 (9th Cir. 1980); *Shotwell II*, 371 U.S. at 341.

[8]United States v. Tenzer, 127 F.3d 222 (2d Cir. 1997) [hereinafter *Tenzer II*].

[9]*See id.* at 223.

[10]United States v. Tenzer, 950 F. Supp. 554, 564 (S.D.N.Y. 1996) [hereinafter *Tenzer I*].

[11]*Id.* at 555.

[12]*Id.* at 556.

[13]*Id.*

[14]*Id.* at 557.

[15]*Tenzer I*, 950 F. Supp. 554, 562 (S.D.N.Y. 1996).

[16]*See* Brief for Defendant-Appellee at 20, *Tenzer I* (No. 96-1653) (arguing that Tenzer offered to pay 25% of his tax liability). *But see* 950 F. Supp. at 662 (stating that the Offer in Compromise was for $250,000 of a $1.3 million liability), Brief for Appellant at 31, *Tenzer I* (No. 96-1653).

A grand jury, however, had been investigating a client of Mr. Tenzer's accounting firm.[17] In 1991, in connection with the investigation, an IRS Special Agent[18] served Mr. Tenzer with a subpoena to produce the firm's accounting documents as they related to the investigation of his client.[19] Mr. Tenzer's reaction to the service of the subpoena aroused the Service's suspicions with respect to his personal liabilities.[20] In 1993, the same Special Agent contacted the IRS Collection Officer with whom Mr. Tenzer had been negotiating the Offer in Compromise.[21] This led to a freeze on the Service's collection of Mr. Tenzer's tax liabilities because of his inclusion in the criminal investigation.[22] According to the Service, the Offer in Compromise did not satisfy the requirements of the Voluntary Disclosure Policy.[23] Thus, the Service authorized criminal prosecution of Mr. Tenzer.[24]

II. THE IRS VOLUNTARY DISCLOSURE POLICY AND ITS HISTORY

In general, under certain circumstances the Service will not prosecute a taxpayer who has voluntarily disclosed particular tax indiscretions to the Service.[25] Whether this behavior is referred to as a practice, informal policy, or formal policy, it will be denominated in this Article broadly as the "Voluntary Disclosure Policy." Since its genesis, the Voluntary Disclosure Policy has taken on various forms that have been shaped by litigation. Although commentators have described the inception as having occurred at different times, the earliest that has been suggested is 1919.[26] Throughout its history, when the Service maintained the Voluntary Disclosure Policy, it did so to encourage voluntary compliance

[17]*See Tenzer I*, 950 F. Supp. at 556.

[18]A "Special Agent" is a criminal investigator. *See* Paul Marcus, *A Return to the "Bright Line Rule" of Miranda*, 35 WM. & MARY L. REV. 93, 120 n.134 (1993).

[19]*See Tenzer I*, 950 F. Supp. at 556.

[20]*See id. at* 556.

[21]*See Tenzer I*, 950 F. Supp. 554, 558 (S.D.N.Y. 1996).

[22]*See id.* The Service put a "914 freeze" on Tenzer's account because the agency does not pursue civil collection while it conducts a criminal investigation of a taxpayer. *Id.* at 558 n.2.

[23]*See id.* at 559.

[24]*See id.*

[25]*See* I.R.M. 342.142, *Shotwell II*, 371 U.S. 341, 344 (1963); United States v. Shotwell Mfg. Co., 355 U.S. 233, 235 n.2 (1957) [hereinafter *Shotwell III*]; *Knottnerus*, 139 F.3d 558, 559 (7th Cir. 1998); *In re* Liebster, 91 F. Supp. 814, 815 (E.D. Pa. 1950).

[26]*See* Steven Toscher, *IRS Voluntary Disclosure and Non-Solicitation Policies*, 44 FED. LAW. 56 n.3 (1997) (stating that the policy began in 1945); JAMES A. BRUTON, III, ET. AL., *Representing A Taxpayer Before the Criminal Investigation Division Arrives*, *in* CRIMINAL TAX FRAUD-1997, at B-13 (A.B.A. Ctr. For Continuing Legal Educ. 1997) (stating that the policy originated in 1945); Martinez, *supra* note 4, at n.54 (stating that Voluntary Disclosure Policy similar to an amnesty began in 1919).

[27]*See IRS Reaches Out To Bring Nonfilers Back Into the Tax System*, IR-News Rel., 1992-94 (September 30, 1992) ("We want to encourage people to come forward voluntarily and get right with the government."); *Spring Meeting of the Tax Division American Institute of Certified Public Accountants*, IR-News Rel., 1992-71 (June 18, 1992) (IRS Commissioner Shirley Peterson stated that "[o]ur new approaches are designed to . . . improv[e] voluntary compliance" and that her "goal is to raise the rate of voluntary compliance"); Jerome S. Horvitz & Henri L. Tallichet, *An Examination of the Voluntary Disclosure Policy*, 11 TAX ADVISER 545, 548 (1980) ("[A] sound [voluntary disclosure] policy should promote effective functioning of the revenue laws, and prompt those guilty of negligence to come forward.").

with the tax laws.[27] The Voluntary Disclosure Policy may also serve as the tax enforcement entities' implicit recognition that after a taxpayer comes forward and discloses her transgressions, it might be difficult to prove the willfulness necessary to obtain a conviction for a tax crime.[28]

It may be a misnomer to refer to "the" Service's Voluntary Disclosure Policy. Although the Service has usually referred to one policy, it appears that there may have been two policies at different times during the course of Service history: one for taxpayers who inadvertently failed to file tax returns, and another for taxpayers that filed fraudulent returns. The former group is commonly referred to as "non-filers," and the latter group is commonly referred to as "tax evaders," toward which the Service has historically taken a harsher stance.

From 1919 until 1934, the Bureau of Internal Revenue (the forerunner to the Service) decided that in voluntary disclosure cases it would consider Offers in Compromise where there was a possibility of criminal liability.[29] It is not clear whether this applied to both non-filers and tax evaders.

From 1934 to 1952, however, the Service changed course. In lieu of the previous policy, the Service instituted a formal policy that it would not recommend criminal prosecution where a taxpayer revealed a tax crime to a Service official prior to the commencement of an investigation.[30] According to Treasury Declaration S-2930, this version of the policy applied to intentional tax evaders as well as non-filers.[31]

Treasury Secretary Morgantheau first publicized the 1934 version of the policy in a 1945 radio address.[32] Throughout the 1934 to 1952 period, courts regarded the policy as providing immunity to taxpayers satisfying the requirements of the policy.[33] According to the Chief Counsel of the Bureau of Internal Revenue, a voluntary disclosure could be completed merely by stating that "I have filed

[28]The willfulness standard is set forth in Spies v. United States, 317 U.S. 492 (1943) (reversing the conviction of taxpayer for felony tax evasion because taxpayer lacked requisite willfulness where he had "a psychological disturbance, amounting to something more than worry but less than insanity").

[29]*See* Martinez, *supra* note 4, at n.54.

[30]*See* United States v. Hebel, 668 F.2d 995, 997 (8th Cir. 1982) ("[T]he IRS and Department of Justice followed a written [voluntary disclosure] policy . . . during the period between 1934 and 1952."); Toscher, *supra* note 27, at 56 n.3; Martinez, *supra* note 4, at n.54 (citing a speech by J. P. Wenchel, PH Fed. Taxes ¶ 76,169, to the Tax Executives Institute for the proposition that "the official position of the Service was not to recommend prosecution of a taxpayer who voluntarily came to the Service").

[31]*See* Treasury Declaration S-2930 (Jan. 10, 1952) ("[I]t has been the long established policy of the Treasury Department to refrain from recommending criminal prosecution where taxpayers make voluntary disclosure of intentional tax evasion prior to the institution of an investigation by the Bureau of Internal Revenue.").

[32]*See* James A. Bruton, III, *Correcting (Or Not Correcting) Erroneous Tax Returns*, 47 INST. ON FED. TAX'N § 53.01, § 53.07, at n.77 (1989). Two months later, Secretary of the Treasury Fred M. Vinson further publicized the Policy through the press. *Id.*; *see also Shotwell I*, 225 F.2d 394, 402 (7th Cir. 1955); *In re* Liebster, 91 F. Supp. 814, 815 (E.D. Pa. 1950).

[33]*See Shotwell II*, 371 U.S. 341, 350 (1963); *Liebster*, 91 F. Supp. at 816 ("The petitioner . . . knew of the Treasury Department's policy to grant immunity from criminal prosecution to taxpayers making voluntary disclosures prior to the initiation of an investigation by the Treasury Department.").

false tax returns and I want to make the government whole,"[34] coupled with "(1) the disclosure of a tax deficiency, (2) an admission that the taxes due had been wilfully evaded, and (3) good faith cooperation with the government thereafter in determining the amount of taxes due."[35]

During this period of the policy, many disputes arose concerning the timeliness and completeness of the disclosure.[36] The most heated dispute, however, involved the accuracy of disclosures. In one notable case, executives of Shotwell Manufacturing approached a Service collections agent in 1948[37] and voluntarily disclosed that they had failed to pay taxes on behalf of the company.[38] The government prosecuted and obtained convictions of the executives in a jury trial in district court for willful attempt to evade Shotwell's taxes for the 1945 and 1946 taxable years.[39] The Seventh Circuit reversed the convictions because the Service violated its own Voluntary Disclosure Policy.[40] It remanded the case for retrial but ordered the suppression of evidence obtained as a result of the voluntary disclosures.[41] Without overturning the legal basis for evidence suppression, the Supreme Court vacated the decision because of new evidence that the defendants had defrauded the courts and the Service by falsifying information in their voluntary disclosure.[42]

As a result of the above disputes, the Service abandoned the formal policy from 1952 until 1961, at least with regard to intentional tax evaders.[43] The Service, however, made it their informal practice during that time not to prosecute voluntary disclosers.[44]

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[34]*See Shotwell I*, 225 F.2d at 403.

[35]*See id.*

[36]*See* Legatos v. United States, 222 F.2d 678 (9th Cir. 1955); Bateman v. United States, 212 F.2d 61 (9th Cir. 1954); Lapides v. United States, 215 F.2d 253 (2d Cir. 1954); Monroe v. United States, 215 F.2d 81 (5th Cir. 1954); White v. United States, 194 F.2d 215 (5th Cir. 1952); United States v. Lustig, 163 F.2d 85 (2d Cir. 1947); *Liebster*, 91 F. Supp. at 814.

[37]*See Shotwell I*, 225 F.2d 394, 399-400 (7th Cir. 1955).

[38]*See Shotwell II*, 371 U.S. 341, 343 (1963); *Shotwell III*, 355 U.S. 233, 235 (1957); *Shotwell I*, 225 F.2d 394, 396-97 (1957).

[39]*See Shotwell II*, 371 U.S. at 343-44; *Shotwell III*, 355 U.S. at 235; *Shotwell I*, 225 F.2d at 397.

[40]*See Shotwell II*, 371 U.S. at 343-44; *Shotwell III*, 355 U.S. at 236; *Shotwell I*, 225 F.2d at 406.

[41]*See Shotwell II*, 371 U.S. at 343-44; *Shotwell III*, 355 U.S. at 236; *Shotwell I*, 225 F.2d at 406.

[42]*See Shotwell II*, 371 U.S. at 347-50.

[43]*See Shotwell III*, 355 U.S. at 233; *see also* Treasury Declaration S-2930 (Jan. 10, 1952) ("While it has been the long established policy of the Treasury Department to refrain from recommending criminal prosecution where taxpayers make voluntary disclosure of intentional tax evasion prior to the institution of an investigation by the Bureau of Internal Revenue, it has been concluded that the policy will no longer be followed.").

[44]*See* Richard J. Trattner & Mark D. Pastor, *IRS Disclosure Policy: The Internal Revenue Service Again Abandons Voluntary Disclosure*, L.A. LAW., May 1978, at 30; *see also Knottnerus*, 139 F.3d 558, 559-60 (7th Cir. 1998) (noting the Service made "numerous public pronouncements" including that it was the "'longstanding practice' of not recommending criminal prosecution of delinquent taxpayers who 'voluntarily file, or make arrangements to file, before being notified they are under criminal investigation'") (citing *It's Never Too Late*, IRS Publication 1715); *IRS Says Non-filers Who Come Forward Are Not Prosecuted*, IR-News Rel., 1992-114 (December 7, 1992) ("[T]he IRS has made a practice of taking into consideration the fact of a taxpayer's voluntary disclosure when determining whether to recommend criminal prosecutions.").

From 1961 until 1990, under specific circumstances the government would consider a voluntary disclosure of a tax crime and correction before Service involvement as a factor in deciding whether to prosecute.[45] Courts held this informal practice provided defendants with no legally enforceable rights.[46]

In 1990, the Service adopted Internal Revenue Manual[47] section 342.142, providing that "a voluntary disclosure may result in no prosecution recommendation."[48] This version of the policy provided that a voluntary disclosure is a communication that is "(a) Truthful; (b) Timely; (c) Complete; and, (d) . . . shows a willingness to cooperate . . . with the IRS in determining his/her correct tax liability."[49] A taxpayer could no longer satisfy the timeliness element upon Service initiation of an inquiry "that [was] likely to lead to the taxpayer, and the taxpayer [was] reasonably thought to be aware of that investigative activity."[50] The section refers to the "IRS initiation" without specifying whether the investigation arose in the context of a civil or criminal case.

An untimely claim could also result if the taxpayer learned of the occurrence of "some event . . . likely to cause an audit into the taxpayer's liabilities, e.g., a newspaper article highlighting commercial bribery in a particular industry or corruption in government office."[51]

Although section 342.142 has been changed twice since 1990, section 342.14(2) has not. This section states that "[t]he [voluntary disclosure] policy was abandoned on January 10, 1952, by Treasury News Release S-2930."[52] In other words, it appears the Service took the position that section 342.142 was not a policy. By leaving section 342.14(2) untouched (stating the policy was abandoned) while changing section 342.142 (setting forth requirements for voluntary disclosures), it appears the Service asserted that the two subsequent versions that superceded the 1990 version also were not "policies."

To support the Service position that there was no "voluntary disclosure policy," the Manual included a disclaimer. It provided that "a voluntary disclosure will be considered along with all other factors in the case in determining whether criminal prosecution will be recommended."[53] The Manual also noted that "[a]

[45]*See Knottnerus*, 139 F.3d at 559-60.

[46]*See* United States v. Hebel, 668 F.2d 995, 997 (8th Cir. 1982) (holding that the defendants were unable to demonstrate that there was a practice of not prosecuting taxpayers who voluntarily disclosed their indiscretions); United States v. Choate, 619 F.2d 21, 23 (9th Cir. 1980) (holding the defendant could not rely on the Voluntary Disclosure Policy). It is interesting to note that in *Choate*, the court's decision hinged on its finding that the Treasury changed its Voluntary Disclosure Policy three weeks prior to the commencement of the investigation of the defendant in January of 1972, suggesting that the policy continued at least internally until that time. *See id.* Yet in *Hebel*, the court found the policy was abandoned in 1952. *Hebel*, 668 F.2d at 997.

[47]Hereinafter, referred to as the "Manual."

[48]I.R.M. 342.142(2) (April 10, 1990).

[49]I.R.M. 342.142(3) (April 10, 1990).

[50]I.R.M. 342.142(4)(a) (April 10, 1990).

[51]I.R.M. 342.142(2)(b) (April 10, 1990).

[52]I.R.M. 342.14(2) (April 10, 1990).

[53]I.R.M. 342.142(1) (April 10, 1990).

voluntary disclosure will not of itself guarantee immunity from prosecution"[54] and that "a voluntary disclosure does not bar criminal prosecution, but rather is a factor to be considered when deciding to recommend prosecution."[55] In addition, the Manual included a provision that "[t]he IRS's voluntary disclosure practice creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided solely for guidance to IRS personnel."[56] It appears that the Service only wanted to take part of the procedural sword, not all of it.[57]

In 1991, the Service added section 31(330) to its Chief Counsel Directives Manual (CCDM), which provided a vague elaboration on the concepts of "voluntariness"[58] and "cooperation." The CCDM required the taxpayer to make "bona fide arrangements to pay the applicable taxes and penalties to the extent of the taxpayer's actual ability to pay."[59] The rest of the section resembled the 1990 Internal Revenue Manual provisions.

In 1992, the Service issued a series of press releases as part of a non-filer initiative stating that it will not recommend criminal prosecution under certain circumstances.[60] These press releases reflected a policy different from that in the 1990 Internal Revenue Manual and the 1991 CCDM. In the first press release, the Service stated that it "will not recommend criminal prosecution of any taxpayer who comes forward, makes a true voluntary disclosure, and files an accurate tax return."[61] A second represented that "[t]he IRS has never recommended criminal prosecution to the Department of Justice when taxpayers came forward and made a true voluntary disclosure of failing to file returns and filed accurate returns of their own volition."[62] In December of 1992, the Service issued a third

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[54]I.R.M. 342.142(2) (April 10, 1990).

[55]I.R.M. 342.142(5) (April 10, 1990).

[56]I.R.M. 342.142(7) (April 10, 1990).

[57]*See* Vitarelli v. Seaton, 359 U.S. 535, 547 (1959) (Frankfurter, J., dissenting) ("He that takes the procedural sword shall perish with that sword.").

[58]CCDM (31)330(4)(c) (December 12, 1991). The CCDM states that:

> Voluntariness is tested by the following factors:
>
> > Actual status of the Internal Service's awareness of the taxpayer as to specific tax investigation potential;
> >
> > Taxpayer's knowledge or awareness of the Internal Revenue Service's interest; and,
> >
> > Taxpayer's fear of "trigger" or "potential trigger" to make the Internal Revenue Service aware of violations. Where the disclosure is "triggered" by an event which would have led the Internal Revenue Service to the fraud, the disclosure is not considered to be truly voluntary.

Id.

[59]*See* CCDM(31)330(4)(d) (December 12, 1991).

[60]*IRS Plans to Bring Nonfilers Back Into the Tax System*, IR-News Rel., 1992-5 (September 1992); *IRS Reaches Out To Bring Nonfilers Back Into the Tax System*, IR-News Rel., 1992-94 (September 30, 1992); *IRS Says Nonfilers Who Come Forward Are Not Prosecuted*, IR-News Rel., 1992-114 (December 7, 1992).

[61] *IRS Reaches Out To Bring Nonfilers Back Into the Tax System*, IR-News Rel., 1992-94 (September 30, 1992).

[62]*IRS Plans to Bring Nonfilers Back Into the Tax System*, IR-News Rel., 1992-5 (September 1992).

press release in which Commissioner Shirley Peterson set forth the requirements that she said would be added to the Internal Revenue Manual concerning the practice of not recommending prosecution for taxpayers that voluntarily disclosed their failure to file.[63]

The December 1992 press release and the Policy subsequently documented in the Internal Revenue Manual at section 342.142(3) on April 5, 1993 set forth the same requirements. It required the taxpayer to inform the Service of her failure to file, demonstrate no receipt of illegal income, make the disclosure before being notified that she was under criminal investigation, either file an accurate tax return or work with the Service to determine the right amount of tax, and pay the liability in full or make "bona fide arrangements to pay."[64]

The press release differed from the Manual provision, however, in its qualifying language. The press release stated "the IRS has no intention of altering its practice or departing from the consistent manner in which it has applied the voluntary disclosure practice in determining whether to recommend criminal prosecutions in nonfiler cases."[65] In contrast, the Manual stated the Policy "creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice provided solely for the guidance to IRS personnel."[66]

Because of these changes during the early 1990's, a criminal defendant could have argued with the government over which voluntary disclosure policy should be applied. In *Tenzer*, such a dispute arose.[67] While the parties "vigorously dispute[d]" which version should be applied, the Second Circuit focused on a single element common to the CCDM and the 1993 policy, which was the "bona fide arrangement to pay" requirement.[68] This case is discussed *infra* in section IV.

In 1995, Internal Revenue Manual section 342.142 was amended to revert back to the 1990 version.[69] It has had no material changes since that time.[70]

III. THE DOCTRINE THAT AGENCIES MUST FOLLOW THEIR OWN RULES

The question whether the Service must follow the Voluntary Disclosure Policy set forth in its Internal Revenue Manual is complex. This section discusses the relevant aspects of the general federal doctrine requiring agencies to follow their own rules.

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[63]*See IRS Says Nonfilers Who Come Forward Are Not Prosecuted*, IR-News Rel., 1992-114 (December 7, 1992).

[64]*See id.*

[65]*See IRS Says Nonfilers Who Come Forward Are Not Prosecuted*, IR-News Rel., 1992-114 (December 7, 1992).

[66]*See Tenzer I*, 950 F. Supp. 554, 560 (S.D.N.Y. 1996) (citing I.R.M. 342.142 (April 5, 1993)).

[67]*See Tenzer II*, 127 F.3d 222, 226-28 (2d Cir. 1997).

[68]*See id.*

[69]*See* I.R.M. 342.142 (August 25, 1995), I.R.M. 342.142 (April 10, 1990).

[70]The only notable change has been to remove, add back, and then remove again the section stating that the policy was abandoned in 1952. *Compare* I.R.M. 342.142 (August 25, 1995), *and* I.R.M. 342.142 (April 10, 1990), *with* I.R.M. 31.3.3.1 (January 17, 1996) *and* I.R.M. Handbook 9.5 § 3.1.13.2.1 (July 30, 1998), *and* I.R.M. Manual 9.5 § 3.3.1.2.1 (April 9, 1999).

Although it is clear there are times when agencies must follow their own rules, the factual circumstances that trigger the application of the doctrine are not always so clear. Certainly, agencies must follow their own rules when the rules confer a benefit to citizens or cause citizens to forego constitutional rights. An agency's regulations have the force and effect of law, unless the regulation is precatory (directory rather than mandatory) or does not substantially prejudice a complainant.[71] Also, an agency will be bound by its own rules is where it has created a situation that equitably estops it from violating its rules.[72] An agency may also have to follow its own rules if it has denied an individual procedural due process.[73]

The source of this doctrine is unclear. Courts have relied both on the Administrative Procedure Act (the "APA") and constitutional principles in requiring that agencies adhere to their own rules.[74] The relevant section of the APA allows a court reviewing an agency action to set the action aside if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law."[75] The constitutional principles of due process[76] and equal protection[77] are involved.

The principal case courts rely on to strike down agency actions failing to comply with their own rules is *United States v. Caceres*.[78] The Supreme Court's opinion acknowledged a significant body of Supreme Court jurisprudence holding that rules of an agency bind itself.[79] The Court modified this concept by applying it only where a significant individual interest is at stake, such as a constitutional or federal statutory right.[80] In *Caceres*, the Court allowed the conviction of a defendant to stand where the Service failed to follow the require-

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[71]*See* Peter Raven-Hansen, *Regulatory Estoppel: When Agencies Break Their Own "Laws,"* 64 TEX. L. REV. 1, 5-6 (1985). An agency regulation may have the force of law when it is an interpretation of a statutory provision. In such circumstances courts must yield to agency interpretation if the statute itself is unclear and the agency has permissibly interpreted the statute. *See* Chevron v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-44 (1984).

[72]*See* Ogala Sioux Tribe v. Andrus, 603 F.2d 707 (8th Cir. 1979) (agency must follow policy where complainant justifiably relied on it); United States v. Leahey, 434 F.2d 7, 10-11 (1st Cir. 1970) (taxpayers may reasonably rely on Service announcements); United States v. Tobins, 512 F. Supp. 308, 314-15 (D. Mass. 1981) (agency may not induce reliance on one policy through an announcement and then follow another policy); *see also* Raven-Hansen, *supra* note 72, at 27-29.

[73]Raven-Hansen, *supra* note 72, at 5-6.

[74]*See* Rodney A. Smolla, *The Erosion of the Principle That the Government Must Follow Self-Imposed Rules*, 52 FORDHAM L. REV. 472, 476-77 (1984).

[75]*See* Administrative Procedure Act, 5 U.S.C. § 706(2)(A) (1998); *see also* Smolla, *supra* note 75, at 474 n.10.

[76]*See* Bridges v. Wixon, 326 U.S. 135, 152-53 (1945) (concluding the rules in that case were "designed as safeguards against essentially unfair procedures" and "to protect the interests of the alien and to afford him due process of law").

[77]*See Tenzer I*, 950 F. Supp. 554, 559 n.3 (S.D.N.Y. 1996) (noting the defense's argument implicated "the equal protection element in the Due Process Clause of the Fifth Amendment").

[78]United States v. Caceres, 440 U.S. 741 (1979) [hereinafter *Caceres*]; *see also In re* Shain, 978 F.2d 850, 853-54 (4th Cir. 1992).

[79]*Caceres*, 440 U.S. 741, 752 n.14 (1979).

[80]*Id.* at 749.

ments of the Internal Revenue Manual, which required the Service to obtain approval from the Department of Justice prior to tape-recording a bribery suspect.[81]

The *Caceres* Court examined the cases that require agencies to follow their own regulations and distinguished the facts before the Court. The Court found the Justice Department's approval was an internal housekeeping measure that did not afford the defendant any protection.[82] There was no federal statute or constitutional protection precluding a government agent from recording a conversation with a suspected criminal.[83] Thus, the Court held the rule binding agencies to their own rules did not apply.[84]

Prior to *Caceres*, a long line of cases acknowledged by the *Caceres* Court (most of them cited in "Famous Footnote 14") bound agencies to their own rules.[85] The first of these cases was *Arizona Grocery v. Atchison Railway Co.*[86] *Arizona Grocery* addressed a federal statute that provided the Interstate Commerce Commission (ICC) with statutory authority to set a maximum reasonable rate that shipping companies could charge for delivery over certain routes.[87] Because the authority was given by statute, the ICC's pronouncements had the force of a statute.[88] Pursuant to its authority, the ICC set a maximum rate.[89] Then, five years later it retroactively reduced the maximum reasonable rate. With the retroactive change, the defendant's rates—which for five years had remained in line with rates allowable at the time—suddenly became unreasonable.[90] Thus, injured parties sued the defendant notwithstanding its reliance on the ICC's earlier pronouncement.[91] The Court held the ICC's retroactive change in maximum rates was an illegal violation of its own rules because the original rate pronouncement had the force of law, which the ICC had to obey.[92]

The next case was *Bridges v. Wixon*.[93] In *Wixon*, the Supreme Court held agencies must follow regulations intended to protect individual due process and ensure fairness.[94] Immigration Naturalization Service (INS) regulations imposed

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[81]*Id.* at 741, 743-44, 749-50.

[82]*See id.*

[83]*See id.* at 749-52.

[84]*Caceres*, 440 U.S. 741 at 754-55.

[85]*Id.* at 749 (citing Bridges v. Wixon, 326 U.S. 135 (1945)), 752 n.14 (citing Morton v. Ruiz, 415 U.S. 199, 235 (1974), Yellin v. United States 374 U.S. 109 (1963), Vitarelli v. Seaton, 359 U.S. 535 (1959), Service v. Dulles, 354 U.S. 363 (1957), and Accardi v. Shaughnessy, 347 U.S. 260 (1954)), 753 n.15 (citing Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Ry. Co., 284 U.S. 370 (1932)). Footnote 14 is referred to here as "Famous" because the district court judge relied so heavily upon it to dismiss charges against the defendant in *Tenzer I*, 950 F. Supp. 554, 555, 559, 560 n.4, 562-63 (S.D.N.Y. 1996).

[86]284 U.S. 370 (1932) [hereinafter *Arizona Grocery*].

[87]*Id.* at 383-88.

[88]*Id.* at 386.

[89]*Id.* at 381.

[90]*Id.* at 381-83.

[91]*Id.*

[92]*Arizona Grocery*, 284 U.S. at 389-90; *see also* Smolla, *supra* note75, at 477-78.

[93]326 U.S. 135 (1945) [hereinafter *Wixon*].

[94]*See id.*

a requirement on itself. Before INS could use a deportee's own statement against him or her in a hearing, the regulations required that INS obtain the deportee's signature on the statement under oath in an interrogation.[95] Statements used against Harry Bridges in such a hearing were neither signed nor made during interrogation under oath, yet the hearing officer allowed INS to use them against Bridges.[96] The Supreme Court held this was not allowed because the regulations were intended to provide protection to aliens. Thus, the INS had to follow its regulations.[97]

One of the most important Supreme Court cases on the enforceability of agency rules as they relate to the Service's Voluntary Disclosure Policy is *Accardi v. Shaughnessy*.[98] Central to that case was the principal that an agency is bound by a rule it promulgates that intentionally benefits both the government and the public.[99] In *Accardi*, the Board of Immigration Appeals had a rule that it would exercise discretion in referring cases to the Attorney General.[100] This benefited aliens by allowing them to influence referrals to the Attorney General and provided the Attorney General with the Board's independent and knowledgeable assessment of the facts. Allegedly, the Board failed to exercise its discretion in deportation proceedings involving a person on a "hit list" prepared by the Attorney General.[101] The practical effect, if true, was that the people on the hit list were deprived of the Board's independent exercise of discretion.[102] The Court enforced the agency's rules against itself and held Mr. Accardi was entitled to an independent hearing.[103]

The *Caceres* Court also referred to *Service v. Dulles*.[104] In *Dulles*, the Supreme Court held agencies must follow their own regulations even when the rules are discretionary.[105] The Secretary of State fired a foreign service officer, which violated the Department of State regulations promulgated by the Secretary. These regulations require that there be an "unfavorable action in the employee's case by the Department Loyalty Security Board."[106] Although a statute gave the Secretary discretion to fire people, the Court held he had to follow his own regulations.

Similarly, in *Vitarelli v. Seaton*, the Supreme Court held agencies must follow their own rules.[107] In *Vitarelli*, the Secretary of the Department of the Interior

[95]*See id.*
[96]*Id.*
[97]*Id.*
[98]United States *ex. rel.* Accardi v. Shaughnessy, 347 U.S. 260 (1954) [hereinafter *Accardi*].
[99]*See id.*
[100]*Id.*
[101]*Id.*
[102]*Id.*
[103]*Id.*
[104]354 U.S. 363 (1957) [hereinafter *Dulles*].
[105]*Id.*
[106]*Id.* at 374-75 (1957).
[107]359 U.S. 535 (1959) [hereinafter *Vitarelli*].

fired an employee allegedly because the employee was a communist.[108] Although the employee could have been fired without cause, the Department's rules prohibited firing an employee for being a communist without a hearing.[109] Because the regulations protected employee rights, the Supreme Court held that the Department had to follow them.[110]

In *Yellin v. United States*, the Supreme Court held congressional committees must follow their own rules.[111] In *Yellin*, a House Committee rule provided that it would hold hearings in private where a majority of the Committee determined that a public hearing would interfere with national security or damage the reputation of a witness.[112] Throughout its history, the Committee behaved as though the rules provided protection to witness' reputations,[113] and the Court held Yellin's situation was no different.[114]

The most recent of the Famous Footnote 14 Cases is *Morton v. Ruiz*.[115] In *Morton*, the Court held, where individual rights are affected, agencies must follow their own rules.[116] The Bureau of Indian Affairs (BIA) denied benefits to Mr. Ramon Ruiz and his wife, both Papago Indians, who lived in Arizona.[117] The reason the BIA gave for the denial was that the Ruizes did not satisfy the requirements of the BIA Manual.[118] Although these requirements were not published, the BIA Manual itself required that substantive policies be published in the Code of Federal Regulations.[119] Because individual rights were affected by the rules, the Court held it was "incumbent upon" the BIA to follow them.[120]

Various lower courts have addressed provisions in agency manuals affecting tax law enforcement. In cases where a manual provided protection to public citizens, the courts have held an agency must obey its provisions.[121] In other cases, where the manual provided more of a guideline for employees of the agency with little or no effect on the lives of citizens, the courts have not bound the agency to the manual.[122]

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[108] *Id.*

[109] *Id.*

[110] *Id.*

[111] Yellin v. United States, 374 U.S. 109 (1963) [hereinafter *Yellin*].

[112] *Id.* at 115.

[113] *Id.* at 116.

[114] *Id.*

[115] 415 U.S. 199 (1974) [hereinafter *Morton*]; *see Caceres*, 440 U.S. 741, 752 n.14 (1979).

[116] 415 U.S. 199, 235 (1974) ("Where the rights of individuals are affected, it is incumbent upon agencies to follow their own procedures.").

[117] *Id.* at 203-05.

[118] *Id.* at 204-05.

[119] *Id.* at 233-34.

[120] *Id.* at 235.

[121] *See* Lindholm v. United States, 808 F. Supp. 3 (D.D.C. 1992) (holding that the Service was bound by its Internal Revenue Manual where it provided a venue where taxpayers may sue); Burd v. United States, 774 F. Supp. 903, 908-09 (D.N.J. 1991) (holding that the Service must follow the Internal Revenue Manual when it institutes a levy on a taxpayer's property).

[122] *See* Barrett v. United States, 100 F.3d 35, 41 (5th Cir. 1996) (holding that a Service agent's failure to follow the Internal Revenue Manual did not cause the act to be willful as a matter of law); Lojeski v. Boandl, 788 F.2d 196, 199 (3d Cir. 1986) (Internal Revenue Manual's required approval of regional counsel priot to filing liens and levies does not establish a due process standard); United

The judicial doctrine that agencies may not violate their own rules is well developed. Although there have been times when agencies have not been required to adhere to their regulations, it has been when factors making the regulations less important than countervailing considerations were present. In other words, unless a rule or regulation promulgated by an agency is merely a "housekeeping" rule, the agency is bound by it.

IV. RECENT CASES AND THEIR EFFECT

A. *The* Tenzer *Case*

In *Tenzer*, it appears the court of appeals left standing the district court's holding that the Service must follow its own Voluntary Disclosure Policy.[123] This did not help Mr. Tenzer because the court held that Mr. Tenzer's actions did not factually satisfy the requirements of the Policy.[124] By computer-generated notices, the Service notified Mr. Tenzer, a tax lawyer, that he failed to file certain tax returns.[125] The notices informed him that he could avoid criminal prosecution by filing his returns and becoming current on his tax liability.[126] As a result, he began negotiating his liability on January 8, 1993, at which time the agent assured him the Service was handling his voluntary disclosure as purely a civil matter.[127] However, on November 15, 1994, the Service recommended prosecution of Mr. Tenzer.[128]

On November 30, 1995, the United States Attorney filed a criminal Information charging Mr. Tenzer with "having unlawfully, willingly and knowingly failed to file income tax returns."[129] Upon Mr. Tenzer's motion, the district court

States v. Irvine, 699 F.2d 43, 44-46 (1st Cir. 1983) (failing to inform taxpayer that he was under criminal investigation was not fatal where the agent had informed him of his Fifth Amendment rights). *But see* Gonsalves v. United States, 975 F.2d 13, 15-16 (1st Cir. 1992) (holding that taxpayer was not allowed to sue the Service because the statutory waiver of sovereign immunity does not apply to appeal rights provided in the Internal Revenue Manual).

[123]*Tenzer II*, 127 F.3d 222, 227 (2d Cir. 1997) (noting "[t]he IRS must afford a taxpayer who has acted in reliance upon the voluntary disclosure policy a reasonable opportunity to satisfy all of the conditions of that policy") (2d Cir. 1998); *Knottnerus*, 139 F.3d 558, 559 (7th Cir. 1998) ("In order to establish that his indictment violated his due process rights, Knottnerus must convince us that he qualified for the protections offered by the IRS Voluntary Disclosure Policy."). It is clear that the *Knottnerus* court's statement of the rule was not intended to constitute binding precedent because it also noted that Knottnerus' claim was "highly dubious" because "[a]n agency's failure to follow its own regulations does not rise to the level of a constitutional violation unless the regulations themselves are compelled by the Constitution." *See id.* at 561 n.5 (citing *Caceres*, 440 U.S. 741, 749-52 (1979)).

[124]*Tenzer II*, 127 F.3d at 228 (holding the voluntary disclosure policy did not apply because Tenzer failed to meet the payment requirements of the Policy), *Knottnerus*, 139 F.3d at 560 (holding that a visit from a Service Special Agent "disqualified [Knottnerus] from the voluntary disclosure program").

[125]*Tenzer II*, 127 F.3d at 223.

[126]*See* Brief for Defendant-Appellee at 3, *Tenzer II* (No. 96-1653).

[127]*Tenzer I*, 950 F. Supp. 554, 557 (S.D.N.Y. 1996); *Tenzer II*, 127 F.3d at 224.

[128]*Tenzer II*, 127 F.3d 222, 225 (2d Cir. 1997).

[129]*Id.*

dismissed the Information, holding the Service failed to follow its own policy.[130] The Second Circuit, on appeal, reinstated the indictment on the ground that the Offer in Compromise was not a bona fide arrangement to pay.[131] In its opinion, the court acknowledged the Service was obligated to obey its own rules.[132]

The Second Circuit opinion in *Tenzer*[133] may have been erroneous. Taxpayers also lost some of the certainty regarding whether voluntarily disclosing tax indiscretions will negate prosecution. To help explain the problems with the opinion and the effect on taxpayers, this Article will critique both the legal and factual analyses of the Second Circuit's opinion.

There was a certain logic to the legal issue in the *Tenzer* case. The taxpayer's logic can be reduced to a simple syllogism: (1) agencies must follow their own policies; (2) the Service had a Voluntary Disclosure Policy; and (3) thus, the Service had to follow the Voluntary Disclosure Policy. In concluding the Service was bound by its Policy, the Second Circuit presumably relied on the district court's analysis, because the appellate opinion cited little authority.[134]

Predictably, Mr. Tenzer agreed with the district court that the agencies are bound by their own policies, which established the major premise of the syllogism. Just as predictably, the government directly attacked this premise. Mr. Tenzer's brief noted the differences between the situation in *Caceres*, where the Supreme Court did not award the defendant with dismissal of charges or suppression of evidence because of the Service's failure to follow its procedures, and the situation in which Mr. Tenzer found himself.[135] In addition, his brief cited Famous Footnote 14 Cases and other cases powerfully establishing that agencies must follow their own rules.[136]

In contrast, the government argued the rule that agencies are bound by their regulations is merely a "general principle" acknowledged by the Supreme Court in *Caceres*.[137] However, famous Footnote 14 sets forth a substantial body of Supreme Court precedent to the effect that agencies must follow their own rules.[138] The Supreme Court in *Caceres* signaled that these cases were not being overturned or adversely affected by its opinion. In their brief filed in the *Tenzer* case, the government failed to cite cases acknowledged by the Supreme Court in Famous Footnote 14: *Morton*, *Vitarelli*, *Yellin*, *Dulles*, and *Accardi*. Indeed, the government's argument that the district court "erroneously emphasized a footnote in the Supreme Court's opinion" disregards a mountain of precedent acknowledged in the famous footnote.[139]

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[130]*Id.* at 225-26.

[131]*Id.* at 227-28 (noting that Tenzer was given sufficient time to comply with the requirements of the disclosure policy but, in the end, did not do so).

[132]*See id.* at 227.

[133]*Tenzer II*, 127 F.3d 222, 222 (2d Cir. 1997).

[134]*See id.*

[135]*See* Brief for Defendant-Appellee at 23-25, *Tenzer II* (No. 96-1653).

[136]*See id.* at 22.

[137]*See* Brief for Appellant at 49, *Tenzer II* (No. 96-1653).

[138]*See Caceres*, 440 U.S. 741, 751 n.14 (1979).

[139]*See* Brief for Appellant at 49, *Tenzer II* (No. 96-1653).

In fairness to the government, the district court did not reference any of these cases either, but rather focused on *Caceres*.[140] The government merely followed the district court's lead. Thus, to attack the overwhelming Supreme Court precedent, the government relied extensively on two Court of Appeals cases interpreting *Caceres*: *United States v. Ivic*[141] and *United States v. Irvine*.[142] *Irvine* involved a situation where a Service agent failed to inform a taxpayer that he was being investigated criminally as required by regulation.[143] However, the Service agent had informed the taxpayer of his Fifth Amendment rights.[144] Moreover, the court held the language of *Caceres* may still provide a remedy where the government's "behavior could significantly prejudice the [exercise of a] constitutional right."[145] Mr. Tenzer was indeed prejudiced because he was induced to forego his constitutional right to remain silent.

The government's use of *Ivic* was also ineffective. First, it did not address the Supreme Court holdings that agencies must follow their own rules. Second, the government cited a particular portion of it out of context. At issue in the portion of the opinion the government relied on was whether RICO convictions should be affirmed where the Department of Justice failed to follow its own guidelines.[146] The *Ivic* court in fact reversed the convictions.[147] In light of the foregoing, it is not surprising that the Second Circuit found the government's argument wanting and required it to follow its own rules.

With respect to the minor premise of the syllogism, that the Service had a Voluntary Disclosure Policy, the court decided in favor of Mr. Tenzer as well. This was a more difficult issue for the court to address. Although each party recited the history of the policy, neither recitation remotely resembled the other. The government acknowledged the Service had a Voluntary Disclosure Policy prior to 1952, but stated that no such policy existed between 1952 and 1992.[148] To support its claim, the government relied on excerpts from various statements by the Treasury and the Service made in 1952, 1961, 1973, and 1992.[149] Mr. Tenzer's recitation of the history merely stated that the Service had had a Voluntary Disclosure Policy since 1961[150] and then focused on the changes from 1992 through 1995. Mr. Tenzer's brief made specific reference to one 1992 Service publication, which states that "[t]he IRS has never recommended criminal prosecution to the Department of Justice when taxpayers came forward and made a

[140]*See Tenzer I*, 950 F. Supp. 554 (S.D.N.Y. 1996).

[141]700 F.2d 51 (2d Cir. 1983) [hereinafter *Ivic*].

[142]699 F.2d 43, 44 (1st Cir. 1983) [hereinafter *Irvine*]; *see* Brief for Appellant at 50, *Tenzer II*, 127 F.3d 222 (2d Cir. 1997) (No. 96-1653).

[143]It is interesting to note that the "regulation" was a provision of the I.R.M. *See Irvine*, 699 F.2d at 44.

[144]*See id.*

[145]*Id.* at 46.

[146]*See* Brief for Appellant at 50, *Tenzer II* (No. 96-1653); *see also Ivic*, 700 F.2d at 64.

[147]*See Ivic*, 700 F.2d at 64.

[148]*See* Brief for Appellant at 24-25, *Tenzer II* (No. 96-1653).

[149]*Id.*

[150]Brief for Defendant-Appellee at 3, *Tenzer II* (No. 96-1653).

true voluntary disclosure of failing to file returns and filed accurate returns of their own volition."[151]

Faced with strong evidence that the Service had a long-standing policy of refraining from prosecution in voluntary disclosure situations, the court apparently decided that a policy was in place at the relevant time.[152] The court did not question the existence of a policy not to prosecute despite the government's arguments that any policy that existed reserved prosecutorial discretion.[153]

Thus, with the major premise and minor premise of the syllogism established, the conclusion was inescapable. The court relied on the government's recitation of the history of the Voluntary Disclosure Policy, which included language that attempts to reserve complete discretion for the Service.[154] But later in the court's opinion it noted the Service is obligated to negotiate with taxpayers in good faith regarding voluntary disclosures.[155]

Although Mr. Tenzer appeared to have won on the legal issues, he was unsuccessful when the Second Circuit applied the law to facts of his case. The court avoided the issue of deciding whether the 1992 or 1993 version of the Voluntary Disclosure Policy should apply to Mr. Tenzer by focusing on an element common to both. According to the court, both the 1992 version and the 1993 version required payment or bona fide arrangements to pay the unreported tax liability in order to qualify for the benefits of voluntary disclosure.[156] The court found Mr. Tenzer had not made bona fide arrangements to pay, and, thus, could not rely upon the policy.

This holding lacked the soundness of the court's legal conclusions. The court found Mr. Tenzer failed to meet the "bona fide arrangement to pay" requirement because he and the Service did not come to an agreement within a reasonable amount of time.[157] To reach this conclusion, the court implicitly found that Mr. Tenzer did not negotiate reasonably. The court implied this in its assertion that "if the parties cannot agree within a reasonable time on a suitable arrangement for payment, then the Service is justified in refusing to treat that taxpayer as a voluntary discloser."[158] Since the court held in favor of the government, it must have found it was Mr. Tenzer that had been unreasonable in the negotiations.

But common sense and evidence concerning Service settlements contradict this claim. By analogy, if Mr. Tenzer had merely been parking his car and had forgotten to put the "tax" in the meter and then later tried to correct it, the court may have reacted differently. Assume Mr. Tenzer realized he forgot to put the money in the meter when he saw the parking tax collection authorities down the

[151] *Id.* at 4-5 (citing IRS Fact Sheet, FS-92-5 (Sept. 30, 1992)).

[152] *See Tenzer II*, 127 F.3d 222, 226 (2d Cir. 1997) (providing a history of the Voluntary Disclosure Policy including a citation to the 1993 version in the Internal Revenue Manual).

[153] *See* Brief for Appellant at 46, *Tenzer II* (No. 96-1653).

[154] *Compare Tenzer II*, 127 F.3d at 227, *with* Brief for Appellant at 24-25, *Tenzer II* (No. 96-1653).

[155] *See Tenzer II*, 127 F.3d 222, 227 (2d Cir. 1997).

[156] *See id.* at 226.

[157] *See id.* at 227-28.

[158] Id. at 227.

street ticketing other cars. He went back to his car, opened the car door, retrieved a nickel from inside the car, and proceeded to the meter to pay the "tax." Although many parking meters take nickels, dimes, and quarters, assume this one only took quarters. Realizing this, Mr. Tenzer opened the door again and began searching for a quarter to satisfy the parking tax. While searching, the parking tax collection authorities wrote Mr. Tenzer a ticket. It is difficult to imagine that the court would have found Mr. Tenzer did not satisfy the tax within a reasonable amount of time if he had still been looking in his car for the quarter.

Yet this is essentially what happened to Mr. Tenzer. He was having personal problems that caused him to fail to pay his income taxes.[159] He knew he should pay the tax. Like the car analogy, when Mr. Tenzer attempted to make an arrangement to pay the tax, he was aware that the Service often settles tax liabilities for less than the full liability.[160] Indeed, Mr. Tenzer's offer to pay close to 20 to 25% was far higher than many offers the Service found acceptable.[161]

Furthermore, the government did not rebut Mr. Tenzer's evidence that the Offer in Compromise was consistent with the manner of calculation set forth in the Internal Revenue Manual.[162] This is interesting because the government relied heavily on the Manual to refuse to process Mr. Tenzer's compromise offer.[163] Mr. Tenzer's representative, Mr. Ernest Honecker, submitted the Offer in Compromise on Mr. Tenzer's behalf.[164] He stated in an accompanying letter that he arrived at the figures based on liquidation and forced sale values consistent with the Manual.[165] It was clear that Mr. Tenzer would have had to liquidate his entire net worth to pay the taxes because he would have had to borrow money from people close to him.[166] Neither party contradicted the evidence that

[159]Brief for Defendant-Appellee at 6, *Tenzer II* (No. 96-1653).

[160]*Id.* at 20. In 1996, the Service settled for an aggregate $287 million with respect to $2.17 billion in aggregate tax liabilities, or 13%. *Id.* (citing *Tax Notes*, WALL STREET JOURNAL, Mar. 26, 1997, at 1).

[161]*Id.*

[162]*See* Brief for Defendant-Appellee at 9, *Tenzer II* (No. 96-1653), Appendix (Volume I) at 88-89, *Tenzer* (No. 96-1653).

[163]*See Tenzer II*, 127 F.3d 222, 224 (2d Cir. 1997) (accepting the government's argument that the Internal Revenue Manual states an Offer in Compromise is unprocessable if the amount offered is below the equity in assets of the taxpayer), Brief for Appellant at 33, *Tenzer II* (No. 96-1653) (referring to I.R.M 57(10)9.1(3)(f) (September 22, 1994), which describes unprocessable Offers in Compromise).

[164]*See Tenzer II*, 127 F.3d at 224; Letter from Ernest Honecker, Attorney for James L. Tenzer, to E. Kishlansky, Internal Revenue Service (February 5, 1993); Letter from Ernest Honecker, Attorney for James L. Tenzer, to Richard M. Kramer, Assistant Chief Operations, Internal Revenue Service (April 14, 1993) (referring to Offer in Compromise and citing and quoting from I.R.M. 57(10)(13.4)(4)).

[165]*See* Letter from Ernest Honecker, Attorney for James L. Tenzer, to E. Kishlansky, Internal Revenue Service (February 5, 1993).

[166]*See id.*; *see also* Brief for Defendant-Appellee at 19, *Tenzer II* (No. 96-1653), Affidavit of Ernest Honecker at ¶ 15 (April 1, 1996).

Mr. Tenzer clearly made arrangements to pay in good faith. The court, even though it acknowledged this evidence, failed to address it.[167] Instead, the Second Circuit relied on the holding of the district court that the Offer in Compromise was "laughable."[168] How the court translated "laughable" into a factual conclusion that Mr. Tenzer did not come to an agreement within a reasonable amount of time remains a mystery.

In sum, it is ironic that the Second Circuit's reversal of the district court on the voluntary disclosure issue hinged on the government's argument that Mr. Tenzer did not come to an agreement within a reasonable amount of time.[169] The irony is that the Service published a notice in July of 1993 regarding voluntary disclosure by non-filers, entitled "It's Never Too Late," to induce non-filers, like Mr. Tenzer, to pay their taxes.[170] The notice stated the Service "wants to help [people who failed to file their tax returns] make a fresh start."[171] In addition, it stated: "Our long-standing practice has been not to recommend criminal prosecution of individuals for failure to file tax returns—provided they voluntarily file, or make arrangements to file, before being notified they are under criminal investigation."[172] In Mr. Tenzer's case, however, the United States Attorney's Office argued for an exception for egregious conduct, which the policy did not provide.[173] In effect, the Second Circuit applied such an exception by finding that a "bona fide arrangement to pay" requirement had not been met where it appeared the taxpayer had attempted to comply with all Service guidelines regarding Offers in Compromise.

B. *The Knottnerus Case*

Additional litigation over the Voluntary Disclosure Policy recently arose in the Seventh Circuit in *Knottnerus*.[174] In *Knottnerus*, Mr. Knottnerus failed to file his tax returns.[175] One day, he noticed a man photographing his house.[176] When Mr. Knottnerus inquired why the man was taking pictures of the house, the man identified himself as a Service agent.[177] Mr. Knottnerus departed from the premises without finishing the conversation.[178] He later contacted the Service asking to participate in the Voluntary Disclosure Program.[179] The court held it was reasonable to infer that he was aware he was under criminal investigation, the

[167]*See Tenzer II*, 127 F.3d 222, 224-25 (2d Cir. 1997).
[168]*See id.* at 228.
[169]*See id.* at 227-28.
[170]*See* IRS Publication 1715 (July 1993).
[171]*See id.*
[172]*See id.*
[173]*See Tenzer I*, 950 F. Supp. 554 (S.D.N.Y. 1996) (noting the government's argument for an egregious case exception and that none exists), Brief for Appellant at 46-47, *Tenzer II*, 127 F.3d 222 (2d Cir. 1997) (No. 96-1653).
[174]*Knotternus*, 139 F.3d 558, 559 (7th Cir. 1998).
[175]*Id.*
[176]*Id.*
[177]*Id.*
[178]*Id.*
[179]*Knotternus*, 139 F.3d 558, 559 (7th Cir. 1998).

absence of which was a requirement for the program, and upheld the Service denial of his participation in the program.[180] The court noted the Service must follow its own Voluntary Disclosure Policy, but held the taxpayer did not satisfy its conditions.[181]

C. *The Crystal Case*

Another dispute arose in *Crystal v. United States*.[182] Mr. and Mrs. John and Victoria Crystal owned a business.[183] It appears that these taxpayers decided to make a voluntary disclosure because their former employee, who embezzled more than $500,000 from the business, threatened to contact the Service.[184] Mr. and Mrs. Crystal asked Mr. Roger Olsen, a former Assistant Attorney General in the U.S. Department of Justice Tax Division, to represent them.[185] Mr. Olsen called the Criminal Investigation Division located in the Los Angeles district office of the Service.[186] He inquired whether his clients should deal with the Los Angeles district or the Southern California district.[187] He did this because the Crystals operated their business in Los Angeles, but lived within the jurisdiction of the Southern California district office.[188]

Mr. Richard Speier, Jr., Chief of the Los Angeles CID office, informed Mr. Olsen that the district where taxpayers live normally handles voluntary disclosures.[189] Therefore, Mr. Olsen contacted the Southern California district and proceeded to make the voluntary disclosure.[190] First, he informed Mr. Wayne McEwan, Chief of the Southern California district CID, that his clients wanted to make a voluntary disclosure.[191] He then proceeded to tell Mr. McEwan the necessary facts of their case without revealing the Crystals' identities.[192] Mr. McEwan acknowledged that the Service retained the Voluntary Disclosure Policy, and then told Mr. Olsen that the Crystals would qualify on the basis of the anonymous information provided.[193] After confirming that his clients would qualify and conferring with them, Mr. Olsen revealed who the taxpayers were so that Mr. McEwan could see if there had been any activity in the system concerning the Crystals.[194]

When Mr. McEwan looked into the matter, he found no indication that the Crystal's were under investigation.[195] He informed Mr. Olsen that this was the

[180]*Id.* at 560.
[181]*Id.* at 559-61.
[182]172 F.3d 1141 (9th Cir. 1999) [hereinafter *Crystal*].
[183]*See id.* at 1142.
[184]*Id.*
[185]*See id.*
[186]*Id.*
[187]*Crystal*, 172 F.3d 1141, 1142 (9th Cir. 1999).
[188]*See id.*
[189]*Id.*
[190]*See id.*
[191]*Id.*
[192]*Crystal*, 172 F.3d 1141, 1142 (9th Cir. 1999).
[193]*See id.*
[194]*See id.*
[195]*See id.*

case.[196] By the time he reported this, on June 5, 1996, an investigation had begun on June 3, 1996.[197] Pursuant to the investigation, the Service issued summonses of the Crystals' records from third parties.[198] The Crystals requested that the district court quash the summonses.[199] The Crystals lost and appealed to the Ninth Circuit.

The Crystals argued the Voluntary Disclosure Policy precluded issuance of the summonses and the Service was not acting in good faith.[200] The Service argued the policy did not protect the taxpayers from the Service's actions in that factual circumstance.[201] The district court found in favor of the Service because "even if the voluntary disclosure were timely and the Crystals had made an actual disclosure, the Service was not precluded from using third party summonses to certify the accuracy of their disclosures or from investigating the Crystals." This makes sense because the policy generally allows taxpayers to avoid prosecution, and the Service had not even gotten to the point of referring the Crystals for prosecution.

D. *Where These Cases Leave Taxpayers*

Because of the wording of the current version of the Voluntary Disclosure Policy and the Second Circuit opinion in *Tenzer*, a taxpayer deciding whether to make a voluntary disclosure faces more uncertainty than before *Tenzer*.[202] Although *Tenzer* holds a non-filer who satisfies the requirements of the policy should remain free from prosecution,[203] that the government lost that argument in the Second Circuit will not prevent it from disputing it again in a similar situation. In fact, "the IRS has made clear its desire never to be held accountable for applying [the Policy] fairly and even-handedly."[204] The Second Circuit also added to the uncertainty when it applied a "bona fide arrangement to pay" requirement even though it appears Mr. Tenzer tried as hard as he could to make such an arrangement.

Knottnerus and *Crystal* do not have a substantive effect on taxpayers. Those cases represent clearer reasons for finding the taxpayers in each case were not entitled to the policy's protection. They do, however, illustrate some of the pitfalls in attempting to obtain the policy's benefits.

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[196]*See id.* at 1142-43

[197]*Crystal*, 172 F.3d 1141, 1143 (9th Cir. 1999).

[198]*See id.*

[199]*See id.*

[200]*See id.* at 1145.

[201]*See id.*

[202]*See* BRUTON, ET. AL., *supra* note 27, at B-29; Toscher, *supra* note 27, at 56.

[203]John J. Tigue Jr. and Linda A. Lacewell, *New Defenses to Criminal Charges*, 216/100 N.Y.L.J. 3 (Nov. 21, 1996).

[204]*See* BRUTON, ET. AL., *supra* note 27, at B-13.

E. *Tactical Maneuvers in the Wake of These Cases*

Tenzer, *Knottnerus*, and *Crystal* highlight the obstacles to making a voluntary disclosure. It appears clear now that the Service must follow its Voluntary Disclosure Policy. That the Service must follow the policy, however, provides little comfort when the government appears willing to renege where a taxpayer has pushed its buttons. Nonetheless, although it could be dangerous for an individual to approach the Service and voluntarily disclose that she failed to file her tax returns, making a disclosure through counsel decreases that danger, although there is no guarantee. Indeed, Mr. Crystal still faced numerous hurdles even though he engaged the services of Mr. Olsen, a former Assistant Attorney General in the U.S. Department of Justice Tax Division.

Proceeding without counsel would entail subjecting oneself to more danger for three reasons. First, experienced counsel can assess the situation and determine on the basis of the taxpayer's particular situation if the Service should be contacted or if the taxpayer should merely file an amended return. A taxpayer facing this predicament for the first time may find it difficult to read the situation. Experienced counsel, on the other hand, may handle voluntary disclosures routinely, and may have a trained eye for pitfalls in making the disclosure.

Second, if it is necessary to contact the Service, a taxpayer cannot obtain assurances from the Service that she will be treated as a voluntary discloser without revealing her identity. Thus, one advantage to legal representation is that a taxpayer approaching the Service through counsel can do so anonymously. Aside from hiding a taxpayer's identity before obtaining assurance that the Service will not recommend prosecution, acting through a legal representative also makes it easier to discuss the case with the Service in hypothetical terms.[205] At some point, as illustrated in *Crystal*, if the Service agrees that the hypothetical fits the policy's criteria, the discussion must become real. The taxpayer must be identified, which involves taking the risk that the Service does not have all the relevant information it needs to provide full protection.

Third, an attorney is in a better position to ascertain the accuracy of the returns before filing. This is because, in ascertaining the accuracy of the returns, an attorney may offer better protection through evidentiary privileges against the discovery of incriminating evidence. This is important because if a voluntary disclosure contains inaccurate information, it can be treated as untruthful and the taxpayer can be prosecuted.[206]

To ascertain the accuracy of the taxpayer's returns, counsel may need to hire an accountant to review the returns. If counsel fails to plan adequately, however, government investigators and prosecutors may, through various means, require the taxpayer to produce the accountant's communications. Counsel can avoid this unfortunate result by bringing the accountant under the umbrella of the

[205] *See*, Bruton, *supra* note 33, at § 53.01.
[206] *See id.*

attorney-client privilege and the work-product doctrine.[207] Courts have long recognized privileges of this sort where an attorney hires an accountant for assistance with legal representation.[208] To insure that the privileges will attach, it is necessary that the attorney, not the taxpayer, secure the services of the accountant through what is known as a *Kovel* letter.[209]

Thus, in representing a client in a voluntary disclosure situation, an attorney should follow three steps. First, the attorney should instruct the client not to contact the Service. Second, counsel should ascertain the correct amount of liability by hiring an accountant with a *Kovel* arrangement. Third, after evaluating the situation, counsel should either file an amended return or contact the Service and discuss the matter hypothetically without revealing the taxpayer's identity. The process discussed here assumes the taxpayer has carefully weighed the benefits and risks of voluntary disclosure and no problems arise during the process of preparation that complicate or in some other way insert more risk into the disclosure.[210]

V. CONCLUSION

The government's desire to retain prosecutorial discretion is not indefensible. Determining whether to have a Voluntary Disclosure Policy and, if so, how to administer it involves many considerations. The main reason for having it is to increase voluntary compliance with the tax laws, such as bringing delinquent filers back onto the tax rolls.[211] When a taxpayer stops paying taxes, there may come a time when she wants to become current with her taxes. If she is afraid to pay all her back taxes and current taxes because of the threat of prison, she may be less likely to get back into the system than if the threat is removed. By removing the threat, the government can decrease the "tax gap" without expending investigative, enforcement, and collection resources.[212] The taxpayer could

[207]BRUTON, ET. AL., *supra* note 27, at B-13; Larry A. Campagna, *See No Evil, Hear No Evil, and Speak No Evil: Handling Voluntary Disclosures Without Creating a Witness Against Your Client, in* CRIMINAL TAX FRAUD-1997, at B-1 (A.B.A. Ctr. For Continuing Legal Educ. 1997).

[208]*See, e.g.*, United States v. Kovel, 296 F.2d 918 (2d Cir. 1961).

[209]BRUTON, ET. AL., *supra* note 27 at B-38; Campagna, *supra* note 208, at B-1. A *Kovel* letter should state the scope of the services the accountant will provide, that the work and communications will be confidential, what the accountant should do in the event of contact by the government, that the work produced by the accountant is owned by the attorney, and how the accountant will be paid. BRUTON, ET. AL., *supra* note 27, at B-38.

[210]Bruton, *supra* note 33, at § 53.09[6].

[211]*See IRS Reaches Out To Bring Nonfilers Back Into the Tax System*, IR-News Rel., 1992-94 (September 30, 1992) ("We want to encourage people to come forward voluntarily and get right with the government."); *Spring Meeting of the Tax Division American Institute of Certified Public Accountants*, IR-News Rel., 1992-71 (June 18, 1992) (Commissioner Shirley Peterson stated that "[o]ur new approaches are designed to . . . improv[e] voluntary compliance" and that her "goal is to raise the rate of voluntary compliance"); Horvitz & Tallichet, *supra* note 28, at 548 ("[A] sound [voluntary disclosure] policy should promote effective functioning of the revenue laws, and prompt those guilty of negligence to come forward.").

[212]*See* U.S. GENERAL ACCT. OFF., PUB. NO. 97-35, TAXPAYER COMPLIANCE: ANALYZING THE NATURE OF THE INCOME TAX GAP (1996).

then become current and put to rest the fear of being caught.[213]

During the Reagan Administration, the government raised a countervailing consideration in response to legislative proposals for a statutory voluntary disclosure system.[214] The main thrust of the objection was similar to objections to tax amnesties. Treating voluntary disclosers with impunity removes the incentive to voluntarily comply with the tax laws.[215] A taxpayer may find out that her neighbor did not pay taxes for several years. After finding out that the neighbor received no criminal punishment for failing to pay taxes, the taxpayer may wonder why she even bothers to pay taxes herself. Seeing that her neighbor escaped tax-free, she may decide that she can also avoid punishment. Therefore, she may just go to the Service when she feels ready to pay, voluntarily disclose that she failed to file, and receive no criminal punishment.

The non-filer program in 1992 and 1993 addressed this concern. While publicizing leniency for voluntary disclosers that came forward, the government also publicized that it was devoting more resources to prosecuting delinquent taxpayers.[216] Thus, the Service created the perception that it was risky not to come forward. Since abandoning the policy, there have been far fewer prosecutions of tax crimes.[217]

Another concern is that a formal Voluntary Disclosure Policy may create an unfair disparity of treatment in the tax system.[218] If the policy is less formal and purely internal, sometimes referred to as a "practice,"[219] then only those who are aware of Service leniency toward voluntary disclosers can benefit from it. This may mean that a taxpayer's choice of a tax counsel can affect the amount of leniency the Service accords the taxpayer.[220] For example, an attorney who has served in the Service or Department of Justice Tax Division may be better equipped to guide a taxpayer through obtaining the benefits of voluntary disclosure than an accountant or any other tax practitioner with less experience concerning the government's prosecution of tax crimes.[221]

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[213]*See IRS Reaches Out To Bring Nonfilers Back Into the Tax System*, IR-News Rel., 1992-94 (September 30, 1992); *Spring Meeting of the Tax Division American Institute of Certified Public Accountants*, IR-News Rel., 1992-71 (June 18, 1992); Kenneth L. Harris, *On Requiring the Correction of Error Under the Federal Tax Law*, 42 TAX LAW. 515, 564 (1989).

[214]*See generally Tax Compliance: Voluntary Disclosure Amnesties Are "Unworkable," Justice Official Tells Tax Bar*, 155 DAILY TAX REPORT K-5 (Aug. 12, 1986).

[215]*See id.* (quoting Assistant Attorney General (in the Department of Justice's Tax Division) Roger Olsen: "The notion that a tax criminal can buy his or her way out of criminal liability just before being caught strikes at the vital degree of respect for the tax system generally observed by the taxpaying public."); Harris, *supra* note 214, at 565 ("[V]oluntary disclosure would undermine the public respect for the Service and for the tax system if the Service were seen to be making deals with certain criminals.").

[216]*See Bar Cool to Voluntary Disclosure Hype*, DOJ ALERT, Nov. 1992, at 7.

[217]*See* Interview with James A. Bruton, III, November 10, 1998.

[218]*See* Harris, *supra* note 214, at 565-66.

[219]*See IRS Releases 'Oral History Interview' of Former Commissioner Caplin*, 94 TAX NOTES TODAY 120-25 (Former IRS Commissioner Mortimer M. Caplin differentiated between the voluntary disclosure policy and practice).

[220]*See* Interview with James A. Bruton, III, November 10, 1998.

[221]*See id.*

An additional consideration (which may have caused the result in *Tenzer*) is taxpayer abuse. A formal policy can lead to disputes over whether disclosure was timely or voluntary, or over the existence of a "bona fide arrangement to pay" if such a requirement exists. Taxpayers may raise such issues merely to evade paying the tax. In *Tenzer*, for example, the district court appeared to have suspected that Mr. Tenzer was abusing the tax system because it noted that, "the misconduct of Tenzer is egregious by any definition of the word."[222] Under the Voluntary Disclosure Policy at the time, however, taxpayer abuse was irrelevant.[223] Allowing tax evaders to take advantage of the policy may send the wrong message to taxpayers that are in compliance with the system.

The Voluntary Disclosure Policy creates a rather odd conundrum. It remains an attractive source of revenue, yet suggestions to codify the policy have been rejected. According to former Service Commissioner Mortimer Caplin, the government decided not to codify it in order to allow the Service to retain discretion.[224]

Recent cases support Mr. Caplin's proposition, and they demonstrate that the Service wants the benefits of the policy, but not the burdens. In a sense, it wants to take the procedural sword, but is not willing to perish with it. The result is that the Service pretends it has not taken the sword, while in light of the disqualifying language surrounding the Voluntary Disclosure Policy, it actually has done so. In the future, the Service will try to interpret the policy narrowly and extend the exceptions where the taxpayer trying to qualify appears to the Service as somehow suspect. It will do so even if the taxpayer appears to be making a valid effort to get right with the government, as was Mr. Tenzer.

[222]*Tenzer I*, 950 F. Supp. 554, 560 (S.D.N.Y. 1996).
[223]*See id.*
[224]Interview with Mortimer Caplin, November 17, 1998.