Tax Law

IRS Disclosure of Protected Tax Data

With all of the hype in the media about government dysfunction, the IRS has not been exempt from its own series of scandals.

In its recent past, it has been accused of wasting money, wrongfully disclosing taxpayer information and targeting specific political groups. And justifiably, many taxpayers are beginning to lose trust in "the system." But through these trials and tribulations, there was always a guidepost that taxpayers (and advisors) could rely upon to identify expected IRS Procedure when a controversy matter arises, namely the Internal Revenue Manual ("IRM").

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Although the Internal Revenue Code (and certain Treasury Regulations) is given the force of law, Tax Advisors have long recognized that the IRM is the official guidance for IRS personnel. It dictates the criteria for IRS procedure during audit, examination and appeal. The IRM sets forth the parameters for the administration of tax, penalties and interest while providing a tangible delineation of IRS requirements and expectations.

As indicated in the IRM:

"The IRM is the primary, official source of IRS 'instructions to staff' that relate to the administration and operation of the Service. The IRM ensures that employees have the approved policy and guidance that they need to carry out their responsibilities in administering the tax laws or other agency obligations."[1]

The greatest benefit to the IRM is its transparency. The IRS employees are given marching orders to follow the IRM, and from its contents, taxpayers could decipher what to expect. They could also determine where their case results would resonate.

In order to understand how information can be disclosed and shared, a brief primer is first needed to explain how tax reporting of foreign income is governed. The Financial Crimes Enforcement Network ("FinCEN") is an agency that operates separately from IRS (yet still a part of the Department of the Treasury).

FinCEN processes and enforces the reporting of offshore financial data to protect against money laundering and terrorism. It handles Foreign Bank Account Reporting ("FBAR") matters and Title 31 of the US Code governs its guidelines. The FBAR form is a policing tool and can be obtained by other government agencies without need for prior authorization. On the other hand, the IRS is a separate component of the Department of the Treasury and is delegated to administer the nation's Income Tax laws. Its guidelines are instead governed under Title 26 of the US Code.

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Despite the existence of a common parent agency, it was understood that information filed with the IRS was private and information filed with FinCEN was, for the lack of better word, public. However as the US economy took a turn for the worse, the government decided it needed more money – a lot of money. It began looking in new places to identify additional sources of revenue, namely, by asserting high penalties for failure to report and disclose offshore accounts.

But in the process of its pursuits, the IRS has begun to stray from the very rules it has established for itself. The result has clouded the transparency of tax audits and risks the creation of additional taxpayer distrust. This past summer, the US General Accounting Office ("GAO") had suggested that Taxpayers who merely initiated "Quiet" voluntary disclosures (just mailing deficient tax filings outside of any Disclosure Program) and "first-time" filers be pursued via data mining.

There is a shortage of citable information with recent Foreign Account Disclosure Programs; particularly those associated with the recent "Loud" Disclosure submissions or "Quiet" Disclosure investigations. This had bolstered the importance of the IRM as a mechanism for navigating the uncharted waters of FBAR controversy matters, particularly for taxpayers who may now be pursued after the recommendations from the GAO.

However, due to the shared need for information, several questions emerge. Do the Income Tax Auditors require approval to pass your personal tax data along to FBAR Auditors? Can FinCEN obtain information for non-tax matters without authorization? Currently, there are information exchange arrangements between the IRS and the State tax authorities. But is it permissible for the IRS to pass that information to other federal agencies as well? And how closely would the income tax returns and/or IRS Income Tax Auditors findings be used as a basis for establishing willful conduct on FBAR violations?

Congress has instituted provisions in the Internal Revenue Code that maintain the privacy of taxpayer data.[2] As a result, Income Tax Auditors are

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prohibited from freely sharing taxpayer information with FBAR Auditors unless a "Related Statute Memorandum" is first obtained.[3]

This means it must first be established that the Title 31 (FinCEN) violations are "related" to Title 26 (Income Tax) violations before the income tax data can be released. This was premised on the belief that Agents should not have carte blanche to peruse any income tax return they would like merely to identify its potential for FBAR violations. In fact, the IRM sets forth the repercussions for the privacy violation itself:

Without a related statute determination, Title 26 information cannot be used in the Title 31 FBAR examination. Any such use could subject the persons making the disclosure to penalties for violating the disclosure provisions protecting Title 26 return information.[4] These issues recently came to the forefront in *Jon C. Hom Associates, Inc. v. the United States*.[5]

In *Hom*, the taxpayer argued that the IRS should be precluded from sharing information discovered during an income tax audit with the FBAR Investigator referred to and sought damages for the unauthorized disclosure. He also proclaimed that the privacy protections under statute[6] state that the information exchange can only be authorized for the collection of tax and that FBAR "penalties" were not "taxes," per se. The taxpayer argued that the IRS had even violated its own rules because it allowed the release of his tax information without the Related Statute Determination required in the IRM.

However, contrary to the IRM, the court interpreted that 31 U.S.C. § 5314 (foreign transactions and bank accounts) is intrinsically a related statute to 26 U.S.C. § 6103 and operates in furtherance of tax administration. The court held that the administration of tax included penalties for non-compliant foreign reporting, and therefore deemed the exchange and utilization of information as permissible. It even set aside the IRM violation by the IRS employee under the IRS' own guidelines, citing the longstanding position that the IRM "confers no rights upon taxpayers."[7]

Taxpayers can no longer presume that documents directed to the IRS are for their eyes only. Despite the statutory protections instituted by Congress to maintain taxpayer confidence, information can be procured without authorization under the guise of effectuating tax administration by other divisions of the Department of the Treasury.

But then a question emerges…due to the fact that the penalty under the Patient Protection & Affordable Care Act was classified a "tax" by the US Supreme Court, will other agencies of government likewise obtain the ability to procure confidential tax return information without notice to Taxpayers? And in light of the recent GAO report declaring the intent to pursue "Quiet" FBAR filers, will reviewing Agents have free reign to cross-check with the income tax file(s) merely to scan for instances of culpable conduct?

The holding in *Hom* sets a dangerous precedent which spans beyond just the sharing of information for enforcement. It endorses the exposure of data to unintended parties and reduces the relevance of the IRM, the roadmap for Federal Tax controversy matters. Information sharing can trigger the erosion of privacy protections. And like the recent National Security Agency scandal, it produces the impression to taxpayers that the system lacks oversight and limitation. Looking ahead, these permissible privacy violations should be watched very closely as the government expands its involvement into the administration of other areas in our lives.

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1. IRM § 1.17.2.3.5.
2. 26 U.S.C. 6103.
3. *See* IRM §§ 4.26.17.2 and 4.26.14.2.2.
4. *See* IRM 4.26.17.2
5. No. C. 13-02243 WHA, 2013 U.S. Dist. LEXIS 142818 (N.D. Cal. Sept. 30, 2013).
6. 26 U.S.C § 6103 (and the associated IRM sections).
7. *United States v. Caceres*, 440 U.S. 741 (1979).