DEALING WITH THE IRS COLLECTION DIVISION

HEALING SELF-INFLICTED WOUNDS -- REPRESENTING NONFILERS©

Burton J. Haynes, Attorney at Law[1]

Never do today what you can put off until tomorrow . . .

All of us procrastinate. But some take things to dangerous extremes -- putting off the filing of tax returns for a few years, or even many years. The IRS estimates that each year some ten million people fail to file their tax returns. What do you do with the new client who walks in and explains that he hasn't filed returns for three, six or ten years? This article will discuss the potential criminal and civil issues facing nonfilers and their advisors, including the large tax debts which usually result from the filing of a group of delinquent returns, or from the IRS's assessment of the tax under its "substitute for return" procedures.

Prosecuting nonfilers -- willful failure to file (§7203).

The government can and does prosecute people for willful failure to file income tax returns.[2] The good news is that this is relatively rare, and most nonfiler cases are resolved without resort to criminal prosecution. But sometimes willful failure to file returns, with the emphasis on the word "willful," leads to indictment, conviction and incarceration.[3]

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[1] Mr. Haynes is an attorney in Burke, Virginia (703-913-7500). Until 1981, he was a Special Agent with the IRS Criminal Investigation Division, and in 1980 was named "Criminal Investigator of the Year" by the Association of Federal Investigators. He specializes in civil and criminal tax disputes, tax collection matters, the tax aspects of bankruptcy and divorce, and forensic accounting in white collar crime cases. This article is part of a series Mr. Haynes writes for The Freestate Accountant on dealing with IRS collection matters. Reprints are available from the Society. Also, many of Mr. Haynes' articles are posted at msacct.org, and in the Author's Row section of the tax website unclefed.com.

[2] State tax authorities can also prosecute for failure to file, but in general the states leave criminal enforcement activity to the IRS, and that will be the focus of this article.

[3] In 2001, the IRS made prosecution recommendations to the Department of Justice Tax Division in 2,511 cases. Half of these cases were rejected by the Tax Division, but of those that were authorized for prosecution, 91% resulted in convictions. Failure to file cases made up only

Section §7203 of the Internal Revenue Code makes it a misdemeanor to willfully fail to pay any tax or to make a return.[4] Four distinct situations are covered: (1) failure to pay a tax; (2) failure to file a return; (3) failure to keep records; and (4) failure to supply information. Despite this range of potential application, §7203 is used most often to prosecute the willful failure to file income tax returns, though each year the government does bring a small number of cases for willful failure to pay.

Each time the obligation to file arises and the taxpayer willfully fails to comply, a separate offense is committed. This means that each tax year for which a return is not filed is charged separately, so failing to file five years worth of returns yields five separate criminal charges, rather than a single charge for a continuing offense.[5] The statute of limitations on prosecution is six years from the due date of the tax return in question.[6]

The "elements" of the offense of willful failure to file, each of which must be proven by the government beyond a reasonable doubt, are as follows:

- The defendant was a person required to file a return.
- The defendant failed to file at the time required.
- The failure to file was willful.

11% of tax prosecutions in 2001, with 34% being evasion cases (see discussion below), and 55% charging other tax offenses such as money laundering and currency transaction violations. (Transactional Records Access Clearinghouse, Syracuse University, Analysis of IRS and Dept. of Justice Data)

[4] IRC §7203 states in part "(a)ny person required under this title to pay any estimated tax or tax, or required by this title or by regulations made under authority thereof to make a return, keep any records, or supply any information, who willfully fails to pay such estimated tax or tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction thereof, shall be fined not more than $25,000 ($100,000 in the case of a corporation), or imprisoned not more than 1 year, or both, together with the costs of prosecution."

[5] U.S. v. Stuart, 689 F.2d 759, 763 (8th Cir. 1982); U.S. v. Harris, 726 F. 2d 558, 560 (9th Cir. 1984).

[6] IRC §6531. The due date includes filing extensions; see e.g. U.S. v. Goldstein, 502 F.2d 526 (3rd Cir. 1974).

The requirement to file an individual income tax return is based on the taxpayer's gross income, so to sustain its burden of proof the government must show that the taxpayer had the requisite amount of gross income.[7] This may be proven by direct or indirect methods.[8]

Often clients can't fathom the application of the term "failure to file" to their own situations. Except for those suffering from the self-serving delusions characteristic of tax protesters,[9] rarely do people affirmatively decide not to file -- they honestly intend to file some day, but they just haven't gotten around to it yet. What they don't adequately appreciate is the legal significance of doing things when the law requires them to be done. As the Supreme Court explained, "(p)unctuality is important to the fiscal system, and these are [criminal] sanctions to assure punctual as well as faithful performance of these duties."[10] Taxpayers have an endless variety of reasons why they are "late" in filing, and though nothing excuses the failure to file, the facts and circumstances do bear on the important question of willfulness.

One thing the typical nonfiler client will want to know is the level of risk that the IRS will initiate a criminal investigation. The answer depends on the unique facts of each case. But you can draw some conclusions by looking at the Service's internal guidance to its own agents. The IRS "pre-screens" the hundreds of thousands of nonfilers cases that it identifies each year[11] to determine which ones should be referred to the Criminal Investigation Division, and the Internal Revenue Manual lists the factors to be considered in deciding whether to make the referral:[12]

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[7] U.S. v. Wade, 585 F.2d 573, 574 (5th Cir. 1978).

[8] The "indirect" methods include a bank deposits analysis, or an analysis of the taxpayer's net worth and expenditures.

[9] As but one example, see U.S. v. Melton, 86 F.2d 1153 (4th Cir. 1996). Many good websites expose the fraudulent activities and bogus arguments of the protester promoters, including www.ustreas.gov/irs/ci/tax_fraud and www.taxprophet.com, but the wackos and con artists are also well represented on the internet.

[10] Spies v. U.S., 317 U.S. 492, 496 (1943).

[11] In 2001, the IRS initiated 1,310,000 Taxpayer Delinquent Return Investigations (or TDIs in IRS-speak).

[12] IRM 4.19.1.6.12.2 (10-1-2001).

- History of nonfiling.
- Repeated contacts by the Service.
- Indication of knowledge of the filing requirements (i.e. a professional with an advanced education, the person who works directly in the tax field, etc.).
- Age and occupation of the taxpayer.
- Substantial tax liability after credits and payments.
- Large number of cash transactions.
- Indications of significant unreported income.

Please take careful note the reference above to "the person who works directly in the tax field." It is sad but true that tax accountants and lawyers are disproportionately represented among the ranks of nonfilers, and given the chance the IRS is delighted to prosecute them because of the perceived impact on "voluntary compliance."[13]

Willfulness.

Willfulness is acting with a particular state of mind; in particular a "voluntary, intentional violation of a known legal duty."[14] In this regard, it is important to distinguish between "intent" and "motive." The IRS doesn't need to prove an evil motive or a bad purpose, such as an intent to defraud the government.[15] Even a good purpose would not excuse a deliberate decision not to file a return which the taxpayer knew ought to be filed. Rather, criminal intent is proven when the government shows that the taxpayer's nonfiling was "voluntary and purposeful and with the specific intent to fail to do that which he knew was required."[16] On the other hand, an attitude of mere "careless and reckless disregard" does not constitute willfulness.[17]

Proving willfulness is typically the biggest challenge facing the government in criminal tax prosecutions. Because taxpayers seldom make clear, unambiguous inculpatory statements about their intent, the IRS must prove intent through indirect evidence. The most common

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[13] Conviction for willful failure to file can easily lead to the loss of one's license to practice.

[14] Cheek v. U.S., 498 U.S. 192 (1991); U.S. v Pomponio, 429 U.S. 10, 12 (1976).

[15] U.S. v. McCorkle, 511 F.2d 482, 484 (7th Cir. 197_), *cert. denied* 435 U.S. 971 (1978). See also U.S. v. Moylan, 417 F.2d 1002, 1004 (4th Cir. 1969), *cert. denied*, 397 U.S. 910 (1970).

[16] U.S. v. Wilson, 550 F.2d 259, 260 (5th Cir. 1977).

[17] U.S. v. Eilertson, 707 F.2d 108, 109-110 (4th Cir. 1983).

evidence is a pattern of failing to file year after year.[18] Missing one return may be a mistake, but failing to file for five, ten or fifteen years is something quite different. For this reason the IRS looks for cases with a pattern of at least three years of nonfiling. An intent to file and pay one's tax in the indefinite future is not a defense, and does not prevent a finding of willfulness.[19] Indeed, in some cases evidence that the taxpayer later filed the missing returns and paid the tax has been excluded at trial. You can't unring the bell, or putting it more elegantly, "subsequent conduct cannot relieve a taxpayer from criminal liability for failure to file tax returns on or before their due date."[20]

Other evidence of intent can involve anything which gives the jury a glimpse of the taxpayer's knowledge, planning or purpose. For example, thwarting normal tax withholding by filing a W-4 claiming exemptions far beyond anything that could be justified can show that the taxpayer planned all along to fail to file his tax returns.[21] Similarly, filing returns for years when refunds were due, but failing to file returns in years when tax was owed suggests a level of thoughtful planning and decision inconsistent with mere honest mistake or misunderstanding.[22]

Prosecuting nonfilers -- tax evasion (§7201).

Violations of IRC §7203 are misdemeanors with a maximum sentence of one year per count. But in extreme cases a taxpayer's willful failure to file returns can be shown to be part of a scheme to evade tax, and in such cases the government can prosecute for the felony offense of tax evasion under IRC §7201.[23] Again each tax year is a separate offense.

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[18] U.S. v. Greenlee, 517 F.2d 899, 903 (3rd Cir.); *cert. denied* 423 U.S. 985 (1975).

[19] Sansone v. U.S., 380 U.S. 343, 354 (1965).

[20] U.S. v. Bourque, 541 F.2d 290, 294 (1st Cir. 1976).

[21] U.S. v Shivers, 788 F. 2d 1046, 1048 (5th Cir. 1986).

[22] U.S. v. Garguilo, 554 F.2d 59, 62 (2d Cir. 1977).

[23] IRC §7203 states in part "(a)ny person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution."

Tax evasion can be one of two crimes, or both: (1) attempting to evade assessment, or (2) attempting to evade payment. Failing to file can be part of a scheme to evade both assessment and payment, and can be charged as such if in addition to the failure to file itself the government can prove appropriate "affirmative acts."[24] Affirmative acts constituting evidence of tax evasion include the making of false statements,[25] especially false W-4s reducing or eliminating the withholding of taxes on the defendant's wages.[26] Other affirmative acts of evasion include placing assets in others' names, dealing in currency, and paying other creditors instead of the government;[27] lying to IRS agents;[28] and laundering money or moving funds offshore.[29] Probably the most quoted list of actions evidencing an affirmative, willful attempt to evade tax was presented by the Supreme Court in Spies v. U.S., 317 U.S. 492, 499 (1943):

> . . . keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal.

So influential was the Spies decision that failing to file a return, coupled with an affirmative act of evasion, has come to be known as "Spies-type evasion." An example is U.S. v. Goodyear, 649 F.2d 226 (4th Cir. 1981). The Goodyears failed to file for the tax year in question, but later falsely told IRS agents that they had earned no income in that year and therefore weren't required to file a return. These false statements to the agents were the affirmative acts of evasion which elevated the charges from a failure to file misdemeanor to felony evasion, and the Goodyears were in due course convicted and sentenced under §7201.

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[24] Failing to file a return, standing alone, is not an attempt to evade. Spies v. U.S., 317 U.S. 492, 499 (1943); U.S. v. Nelson, 791 F.2d 336, 338 (5th Cir. 1986).

[25] U.S. v. Callanan, 450 F.2d 145, 150 (4th Cir. 1971).

[26] U.S. v. DiPetto, 936 F.2d 96 (2nd Cir.), *cert. denied* 502 U.S. 866 (1991).

[27] Cohen v. U.S., 297 F.2d 760, 762, 770 (9th Cir.), *cert. denied*, 369 U.S. 865 (1962); U.S. v. Hook, 781 F.2d 1166, 1169 (6th Cir.),, *cert. denied*, 479 U.S. 882 (1986); U.S. v. Shorter, 809 F.2d 54, 57, (D.C. Cir.), *cert. denied*, 484 U.S. 817 (1987).

[28] U.S. v. Brimberry, 961 F.2d 1286, 1291 (7th Cir. 1992).

[29] U.S. v. Voorhies, 658 F.2d 710, 712 (9th Cir. 1981).

Voluntary disclosure policies.

From time to time a taxpayer, especially one who has the benefit of informed representation, will decide to correct his nonfiling before the government gives him a new wardrobe and a new mailing address. Usually this can be safely accomplished under the IRS and Department of Justice "voluntary disclosure" policies. We could devote an entire article to the history of these policies. However, the basic operative rule is that in general prosecution will not be pursued if a nonfiler (with income from legal sources only) corrects his past mistakes by filing his delinquent returns before coming under scrutiny by the IRS Criminal Investigation Division.[30] The IRS's latest formulation of this policy, just revised and released in December 2002,[31] reads in part as follows:

> (3) A voluntary disclosure occurs when the communication is truthful, timely, complete, and when:
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> > a. the taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining his or her correct tax liability; and
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> > b. the taxpayer makes good faith arrangements with the IRS to pay in full, the tax, interest, and any penalties determined by the IRS to be applicable.

Distilled to its essential minimum, there are two key requirements: (1) the disclosure must be timely, and (2) thereafter the taxpayer must fully cooperate with the government. Here's the latest IRS explanation of when a disclosure is deemed "timely:"

> (4) A disclosure is timely if it is received before:
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> > a. the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation;
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> > b. the IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific taxpayer's noncompliance;

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[30] See §4.01 *et seq.* of the Department of Justice Tax Division Manual for Criminal Tax Trials.

[31] IRM 9.5.3.3.1.2.1 (12-11-02); IRS News Release IR-2002-135 (12-11-02).

> c. the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or
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> d. the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

The disclosure is not timely if the IRS has already initiated an investigation, or if the taxpayer is aware of some event which is likely to lead to such an investigation.

As an example of being a day late and a dollar short, consider U.S. v. Crawford, 121 F.3d 700 (4th Cir. 1997). Mr. Crawford got a call from an IRS Special Agent, who set up an appointment to interview him the next day. That evening, Crawford went to his faithful accountant, and they worked all night to prepare four delinquent tax returns. The returns were filed the next day, with payment, prior to the meeting with the Special Agent. The IRS saw no "voluntary disclosure" problem, and Mr. Crawford was in due course convicted of failure to file and obstruction of justice.

Though it is too late once the Special Agent calls, the new policy pronouncement by the IRS confirms that the Service truly wants to bring noncompliant taxpayers back into the system. In particular, it clarifies the situation of someone who has received a "nonfiler notice" inquiring about missing returns, assuring them that the receipt of the notice does not deprive them of the chance to get right with Uncle Sam without being prosecuted. Specifically, it includes the following as an example of a timely voluntary disclosure:

> (6) Examples of voluntary disclosures include:
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> d. A disclosure made by an individual who has not filed tax returns after the individual has received a notice stating that the IRS has no record of receiving a return for a particular year and inquiring into whether the taxpayer filed a return for that year. The individual files complete and accurate returns and makes arrangements with the IRS to pay the tax, interest, and any penalties determined by the IRS to be applicable in full. This is a voluntary disclosure because the IRS has not yet commenced an examination or investigation of the taxpayer or notified the taxpayer of its intent to do so and because all other elements of (3), above, are met.

This eliminates the concern that the "contact" from the Service precludes making a protected voluntary disclosure. Note also that not having the money to pay the tax in full is not an impediment to a voluntary disclosure. It is sufficient if the taxpayer "makes arrangements with

the IRS to pay the tax." This can include an installment agreement, and offer in compromise, or any other reasonable and cooperative approach to dealing with the liability.

Preparing to make the disclosure.

As should by now be clear, getting to the IRS before the IRS gets to the taxpayer can mean the difference between simply filing the missing returns and dealing with the tax, or being prosecuted and sent to jail. Accordingly, it is extremely important to get the voluntary disclosure process moving as soon as the options have been fully considered and it is determined that a disclosure is possible and appropriate under the circumstances. Unfortunately, it may take weeks or months to actually assemble the missing tax returns. Should one avoid any contact with the IRS until the returns are ready? Each case must be carefully considered in light of its own unique facts, but often it is best to make a preliminary disclosure to the Service stating that certain returns are unfiled, that the taxpayer has arranged for the preparation of the returns, and that they will be filed as quickly as careful fact gathering and preparation permits. This preliminary disclosure could offer protection if by some horrible coincidence a criminal investigation begins before the delinquent returns are ready to be filed. Furthermore, since nonfilers are inveterate procrastinators by nature, taking the important and irrevocable first step of notifying the IRS that the taxpayer exists, that he hasn't filed, and that the tax returns are being readied for submission, tends to "encourage" the client to carry through and complete the process.

Every practitioner who represents nonfilers has his or her own preferred method, but one effective way of making the first contact with the IRS is through a Freedom of Information Act request filed with the local Disclosure Office. After all, often the IRS itself will be the best source for much of the information needed to prepare the delinquent tax returns. Specifically, the IRS can provide (1) "record of account" transcripts for each of the tax years in question so you can see which returns are missing,[32] (2) the computations used for any substitute for return assessments the IRS has made, (3) payor information printouts showing W-2s, 1099s, 1098s and other "information returns," and (4) return transcripts showing the data on the most recently filed returns line by line. And as stated above, the request itself puts the IRS on notice that a voluntary disclosure is in process.

In addition to whatever is available from the IRS, the practitioner will also need a great deal of help from the client. Other information can be obtained from the taxpayer's employers,

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[32] No, the client often will not know. The only way to live with a problem like this without going nuts is to put it out of your mind, so many nonfilers are shocked when they learn just how long it has been since they actually filed their tax returns.

banks and brokers. But in the end, especially when tax returns need to be prepared going back many years, it may be necessary to rely on reasonable, good faith estimates for some items. The use of any such estimates must be disclosed in the returns, and the assumptions and methodology should be carefully documented in case the IRS wants to know how the estimates were derived.

Period of retroactive compliance.

Another question a nonfiler client will want you to answer is how far back you will have to go in preparing returns. For someone who hasn't filed for three years, the answer is easy. But what about the guy who hasn't filed since the Redskins were in the Superbowl? The three year statute of limitations on assessment begins to run on the date the tax return is filed, with the result that if the return has never been filed the IRS can assess the tax forever (or as I like to tell clients, "three years from never is a long time from now"). This being said, in dealing with a noncompliant taxpayer who wants to correct the error of his ways, for its own administrative reasons the IRS will not insist on the filing of tax returns so old that even finding the blank forms would require a degree in archeology. Generally, the Service will demand tax returns going back only six years. Indeed, managerial approval is required if an agent wishes to pursue enforcement activity for anything more than or less than this six year retroactive compliance period.[33]

Interest and penalties.

Once the missing returns are prepared, they will show how much tax is owed. Interest and penalties, however, must be calculated so that the full magnitude of the client's problem will be known.[34] Numerous penalties can be asserted against nonfilers, including the late filing penalty and a special version of the civil fraud penalty.

The late filing penalty is 5% for each month, or part thereof, to a maximum of 25% (§6651(A)(1)). It is computed on the net amount due on the return after any timely payments or

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[33] IRM 4.12.1.3 (05-03-1999) provides that in determining whether to deviate from the normal six year enforcement period the following factors should be considered: the taxpayer's prior history of noncompliance, the existence of income from illegal sources, the effect on voluntary compliance, the anticipated revenue in relation to the time and effort required to determine the tax due, and any special circumstances of a particular taxpayer, class of taxpayer, or industry.

[34] Computing penalties and interest can be very complicated. A convenient software program called TaxInterest is available at a reasonable price from Time Value Software (www.timevalue.com). The program is used by some IRS functions, including the Appeals Office, to quickly estimate penalties and interest.

credits. It accrues on the due date of the return, so interest runs on the penalty itself as well as on the tax. If the failure to file is due to fraud, the penalty is tripled to 15% per month to a maximum of 75% (§6651(f)).[35]

In addition, a late payment penalty is imposed at 0.5% per month for failure to pay the tax shown on a return or an assessed deficiency, again to a maximum of 25% (§6651(a)(2)). If the IRS issues a notice of intent to levy, this penalty increases to 1% per month (§6651(d)), and in some cases if the taxpayer has entered into an installment agreement it can be reduced to 0.25% per month (§6651(h)). The late filing and late payment penalties are "coordinated" so that the combination is limited to 5% for any month for which both penalties would apply.[36]

Delinquency penalties can be avoided by showing that the late filing or late payment was due to "reasonable cause and not willful neglect." It is therefore important to gather and fully document any facts that might support a reasonable cause argument. The IRS's interpretation of reasonable cause for this purpose is presented in Part 20 of the Internal Revenue Manual. According to the Manual, "any reason which establishes that the taxpayer exercised ordinary business care and prudence, but was unable to comply with a prescribed duty within the prescribed time, will be considered."[37] A reasonable cause argument has a much better chance of success if it provides answers to the questions which the Manual instructs agents to consider:

- What happened and when did it happen?
- What facts and circumstances prevented the taxpayer from filing a return, paying a tax, or otherwise complying with the law?
- How did the facts and circumstances prevent the taxpayer from complying?
- How did the taxpayer handle the remainder of their affairs during this time?
- Once things changed, what attempt did the taxpayer make to comply?

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[35] IRM 20.1.2.7 (7-31-2001); Stephen M. Harris, "A Primer on the Civil Fraud Penalty," 97 Tax Notes 1509 (2000).

[36] IRS Chief Counsel Memorandum ILM 1997-10.

[37] IRM 20.1.1.3.1 (8-20-1998). Regs. 301.6651–1(c); IRS Policy Statement P–2–7.

The greatest problem facing most nonfilers in securing relief from the delinquency penalties is their long history of noncompliance. The Internal Revenue Manual specifically requires considering the taxpayer's compliance history in deciding whether to abate penalties:

> Compliance History. Check the preceding tax years (at least 2) for payment patterns and the taxpayer's overall compliance history. The same penalty, previously assessed or abated, may indicate that the taxpayer is not exercising ordinary business care. If this is the taxpayer's first incident of noncompliant behavior, weigh this factor with other reasons the taxpayer gives for reasonable cause, since a first time failure to comply does not by itself establish reasonable cause.

Nevertheless, given the magnitude of the penalties, all available arguments are worth making, especially if there is evidence of something that was outside the taxpayer's control. The IRS's stated position is that "(r)easonable cause is generally established when the taxpayer exercises ordinary business care and prudence but, due to circumstances beyond the taxpayer's control, the taxpayer was unable to timely meet the tax obligation."[38]

Filing status.

As regular readers of this series of articles on dealing with the IRS Collection Division will most certainly know, determining the appropriate filing status for the returns of married taxpayers requires far more thought and analysis than it often receives. It is not appropriate to merely assume that because the taxpayers are married their returns will of course be filed "married filing jointly." In every engagement, particularly one involving the preparation of a series of unfiled income tax returns, any sapient tax professional will ask himself two key questions:

(1) Who is my client?

(2) Once the returns are filed, can the tax be paid?

Remember, you can always amend from separate returns to a joint return, but you can't go the other way. The decision to file married filing jointly is irrevocable. And even as expanded by the IRS Restructuring and Reform Act of 1998, the innocent spouse rules will not save your bacon if it later becomes clear that filing the delinquent returns jointly was a strategic blunder. The innocent spouse rules work well for divorced, widowed or separated persons trying to

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[38] IRM 20.1.1.3.1.2(2)(d) (8-20-1998).

escape tax deficiencies resulting from a spouse's unreported income or erroneous deductions. But they are almost useless with regard to taxes shown on a joint return but not paid.[39]

In this regard, whether the tax is owed jointly or only by one spouse has important consequences when it comes to resolving the liabilities through bankruptcy or an offer in compromise.[40] Some clients or even return preparers will protest "but filing separately results in a higher total tax. . ." Please! This is only relevant if the total liability (including federal and state taxes, penalties and interest) is actually going to be paid. Always remember that one unpayable amount is the exact functional equivalent of any other unpayable amount. The minor "savings" resulting from filing jointly is completely meaningless if the total amount owed is so large that it can't be paid anyway and will have to be resolved through bankruptcy or an offer in compromise.[41]

Time-barred refunds.

Most nonfiler cases involve substantial unpaid tax liabilities. Indeed, it is often the fear of filing a return showing a balance that the taxpayer can't afford to pay that starts the cascade of nonfiling. In some cases, however, the taxpayer may actually be due a refund for at least some of the years for which returns are unfiled. One of the many nasty surprises awaiting such taxpayers is that these refunds may be time-barred. The IRS cannot issue a refund if a claim (here, the tax return itself) is not filed by the later of three years from the return due date or two years from the date of payment.[42] This rule prohibits not just mailing the taxpayer a refund check, but even crediting the overpayment against underpayments in other tax years.

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[39] See the author's articles on the innocent spouse rules in The Freestate Accountant, Aug-Sep 1998 and Jun-Jul 2000, or at the tax website unclefed.com.

[40] See the author's articles on negotiating offers in compromise and discharging taxes in bankruptcy in The Freestate Accountant, Dec-Jan 1999 and Feb-Mar 1999, or at unclefed.com.

[41] It is impossible to overstate the importance of thinking about these issues before irrevocable actions are taken. Let's put it this way: Imagine the phone call with the lawyer for the wife of a businessman client for whom you prepared five years worth of delinquent income tax returns a while back, and who now has to join her husband in declaring bankruptcy because the tax returns were filed jointly even though she had no income, with the result that the family home will be unnecessarily lost to the IRS. Your next call would be to your malpractice carrier.

[42] IRC §6511(a); IRM 25.6.6.4 (10-1-2001).

A word to the wise: Because of harsh effect of the statute of limitations on refunds, tax professionals are well-advised to check for any possible statute of limitations bar dates at the initial meeting with the client or shortly thereafter. While the client may have created the problem entirely on his own by not filing for many years, he will nevertheless be upset to learn that a refund bar date passed after his initial meeting with you but prior to the preparation of his delinquent returns. If a bar date is looming, obviously that particular return needs immediate attention, even if this means filing on the basis of good faith estimates and then amending the return later after the facts are more fully known.

IRS substitute for return procedures.

The IRS focuses on finding nonfilers and bringing them back into the tax system, while prosecuting some particularly extreme cases so that the resulting publicity will foster "voluntary compliance" among others. The IRS identifies nonfilers primarily by matching W-2s, 1099s and K-1s to taxpayer accounts, a process which is becoming increasingly automated and efficient.[43] When nonfilers are found, the IRS often utilizes its authority under §6020(b) to assess the tax, penalties and interest.[44]

These substitute for return (or SFR) procedures are sometimes thought of as the IRS preparing the delinquent taxpayer's returns, although this is not really what is going on.[45] Instead, the SFR procedures are more akin to those by which deficiencies are asserted on filed tax returns.[46] Specifically, the taxpayer is given a "nonfiler notice," which includes a report explaining the amount and basis of the proposed assessment, and he then has 30 days to agree or to file a protest letter seeking a conference with the appeals office. If no response is received, the Service issues a statutory notice of deficiency (i.e. a 90-day letter), whereupon the taxpayer can

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[43] See IRM 5.1.11.8(1) *et seq.* for a description of the IRS's "Automated Substitute for Return (ASFR) system by which the Service Centers assess taxes for wage earners who fail to file.

[44] IRC §6020(b) states "(i)f any person fails to make any return required by any Internal Revenue Law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise."

[45] The IRS does have the authority under §6020(a) to prepare a return for a taxpayer with the taxpayer's cooperation, but that is not the approach taken in the typical nonfiler case.

[46] See IRM 4.1.4.23 *et seq.* (5-19-1999).

file a petition with the Tax Court. If no petition is filed, the tax is assessed and the collection process begins.[47]

Just as it is best to correct the nonfiling before a criminal investigation starts, it is also advisable to file the missing tax returns before an SFR assessment is made. First, SFR assessments are often wrong. The IRS gives the taxpayer credit for only one personal exemption and the standard deduction. They also take income from K-1s, while ignoring expenses or losses shown on those same K-1s.[48] Furthermore, there is a great deal of information the IRS just doesn't have. For example, the taxpayer may have substantial itemized deductions or loss carryforwards. Or a broker may have filed a Form 1099-B showing the gross proceeds from sale of securities, but the IRS has no way to know the taxpayer's basis in the securities sold. The IRS therefore assumes that the net gain is equal to the amount realized shown on the Form 1099-B. Obviously, this can overstate the gain, or even show a gain when there was a large net loss.

Perhaps even more importantly, there is at present a split of opinion among the federal courts as to whether a document purporting to be a tax return and properly signed under penalties of perjury is effective as a return if it is filed after an SFR assessment has been made.[49] This can be crucial if the taxpayer later seeks relief in bankruptcy. Under BC §523(a), an income tax debt is dischargeable in a Chapter 7 case only if the bankruptcy petition is filed more than two years after the filing of the tax return for that year. But if a delinquent tax return given to the IRS after

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[47] Sometimes it is the wage levy served to collect on the SFR assessment that finally brings the taxpayer to your office. In other cases you might be able to quickly negotiate an installment agreement and get the levy released. But with a nonfiler, the IRS will keep the levy in place until "current compliance" is achieved. This may launch you into furiously preparing those returns which remain delinquent so they can be filed and the installment agreement implemented before the client's next paycheck is due.

[48] IRS Chief Counsel Memorandum 200142024 (10-19-2001).

[49] The problem stems from two decisions in the Sixth Circuit: In re Hindenlang, 164 F.3d 1029 (6th Cir. 1999) and In re Mickens, 214 B.R. 976 (N.D. Ohio 1997), aff'd, 173 F.3d 855 (6th Cir. 1999). These cases hold that a return filed after an SFR assessment is a nullity and not effective for purposes of BC §523(a)(1). These opinions, and some which have followed them in the Third and Eleventh Circuits, are in conflict with decisions in the Seventh, Ninth and Tenth Circuits, including Woods v. IRS, 2002 Bankr. LEXIS 1092 (Bankr. S.D. Ind. 2002), In re Crawley, 244 B.R. 121 (Bankr. N.D. Ill. 2000), In re Nunez, 232 B.R. 778 (BAP 9th Cir. 1999), and In re Savage, 218 B.R. 126 (BAP 10th Cir. 1998). There are no reported opinions in the Fourth Circuit or the D.C. Circuit addressing this question, so the law here is at present unclear.

an SFR assessment has been made is not considered a tax return, then this two year requirement can never be met. When returns haven't been filed for many years, often the taxes, penalties and interest accrue to a sum far beyond the taxpayer's ability to pay, and a discharge in bankruptcy may be the only way out. Hence, preserving the opportunity to obtain relief in bankruptcy by avoiding SFR assessments is extremely important, and is yet another reason for the delinquent taxpayer to get to the IRS before the IRS gets to him.

Conclusion.

Many things can happen to nonfilers, and all of them are bad. Trying to heal these self-inflicted wounds is often difficult and time-consuming. But if the client truly wants to expiate his past sins and make a fresh start, it can be a rewarding engagement of great benefit to the client, his family, and to the tax system. Effective representation requires recognizing the legal and ethical problems presented by such cases, gathering and carefully evaluating the facts, formulating an appropriate course of action, and following through over a period of months or even years. It is hoped that the information presented in this article will help you deal with these complex issues with confidence and success.