GET WITH THE IRS SOONER, RATHER THAN LATER OVER UNFILED RETURNS

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Many times, small business owners get so focused in the daily task of managing their business that do not keep detailed records of income and expenses. After years of poor record keeping, many people eventually become overwhelmed and stop filing tax returns. This anxiety is also compounded by the fact that many have heard that they can go to jail for failing to file. However, with some guidance, non-filers can begin to make up their unfiled returns and better control the financial aspects of their business.

Criminal Issues

In the vast majority of cases, the IRS is focused on securing compliance and payment of a late-filed tax liability. It is important to remember, however, that the IRS will not issue refunds on late filed returns if they are filed more than three years from the original due date. IRS policy is to accept a voluntary submission of up to the last six years of unfilled returns as an indicator of full compliance.

The IRS is more likely to consider criminal charges against a non-filer in a high-income bracket that is educated and maintains a professional status. High risk is also attendant to a non-filer who engages in frivolous IRS correspondence, misses IRS appointments and makes false statements to the IRS. A pattern of non-filing is also preferred. Many unfiled returns prove a greater intent than a few. Cash transactions and large amounts of unreported income also indicate intent to hide income from the IRS.

The IRS focuses its criminal agents on specified target areas (tax return preparer fraud), targets of public interest, cash dealings and severe manipulations of the tax code. Non-filing is serious, but not always criminal. This should not be down played, but rather used as a source of fact as to what most non-filers should focus on: preparing accurate returns and addressing balance due/refund issues.

IRS Action When No Return is Filed

The IRS has the authority to prepare and file estimated returns for you if it is not done voluntarily. These estimates, often referred to as substitute returns, are based on information available to the IRS (such as W-2s and 1099s). Estimated returns gives the IRS a mechanism to get an assessment on its books to start collection proceedings. It is common to get a bill from the IRS even if no return is filed.

However, the balance determined by the IRS will almost always be higher because it does not take expenses into account. For example, for self-employed taxpayers, the IRS will prepare a Gross Return without any deductions for subcontractors, cost of goods sold, materials or other expenses. An estimated return filed by the IRS will also not allow mortgage interest, employee business expenses or basis in stock sales.

An original return can be filed with the IRS to lower the liability. Although acceptance of the original return is voluntary with the IRS after an estimated amount is put on its books, the IRS usually will accept an original return filed in good faith. However, if the IRS does not accept the original return, you will have no choice but to pay the liability and file a claim for refund or file a petition to U.S. Tax Court.

Preparing Tax Records Acceptable to the IRS

There are a number of ways to account for your income and expenses so that it is acceptable to the IRS.

To account for income, you can obtain W-2's or 1099's from your employers or the IRS if you did not retain copies. Upon request, the IRS will provide you with the information that has been reported to it about you, including wages, withholding, miscellaneous income, dividends, interest, gross proceeds from stock sales and mortgage interest paid.

When the W-2's or 1099's do not exist, or they are inadequate, indirect methods can be used for determining income.

One indirect way to account for income is using total expenditures as a measure of income. The presumption is that if you spent it, you earned it.

Another method is to use bank account deposits to establish income. Loans and gifts should be identified on the bank deposits so as not to be included as income.

To account for expenses, it is permissible to establish good faith estimates that recreate expense habits if direct records are inadequate. If it can be established that a deductible expense was incurred but there is no proof of payment, the amount of the deductible can be reasonably recreated and estimated. There must be credible evidence that provides a rational basis for the estimate.

For example, for business use of automobiles, determine how many miles have been driven in a year and what per cent was for business. Calendars can be referenced to recreate a log of business trips. If a prior year return was filed based on actual records, it can serve as a reference point to determine a range of expenses.

Interest and Penalties for Non-Filers

While it is easy to get behind on filing taxes, non-filing can be expensive. The IRS calculates interest on both tax and penalties due on unfiled returns, beginning on the original due date. Penalties can be up to 25% of the tax owed. Interest runs from the due date of the returns. As a general rule, for every five years that a return remains unfiled, the original tax amount will double. The sooner a non-filer files, the sooner you will regain control over your taxes and income.

Howard Levy is a former trial attorney for the IRS and has a Masters of Laws in Taxation. His tax practice includes IRS Collection Proceedings, U.S. Tax Court Proceedings, IRS Offers in Compromise, IRS Administrative Appeals and the use of bankruptcy to resolve IRS controversies. He is a frequent speaker on the IRS locally and nationally. A member of Voorhees & Levy, LLC, Cincinnati, Ohio, Levy can be contacted at howard@voorheeslevy.com.