

REPRESENTING NON-FILERS

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Non-filers are often overwhelmed by their predicament. Many times they have heard that they could go to jail for not filing tax returns. Some are paralyzed by poor record keeping that makes them believe that preparing a return is impossible. Others are overwhelmed by the large number of tax returns they have failed to file. Tendency to avoid the problem is also compounded by the realization that they will owe money to the IRS if the returns are filed.

Enrolled agents can help non-filers find solutions to these concerns by separating fact from myth. An enrolled agent can then advise a client on real versus perceived criminal issues, common IRS enforcement techniques against non-filers and options to overcome poor record keeping. Understanding each component of the problems facing a non-filer will help resolve collection issues before they occur.

IRS Enforcement of Filing Requirements

There are limitations on how many returns a non-filer needs to prepare to get current with the IRS. It is not an open ended process.

IRS Policy Statement P-5-133, effective August 6, 2006, provides guidelines as to enforcement actions against non-filers. In most circumstances, IRS policy is that they will accept the last six years of returns to cure a pattern of non-filing.

The IRS considers non-filing to be problematic in “balance due” account situations only. The IRS will pursue non-filers only when indications are that there will be a balance due on the return. If IRS indicators reflect that securing the return will result in a refund, no contact will be made with the taxpayer. The IRS devotes its resources to pursuing the accounts that appear to be unpaid, not in generating refunds. There are also no civil or criminal implications for non-filers of refund returns.

Criminal Issues

In the vast majority of non-filing cases, the IRS is focused on the problem at hand: bringing the target into compliance and securing payment of the liability. Most non-filing cases are limited to these issues.

The IRS cannot pursue each and every non-filing case for criminal prosecution. 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. The garden variety non-filer does not fall within any of these categories. Non-filing is serious, but not always criminal.

In fiscal year 2006, the IRS Criminal Investigation Division opened 3,907 cases. Of these, 562 taxpayers were investigated for criminal acts associated with non-filing. Non-filers comprised 15% of the total criminal investigations initiated by the IRS in fiscal year 2006. This rather low rate of criminal investigation of non-filers (compared to the number of non-filers overall) should not be down played, but rather used as a source of fact as to what a non-filer should focus on (preparing accurate returns and addressing collection/balance due issues).

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.

Criminal tax fraud involves willfulness, an act of conduct done with a bad or evil purpose.

There is no limitations period for the prosecution of criminal tax fraud on unfiled returns. Once a return is filed, the limitations period is six years from the date of filing.

Methods of Determining Income for the Returns

Many non-filers have poor record keeping and believe that preparing a return is impossible without records. Record keeping issues should not prevent the filing of past due returns or accounting for earned income. There are solutions for poor record keeping. There are both direct and indirect methods available to determine taxable income when a taxpayer does not have any records.

A direct method involves obtaining the W-2's or 1099's for use on the return. Unfortunately, many non-filers no longer have these records, or the records are incomplete. These documents can be obtained with a power of attorney from the taxpayer and contacting the IRS Practitioner Priority Service at (866) 860-4259.

The Practitioner Priority Service will provide IRS transcripts detailing the information that has been reported to the IRS, including wages, withholding, miscellaneous income, dividends, interest, gross proceeds from stock sales and mortgage interest paid. These records will identify the information that has been

reported to the IRS and insure that, at the very least, the return matches the IRS records.

When no books and records exist, or they are inadequate, indirect methods can be used to determine income. These methods are commonly used by the IRS to prove income in cases where no direct evidence exists. The most common indirect methods are the net worth method, the total expenditures method, and the bank deposits method.

The net worth method is based on a presumption that an increase in assets (or net worth) from one year to the next indicates income earned. The amount of increase is determined by establishing a net worth at the beginning of a given year and then comparing this beginning net worth with the net worth at the end of the year.

The total expenditures method is similar to the net worth method, but uses personal expenditures instead of hard assets. The presumption is that the taxpayer is spending his or her earnings. This method is used when a taxpayer has spent substantial income on consumable goods and services such as food, vacations, travel, gifts to third parties, etc., as opposed to durable and tangible property such as stocks, bonds, or real estate. It is used most often where the taxpayer spends income to support a lavish life-style and has little, if any, net worth.

A review of a taxpayer's monthly personal expenditures is also a good way to double check the accuracy of the gross income on the return when using 1099's.

The bank deposits method of proving income utilizes bank account records to establish a taxpayer's income. All bank deposits are considered to be income unless proven otherwise. Loans and gifts should be identified on the bank deposits so as not to be included in income.

Methods of Determining Expenses for the Returns

Lack of verification of all expenses is also common for non-filers, and should not prevent the preparation of the returns. There are two ways of handling expenses on a late-filed return when no direct records exist.

One approach is to file a "gross return" that reports all income but does not reflect any expenses. If the taxpayer will owe money on the returns that cannot be paid (regardless of whether the expenses are claimed), there is no benefit of recreating and estimating the expenses. The non-filing will ultimately be a collection matter, with or without the expenses.

If the filing of a gross return is contemplated, a preliminary financial statement should be completed to analyze the taxpayer's collection potential with the IRS. If the taxpayer is a good candidate for an offer in compromise, or lacks any ability to ever pay the liability, gross returns should be considered.

When there is a financial possibility of repaying the liability or even generating a refund but expense records are nonexistent, it is permissible to establish good faith estimates that recreate the taxpayer's expense habits. If a taxpayer establishes that he or she paid a deductible expense but cannot substantiate the precise amount, the amount of the deductible expense can be estimated. Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930); Vanicek v. Commissioner, 85 T.C. 731, 742-743 (1985). There must be credible evidence that provides a rational basis for the estimate.

If a taxpayer has business use of a vehicle, determine how many miles he or she usually drives a year, and what percent is for business. Most taxpayers drive within a range year to year. Or they have a pretty good idea how often they fill up their tank, and how much a fill-up costs.

If a prior year return was filed based actual records, that return can also serve as a reference point to determine a range of expenses to income. For example, if subcontractors ran 25% of gross income in a prior year, comparisons can be used for current years' returns.

Non-filing situations are rarely audit situations in which every item of income and proof needs to be verified. The chances of an unfiled return being audited are low. The chance of an audit is outweighed by the greater interest of completing and filing a return as expeditiously and accurately as possible.

IRS Substitute for Returns

The IRS has the ability to prepare and file returns for taxpayers who do not cooperate in filing voluntarily. These returns are commonly referred to as "Substitute for Returns." The authority of the IRS to file returns for delinquent taxpayers is found in I.R.C. Section 6020(b).

Substitute for returns estimate the taxpayer's liability based on information available to the IRS, such as W-2's and 1099's. An IRS substitute for return will almost always result in a balance due that is higher than that on an actual return as it does not allow any expenses. The IRS can also prepare returns using the net worth, personal expenditures or bank deposits methods of determining income.

The IRS will usually refrain from making estimated returns when there are indications (such as sufficient withholding) that there will be a refund on the return.

For self-employed taxpayers, the IRS will prepare a gross return without any deductions for subcontractors, cost of goods sold, materials, etc. A substitute return will also not allow itemized deductions, exemptions or basis in stock sales. It frequently uses the wrong filing status.

A substitute return permits the IRS to get an assessment on its books to commence collection. Without the ability to file estimated returns, the IRS would be handcuffed in pursuing non-filers. It almost always will overstate the liability.

Procedurally, the filing of the substitute for return is preceded by an initial letter to the taxpayer requesting that the returns be voluntarily filed. When no response is received, the IRS will then send out two additional notices to the taxpayer consisting of (1) the preliminary notice of assessment and (2) a notice of deficiency.

The preliminary notice of assessment will list what the IRS proposes to put on the return and the amount of the liability. It will identify the sources of income used for the return, filing status, dependents and penalties that will be charged. The taxpayer will have the opportunity to agree with the proposal or submit information detailing the correct amounts, or file the original or the return.

If the IRS does not receive a response to the preliminary notice of assessment, it will proceed to prepare a Notice of Deficiency. The Notice of Deficiency is the final notice to the taxpayer of the substitute return filing. It gives the taxpayer 90 days to file a petition to U.S. Tax Court to dispute the estimated liability. If a petition is not filed to Tax Court, the IRS will make an assessment of the liability and proceed to collect the amount owed.

At any time in this process, the taxpayer can file the original return with the IRS to lower the liability. However, abatement and acceptance of processing the return is voluntary with the IRS after it has made an assessment. Although the IRS will, in most cases, accept an original return even after an amount is assessed, if it does not, the taxpayer will have no choice but to pay the liability and file a claim for refund.

IRS Pursuit of Non-Filers

In addition to the substitute for return notification process, the IRS Collection Division employs Revenue Officers to target non-filers. The Collection Division is used in non-filing cases as the compliance issue is identified as a collection problem. The IRS involves its collection function as it can simultaneously secure the returns and pursue payment.

Revenue Officers are most likely to pursue non-filers when the case involves

either a self-employment tax issue or employment taxes. A Revenue Officer will appear at a taxpayer's job or place of business and request that the taxpayer become compliant in his filings. Specific time tables will be demanded to file the returns. Revenue Officers have the ability to closely watch and monitor a target's activities and can act swiftly, if necessary.

When a Revenue Officer is assigned the task of securing unfiled returns, a letter will often be issued stating that the returns are unfiled and requesting that the account be brought current. If a courtesy contact fails, the IRS has the power to summons the taxpayer to bring the information to the Revenue Officer at a specified date and time. The IRS can also summons information from banks that will help it determine income.

Interest and Penalties for Non-Filers

Non-filing can be expensive. The IRS calculates interest on both tax and penalties due on unfiled returns. Interest runs from the due date of the return at rates generally between 6%-8%, depending on the economic environment. The IRS also pays interest on overpayments and refunds that are timely claimed. Generally, a taxpayer who files a return more than three years after its due date will not be eligible to receive any refunds.

In addition to interest, non-filers will have penalties on delinquent returns and substitute returns. These penalties include late filing (5% per month of the tax due up to a maximum of 25%), failure to pay (.5% per month of the tax due up to maximum 25%, increasing to 1% per month after a notice of intent to levy is issued) and negligence (20% of the tax due).

As a general rule, every five years, interest and penalties will double the tax originally due. For example: a \$10,000 tax due on a 2001 tax return that was filed in 2007 will result in a \$20,000 balance due when filed. The cost of non-filing is substantial when this is parlayed over several years of delinquencies.

Practical Considerations in Representing Non-Filers

The best way to file past due returns is by hand. With a non-filer, it is very important to retain proof of filing. To file by hand, take the returns and a copy to an IRS office – file the original, ask the IRS to time-stamp the copies for proof of filing.

The IRS often files substitute returns after a business is closed if the business fails to properly notify the IRS that it has ceased operations. This is common in employment tax situations, where the IRS will look for Form 941 returns not knowing that the business has closed. Final returns need to be filed notifying the IRS

that there is no additional filing requirement to prevent substitute returns from being filed after the business has closed.

When preparing late filed returns for married taxpayers, consideration should be given as to whether the liability should be split and attached more to one spouse than the other. This could eliminate the need for a spouse to raise innocent spouse claims with the IRS. Also, consideration should be given to protect the spouse with assets from the liability if that spouse did not cause the liability.

As late filing and nonpayment often coexist, a review of the taxpayer's financial options should always be part of the process. Preparation of financial statements for IRS collection purposes should be considered simultaneously with preparation of the returns. Proper planning in advance can make a difference.

Howard Levy is a former trial attorney for the IRS and has a Master of Laws in Taxation. His tax practice includes IRS Collection Proceedings, U.S. Tax Court Proceedings, IRS Offers in Compromises, IRS Administrative Appeals and the use of bankruptcy to resolve IRS controversies. Levy is a frequent speaker on the IRS on both a local and national level and has authored numerous articles on the IRS for legal publications. Howard is admitted to practice before the U.S. Tax Court. He is a member of Voorhees & Levy, LLC, Cincinnati, Ohio and can be contacted at howard@irsandthelaw.com.