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the Practical Accountant

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A taxpayer who has failed to file income tax returns for the past few years now decides to mend his ways—and comes to you for advice. This article provides some ground rules for helping such a taxpayer resolve his problems.

How to Help the Nonfiler

by Barry Leibowicz

Once a taxpayer has failed to file an income tax return, he often refrains from filing subsequent returns for fear of alerting the IRS to his existence and/or his delinquency. As a result, his problems compound, with the liabilities, penalties, and interest multiplying as he walks a path that may eventually lead to prosecution.

If a nonfiler caught in this web comes to you for help in straightening out his affairs before his delinquency is discovered by the IRS,[1] how should you advise him?

Since criminal liability is a possibility, the first step is to suggest that the taxpayer retain an attorney, who in turn is likely to retain you as the accountant.[2] Then, you and counsel will

determine (1) the extent of the taxpayer's delinquency; (2) whether, and how, to disclose the delinquency to the IRS; (3) whether, and how, to negotiate a compromise; and (4) how to minimize the civil penalties. This article will consider each of these elements.

THE EXTENT OF THE DELINQUENCY

The mere absence of *tax liability* for a given tax year, whether the result of deductions against gross income or credits against any tax, will not dispense with the necessity for filing a return. Rather, the filing requirement for individual returns as specified in Section 6012, is keyed to the amount of a taxpayer's *gross income* and is dependent in part on his filing status (e.g., a married couple with joint gross income of $7,400 or more is required to file a return). Our first step, therefore, is to determine whether the nonfiler had a duty to file (although it would be rare for a client not to have such a duty).

If any returns were in fact submitted, we would then have to determine whether they were sufficient to constitute a filing. For example, a return that is unsigned is deemed no return at all.[3] Similarly, an incomplete return (e.g., showing a net income figure but being otherwise blank), even though signed, may not be sufficient to meet the filing requirement.[4]

After the scope of the taxpayer's delinquency is clear we would prepare any delinquent returns. In addition to being a major step along the road to clearing up the taxpayer's delinquency, the preparation of returns allows us to ascertain the extent of the taxpayer's liability.

DISCLOSING THE DELINQUENCY

The course of action to follow in any particular failure-to-file situation depends primarily upon the underlying facts and the nature and extent of the delinquency. No path is absolutely safe. Rather, a choice must be made from the various possibilities on the basis of the relative probability of success, with the full cooperation and understanding of the client, who should be made aware of the advantages and risks inherent in each of the possibilities.

While it may be tempting to advise the client to do nothing about the delinquency, particularly when he has not filed for some years and has escaped detection, such a recommendation would generally not be appropriate. Although there are instances in which a client might be advised not to file a delinquent return, those situations would be extremely rare. The six-year criminal statute of limitations for a willful failure to file commences running only from the moment a nonfiling becomes "willful." A decision not to file an admittedly delinquent return could start the statute of limitations on an originally innocent failure which has now become willful. This result might be mitigated somewhat by the Fifth Amendment arguments for nonfiling upon advice of counsel, particularly where a voluntary disclosure (as discussed below) is not available, but it would generally be best to go as far back as the situation permits in clearing delinquencies. A decision not to clear all delinquent years would present a danger which would continue to linger, pending the running of a lengthy statute of limitations that is often difficult to compute with certainty.

Voluntary Disclosure

Prior to 1952, the safe course to follow in virtually any failure-to-file situation was to make a *voluntary* disclosure. Absent an investigation in effect prior to the disclosure, nonprosecution for the disclosed acts or omissions was automatic. This policy was eliminated in 1952,[5] and the avowed policy of the Service thereafter was "to recommend criminal prosecution in every case where the facts and circumstances warrant that action."[6]

While the tone of the withdrawal of the voluntary disclosure policy would seem to indicate that no advantage is to be gained from disclosing a delinquency, subsequent IRS pronouncements suggest the contrary. In response to an apparent concern by taxpayers that the filing of delinquent returns or the voluntary disclosure of tax frauds would lead to civil and criminal penalties, the Service stated its policy as follows:

> "[E]ven true voluntary disclosure of a willful violation will not, of itself, guarantee prosecution

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"The danger of disclosure is that the IRS is alerted to the client's omission."

> immunity. At the same time, the Service will carefully consider and weigh it, along with all other facts and circumstances, in deciding whether or not to recommend prosecution. Voluntary disclosure would, of course, have to be made before any investigation had been initiated."[7]

Since the adoption of this informal policy, the voluntary nature of a disclosure is not merely one of many factors, but rather is a *major* factor in the IRS' decision whether to prosecute. Therefore, where there is no reason to believe that an investigation is in progress, timely voluntary disclosure can often (but not always) be a particularly effective means of precluding the imposition of criminal penalties upon the client.

The obvious danger presented by disclosure is that the IRS' Criminal Investigation Division is often made aware of the client's omission. Furthermore, there is no guarantee of immunity, since nonprosecution depends solely on administrative discretion. Accordingly, although voluntary disclosure is appropriate in many cases, it must be made with extreme caution, keeping in mind that admissions made by the taxpayer (or his counsel) frequently form the basis for a criminal prosecution.

The Manner of Disclosure

If it is decided, in concert with the client, to disclose prior delinquencies, file the appropriate returns, and pay the requisite amounts, the *manner* of the disclosure must be considered. All the possible choices carry significant degrees of risk.

The mere voluntary filing of the delinquent returns may constitute a voluntary disclosure for purposes of any Government decision as to whether or not to prosecute. This procedure has the advantages both of simplicity and of avoidance of direct involvement with the Criminal Investigation Division. However, if the returns are forwarded from the Service Center to the Criminal Investigation Division, they might be used in a criminal prosecution as *prima facie* evidence of the facts stated therein, since no prior protection against prosecution would have been obtained. (And if the filing of the return was, in fact, made after the commencement of a criminal investigation of the client, the disclosure itself would offer no defense to prosecution and might actually provide the Service with sufficient information to prove its case, with disastrous results.)

An alternative method of making a disclosure is to contact the District Director or the Criminal Investigation Division and disclose the existence of a potential liability for failure to file. During this initial inquiry, no disclosures should be made other than the bare minimum necessary to determine the likelihood of a decision by the Service to prosecute criminally the particular failure to file. (It should always be remembered that since a successful prosecution by the Service would require an eventual determination of willfulness, no admission should be made which could serve as a basis for such a determination.) Of course, even the mere disclosure of the identity of the taxpayer necessary to secure the protection available through a voluntary disclosure presents some risk but, based on past experience with this procedure, the risk is minimal. Only after the required disclosure is made, and it is clear that no prosecution will be forthcoming, should the taxpayer disclose the extent of his delinquency and take the steps necessary to correct it, which could in other circumstances constitute dangerous admissions. Since the Criminal Investigation Division will make no guarantees of nonprosecution in the event of a voluntary disclosure, one must rely generally on the passage of time without criminal action to indicate the nonprosecution decision.

Since civil penalties (discussed later) and interest may be imposed even under an assurance of no criminal prosecution, disclosure should be made in a manner that will minimize these penalties. The disclosure should also be as accurate as possible to prevent the escala-

tion of a potential Section 7203 failure-to-file misdemeanor into a Section 7201 felony (see the box opposite).

If, after the disclosure, it appears that an investigation is, in fact, under way or that prosecution is contemplated, no disclosure whatsoever should be made, and steps should be taken to minimize the likelihood of a successful prosecution by the Government.[8]

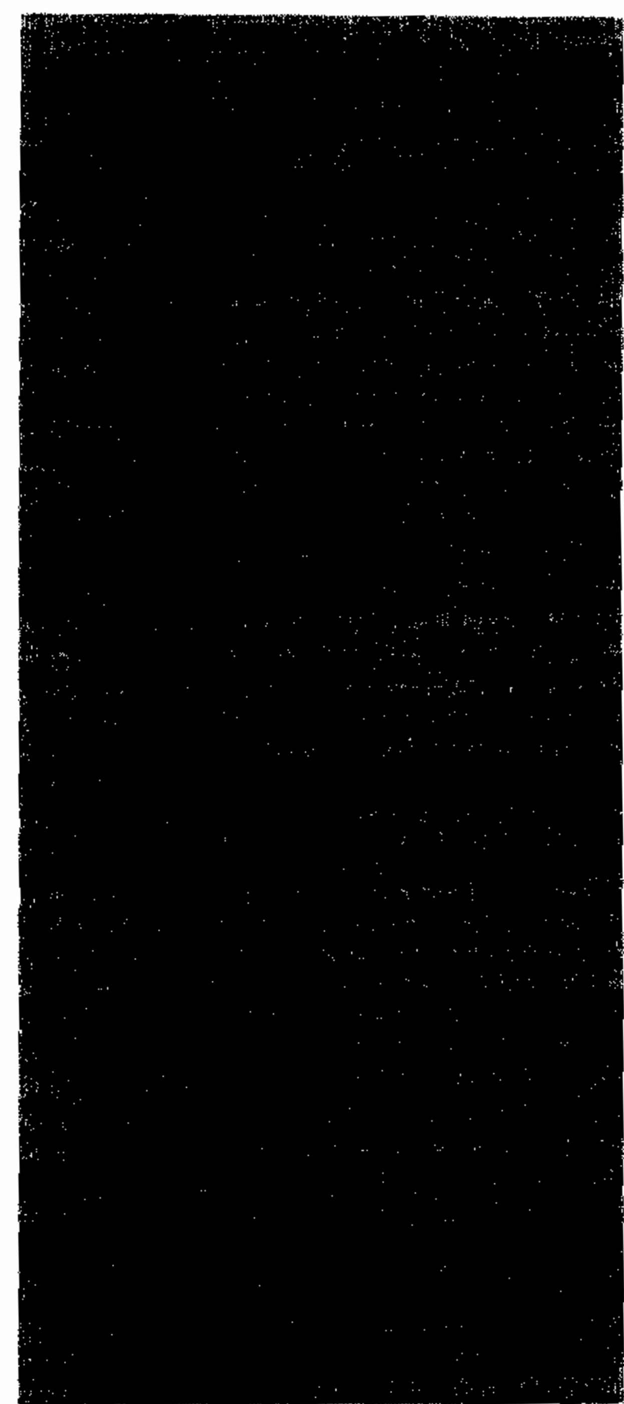
The decision must be made whether to disclose voluntarily by a simple filing or by contacting the District Director or Criminal Investigation Division, with recognition of the relative advantages and risks of each option. No absolute rule is available. If the Government would clearly lack the ability to prove the elements necessary for a criminal failure to file, disclosure by filing alone should be sufficient.[9]

In *Thompson*, the Government was held to have the burden of proving three essential elements of a willful failure to file by showing that:

- The defendant was *required* to file an income tax return for the taxable year in question,
- The defendant *failed* to file a timely income tax return and
- The defendant's failure to file a timely income tax return was a *knowing and willful* failure.

If these three elements are present and there are reasonable prospects of indictment, disclosure of more than the barest essentials should be made only after securing appropriate protection against prosecution.

Regardless of the method of disclosure, any filing should be done in the manner that is most likely to minimize the cost to the client of taxes and penalties. Of major significance, therefore, is a determination of the availability of any statute of limitations (see the box on page 46).



NEGOTIATING A COMPROMISE

A problem frequently encountered in filing delinquent returns for a significant period of years is that the tax liability plus the applicable penalties and interest are significantly in excess of the client's ability to pay. In such an instance, the appropriate course to pursue would be that of an offer in compromise.

Under the offer in compromise procedure, the client and the IRS (after a thorough investigation by the IRS of the client's assets, liabilities, and ability to pay) come to a compromise of past liabilities, which is paid on terms agreed to by the parties. (Frequently, the amounts offered result from borrowings by the client on whatever assets he has.) Of course, to make the compromise attractive, the amount to be paid by the taxpayer should be in excess of that which the IRS could secure by levy and sale.

If an offer in compromise is to be made, it is usually best to defer full payment until the conclusion of any negotiations. The reason is that the Service, in determining the acceptability of a proposal (and rating the performance of the Agent who is in charge of determining the terms of an agreement), looks closely at the percentage that the offer bears to the *outstanding* liability. Amounts paid with the return are not part of the outstanding liability.

EXAMPLE: If a taxpayer were to pay $5,000 of a $30,000 liability with his return, and then offer an additional $2,500 in compromise, the Service would view that as an offer of 10% ($2,500 on a $25,000 outstanding liability). However, if no payment at all were made with the return, and the offer was $7,500 out of the total $30,000 outstanding, the Service would view that as a 25% offer, which would be considerably more acceptable.

MINIMIZING THE CIVIL PENALTIES

The civil penalties are of major significance in the filing of delinquent returns. Being *ad valorem* penalties, they are determined as a percentage of any underpayment. Thus, in the absence of any deficiency, no civil penalty is payable.[10]

Under Section 6653(b), if a return is fraudulent, a penalty equal to 50% of the underpayment is assessed. In the absence of fraud, the penalties of Section 6653(a) for "negligence or intentional disregard of rules and regulations"[11] and of Section 6651 for failure to file or pay the tax[12] may be applicable.[13] However, these penalties may not be imposed if the 50% fraud penalty is imposed.[14]

The burden of proof is on the Service if it attempts to impose the fraud penalty. However, the burden of proof is on the taxpayer to refute the Service's application of the negligence or failure-to-file/pay penalties.[15] It is much easier to avoid the negligence penalty than the failure-to-file/pay penalties. To avoid the negligence penalty, the taxpayer need prove only that the underpayment was not the result of negligence or intentional disregard of rules and regulations;[16] generally, such proof involves a showing of "due care." However, the avoidance of the penalties for failure-to-file/pay is more difficult, requiring the taxpayer to show "reasonable cause" for the failure.[17]

The requisite showing of reasonable cause should be made in a statement under penalty of perjury filed with the District Director or the Director of the Service Center where the delinquent return is filed.[18] If the Director determines that reasonable cause existed, the penalty will not be assessed.

Although Reg. 301.6655-1(c) sets forth in a general manner the standards to be used in determining reasonable cause,[19] it does not provide specific examples. Guidance in this area must be derived from the applicable case law and other precedent. For example, the regulations issued under Section 3250 of the 1939 Code, dealing with occupational taxes, state that "reasonable cause" exists where:

1/ The return was mailed in time (whether or not the envelope bore sufficient postage) to reach the collector's office, in the normal course of the mails, within the legal period. If the due date was a Sunday or holiday, the following business day is within the legal period.

2/ The return was filed on time, but was filed in the wrong collection district or directly in the Commissioner's office.

3/ The delay or failure was due to erroneous information given the taxpayer by an IRS employee.

4/ The delay was caused by the death or serious illness of the taxpayer or by serious illness in his immediate family.

5/ The delay was caused by the unavoidable absence of the taxpayer.

6/ The delinquency was caused by the destruction by fire or other casualty of the taxpayer's place of business or business records.

7/ The taxpayer, prior to the time for filing his return, made timely application to the District Director's office for proper blanks and these were not furnished in sufficient time to permit the executed return to be filed by its due date.

8/ The taxpayer personally visited the District Director's office before the expiration of the time for filing the return, for the purpose of securing information or aid in making out his return, and through no fault of his own was unable to see an IRS representative.[20]

While these circumstances are spelled out as constituting reasonable cause for a failure to file/pay, they are not the only grounds available for avoiding the penalties.

A determination of whether there is reasonable cause for abating the penalties under Section 6651 can be made only after a thorough examination of all aspects of the client's life. A check of business and financial circumstances alone would be inadequate. Physical, mental, and emotional status must also be reviewed, in the light of the effect they might have had on the taxpayer's ability to meet his tax obligations. Only then, and after study of the applicable case law, can a decision concerning the existence of reasonable cause be made.

While the majority of cases relating to reasonable cause have been decided in favor of the Government, the reason for this imbalance is that the IRS has not litigated unless the facts strongly favored its position. Hence, the affidavit of reasonable cause presented to the Director should be well prepared, disclosing facts that would lead him to believe that the case would be a poor choice for litigation.

Innocent Mistake

Routinely rejected by both the Service and the courts is the concept of "innocent mistake." That there was in fact no willful neglect will not, by itself, prevent the penalty from

being imposed. It is well settled that forgetting to file tax returns does not constitute reasonable cause.[21]

> CASE: In *Henningsen*, 57-1 USTC ¶ 9637, 243 F-2d 954 (CA-5, 1957), the taxpayer mistakenly believed he was a resident of China, and therefore was not required to file a return. The Court held that "there is no uncertainty as to the settled rule that uninformed and unsupported belief or an innocent mistake does not of itself constitute reasonable cause."

Reasonable cause may be found, however, where the mistake arose because "substantial issues of law and fact" were involved and "reasonable men might well differ as to whether there was a tax due."[22] Similarly, the penalty is not imposed when the failure to timely file is "attributable to reliance in good faith upon the advice of a reputable accountant or attorney, experienced in federal tax matters, and to whom all relevant information has been furnished."[23] On the other hand, if the taxpayer chose a tax advisor who is not competent, having "no special knowledge or training in the tax law," a mistake resulting from reliance upon his advice will not be reasonable cause.[24]

Illness

The ground chosen most frequently for asserting reasonable cause is illness. However, an illness coinciding with the failure to file is not always a panacea.

> CASE: In *Williams,* 16 TC 893 (1951), the court rejected assertions of reasonable cause based upon the taxpayer's physical incapacity, even though the taxpayer had suffered several strokes over a six-year period culminating in his death. The failure of the testimony to establish that the resulting incapacity was continuous precluded a finding of reasonable cause. The mere possibility that the incapacity existed only at intervals that did not coincide with the due dates of the returns sufficed for a finding in favor of the Government's imposition of penalties. Furthermore, since the taxpayer normally filed joint returns with his wife, an incapacity that affected only him would, absent additional facts, be insufficient for a finding of reasonable cause for late filing.

Clearly, the burden carried by the taxpayer is heavy. To succeed, he must demonstrate the existence of an illness that was, in fact, incapacitating *and* that existed at the time the return was due. Additionally, it will probably be necessary to prove that the incapacity continued from the original due date to the actual filing date. The incapacity should prevent not only the filing by the taxpayer, but also a timely filing by others on the taxpayer's behalf. Only the statement of all these factors in a well-presented and documented record will make elimination of the penalty likely.

Mental illness is as much a ground for reasonable cause as physical incompetency.[25] Illnesses of the mind generally are long-term and continuous. They may affect some facets of the taxpayer's life, such as his ability to meet his tax liabilities, while leaving other areas intact. Often existing for lengthy periods prior to discovery and treatment, mental illnesses are subject to retrospective diagnosis and evaluation by expert witnesses. They may preclude the taxpayer from seeking help to prepare returns, even when help would be available to him upon request.

Other Justifications

Other reasons that have succeeded in setting penalties aside are:

- Timely filed returns were inexplicably misplaced.[26]
- Necessary forms were unavailable.[27]
- The necessary corporate officer was unavailable.[28]

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Difficulty of Proof

The ability of the taxpayers in these cases to prove reasonable cause is the exception rather than the rule. Taxpayers are generally unsuccessful in seeking to overturn a District Director's initial unfavorable determination as to reasonable cause.

It is, therefore, very important that the taxpayer's case be presented to the Director in the most advantageous manner possible at the very earliest stages of the proceeding. The initial affidavit of reasonable cause should contain every possible item of proof, exhibit, argument, and rationale. Nothing should be left out. Only in this way are the chances of success maximized.

CONCLUSION

There are no pat formulas that will adequately serve every client with a nonfiling problem. While a thorough understanding of the applicable law is required, intuition, discretion, and good judgment are just as relevant to success. ■

1. Most nonfilers seek professional advice only after an IRS investigation is under way. However, this article will address the problems of the nonfiler whose delinquency has *not yet* been discovered.

2. To prevent the disclosure of communications, you must be brought within the purview of the attorney-client privilege (since there is no *accountant*-client privilege). The courts have recognized that an accountant may be covered by the attorney's privilege if hired by the attorney under appropriate circumstances. *Bauer v. Orser*, 66-2 USTC¶9755, 18 AFTR 2d 6055 (DC N. D., 1966); *Kovel*, 61-2 USTC ¶9111, 9 AFTR 2d 366 (CA-2, 1961).

3. *Vaira*, 71-1 USTC ¶9495, 28 AFTR 2d 71-5033 (CA-3, 1971).

4. *Schroeder*, 61-2 USTC ¶9531, 7 AFTR 2d 1673 (CA-8, 1961).

5. Press Release, Treasury Information Service No. S-2930, 1/10/52, P-H Fed. Tax Rep. ¶76,157 (1952).

6. *Id.*

7. Statement of Commissioner Mortimer M. Caplin, IRS News Release No. IR-432, 12/13/76, P-H Fed. Tax Rep. ¶18,604(A) (1963).

8. See Tilzer, *Protecting Taxpayers' Rights During the Tax Fraud Investigation Process*, 41 J. Taxation 356 (1974); Boughner, *How Practitioners Should Handle Willful Failure To File Cases*, 32 J. Taxation 46 (1970).

9. *Thompson*, 64-2 USTC ¶9881, 14 AFTR 2d 6030 (CA-2, 1964), *aff'g*. 64-2 USTC ¶9500, 13 AFTR 2d 1269 (DC Conn., 1964).

10. *Harris*, 51 TC 980 (1969).

11. The penalty is 5% of the underpayment.

12. The penalty for failure to *file* is 5% of the underpayment per month or part thereof, to a maximum of 25%. The penalty for failure to *pay*, is ½% of the underpayment per month, to a maximum of 25%. Both penalties run *concurrently*, with the failure-to-file penalty reduced by the failure-to-pay penalty. Together they may not aggregate more than 25% of the underpayment. Section 6651(c)(1)(A) and *Rev. Rul.* 54-427. The penalty is thus effectively 25% of the underpayment for any failure to file that has continued for five or more months. Obviously, since the penalty is a percentage of the underpayment, absent a failure to pay, the penalty for failure to file would be zero. *Rev. Rul.* 54-427.

13. *Robinson's Dairy, Inc.*, 62-1 USTC ¶9447, 9 AFTR 2d 1400 (CA-10, 1962).

14. Reg. 301.6653-1(b)(2).

15. *Lee*, 55-2 USTC ¶9784, 48 AFTR 365 (CA-5, 1955), *cert. den.*

16. *Marcello*, 67-2 USTC ¶9516, 19 AFTR 2d 1700 (CA-5, 1967).

17. Reg. 301.6651-1(c); *Lee*, see note 15, *supra*. The taxpayer bears a greater burden to avoid the imposition of the Section 6651 delinquency penalty than the Section 6653(a) negligence penalty, since Section 6651 requires "reasonable cause" to be shown while Section 6653 requires only the absence of negligence or intentional disregard. Meeting the reasonable cause standard necessary to avoid the delinquency penalties will therefore be sufficient to avoid those for negligence as well.

18. Reg. 301.6651-1(c) provides: "If the district director, the director of the service center . . . determines that the delinquency was due to a reasonable cause and not to willful neglect, the addition to the tax will not be assessed. If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship . . . if he paid on the due date. In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax. . . ."

19. See note 18, *supra*.

20. 8 Stand. Fed. Tax Rep. (CCH) ¶5524.356 (1979).

21. *West Virginia Steel Corp.*, 34 TC 851 (1960).

22. *Dillin*, 56 TC 228 (1971).

23. *Rev. Rul.* 53-172. See also *Dexter*, 70-1 USTC ¶9136, 25 AFTR 2d 70-359 (DC Miss., 1969).

24. *Mayflower Inv. Co.*, 57-1 USTC ¶9268, 50 AFTR 1196 (CA-5, 1956).

25. *Estate of Forbes*, 12 TCM 176 (1953).

26. *Bouvelt Realty, Inc.*, 46 BTA 45 (1942).

27. *Olds*, 15 BTA 560 (1929), *aff'd.*, 3 USTC ¶973 (CA-6, 1932).

28. *Bankers Dairy Credit Corp.*, 26 BTA 886 (1932).

TORTURED SLAVES MAKE THE BEST ACCOUNTANTS

The ancient Greeks circa 1400 B.C. were very warlike and had little use for writing, arithmetic or accounting. Therefore, slaves were often used to keep the king's accounting records. Slaves were preferred as accountants because the law forbade torturing free men. Thus, the statements of a slave under torture were considered more conclusive evidence than those of a free man under oath. This crude method of obtaining reliable financial data was an effective and generally accepted auditing procedure.