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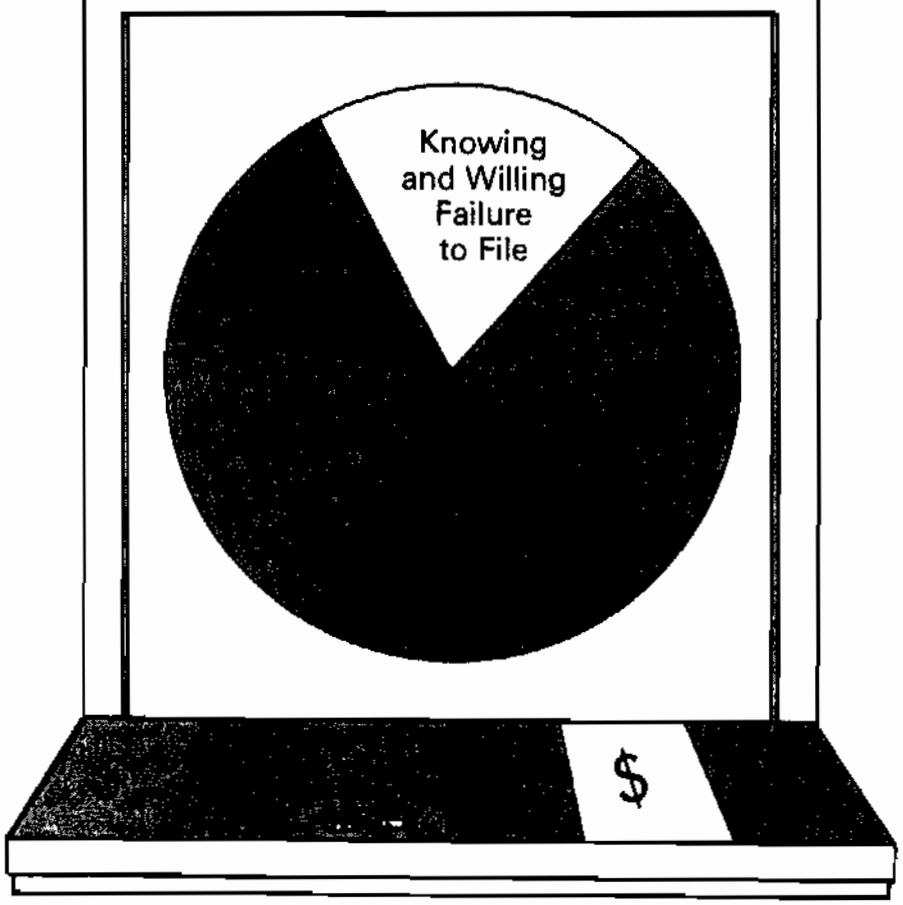
The Problems of a Nonfiler



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A taxpayer who fails to file a required income tax return is faced with a host of problems that tend to compound themselves yearly. He has a feeling that, having failed to file, he dare not alert the Internal Revenue Service ("Service") to his existence by filing a current return. Year after year, his liabilities multiply, as he walks a path that ultimately may lead to prosecution. Usually, the tax prac-

titioner is first consulted when the Service has discovered the taxpayer and the taxpayer faces a term in prison or substantial financial penalties. This article, however, will address itself to the problems of the delinquent taxpayer against whom no investigation is underway but who wishes to clear his delinquency. Unless otherwise indicated, all section references are to the Internal Revenue Code ("Code"), as amended.

NEED FOR A RETURN • The mere absence of any tax liability for a given tax year, whether as the result of zero taxable income or the existence of sufficient credits to offset any liability, will not dispense with the necessity of filing a return. The requirement of filing is keyed to the amount of a taxpayer's gross income, as specified in section 6012, and is dependent in part on his filing status. Section 6012 calls for a return by all taxpayers whose joint gross income is $7,400 or more and by a substantial number of individual taxpayers with even lower gross incomes. It would, therefore, be a rare taxpayer who is not required to file, but the establishment of a duty to file is nevertheless a requisite first step.

A determination must also be made as to whether any returns that were in fact submitted are sufficient to constitute a filing. A return that is unsigned is deemed no return at all. *Vaira v. Commissioner,* 444 F.2d 770 (3d Cir. 1971). A return that is incomplete, showing, for example, a net income figure but being otherwise blank, may not be sufficient to meet the filing requirement even if signed. *See Schroeder v. Commissioner,* 291 F.2d 649 (8th Cir. 1961).

After the scope of the taxpayer's delinquency is clear, it is appropriate to prepare any delinquent returns. Often the assistance of a certified public accountant in the preparation of required returns may be advisable. Timing decisions that, because of the statute of limitations and other factors, are often crucial to a taxpayer's liability can be more convincingly presented if they are made by an accountant under applicable standards than by the attorney-advocate. Potential defenses and prosecutions are often based upon accounting determinations, and the objective analytical skills of an accountant can aid counsel for the taxpayer greatly in the presentation of his case.

In order to prevent the disclosure of communications, the accountant, having no privilege of confidentiality of his own, must be brought within the purview of the attorney-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. *Baver v. Orser,* 258 F.Supp. 338 (D.

N. Dak. 1966); *United States v. Kovel,* 296 F.2d 918 (2d Cir. 1961).

THE PENALTIES FOR FAILURE TO FILE • Section 7203 makes any willful failure to file a misdemeanor, punishable by imprisonment of up to one year, a fine of $10,000, or both. The misdemeanor results from a "willful but passive neglect of the statutory duty"; the crime is raised to the status of a felony upon "a willful and positive attempt to evade tax in any manner or to defeat it by any means," *Spies v. United States,* 317 U.S. 492, 499 (1943).

In order for the felony to occur, some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer must be present. The evil motive may be inferred from affirmative conduct the likely effect of which would be to mislead or conceal. The felony is punishable with a maximum of five years imprisonment, a fine of $10,000, or both. § 7201.

For a failure to file to have been willful and therefore subject to any criminal penalty, it must have been the result of a "voluntary, intentional violation of a known legal duty." *United States v. Bishop,* 412 U.S. 346, 360 (1973). Mere carelessness or accident, as well as any failure for which there is a reasonable, justifiable excuse, is insufficient to prove the existence of a misdemeanor. *United States v. Murdock,* 290 U.S. 389 (1934).

Punishment for willful failure under sections 7201 or 7203 cumulates for each year in which a failure has occurred, subject only to the six-year statute of limitations of section 6531. Generally, the period of limitations for a criminal failure to file runs from the due date of the return, taking into account any extensions. *United States v. Twining,* 36 A.F.T.R.(2d) 75-5542 (N.D. Calif. 1975). However, if the failure to file is not willful on the due date, becoming willful only at some later date, the crime is deemed committed on the later date, from which the statute commences to run. *United States v. Andros,* 484 F.2d 531 (9th Cir. 1973).

VOLUNTARY DISCLOSURE • The choice as to which course of action to follow in any particular failure to file case is dependent primarily upon the underlying facts and the nature and extent of the resulting delinquency. No path that counsel selects is absolutely safe. Rather, counsel must pick from various possibilities on the basis of their relative probability of success, with the full cooperation of a client who is aware of the risks inherent in any choice.

Success must mean not only present freedom from imprisonment or fine, but the elimination as well of any future punishment. While it

may be tempting to advise a client to do nothing in regard to a prior delinquency, particularly when he has not filed for some years without detection, such a recommendation would not be prudent. The danger would continue to linger pending the running of a lengthy statute of limitations that is difficult to compute. Further, the existence of prior criminal liability may encourage subsequent criminal acts or elevate a prior misdemeanor to the status of a felony. To do nothing, although seemingly expeditious, is often the worst of all possible choices.

Prior to 1952, the safe course to follow upon any failure to file was to make a voluntary disclosure. Absent an investigation in effect prior to the disclosure, nonprosecution for the disclosed acts or omissions was automatic. However, this policy concerning voluntary disclosures was eliminated in 1952. Press Release, Treas. Information Service, No. S-2930, Jan. 10, 1952, *Fed. Tax Rep.* (P-H) ¶ 76,157 1952. The avowed policy of the Service thereafter was "to recommend criminal prosecution in every case where the facts and circumstances warrant that action." *Id.*

While the tone of the withdrawal of the voluntary disclosure policy would seem to indicate that no advantage is to be gained from disclosing delinquencies, subsequent pronouncements of the Service suggest the contrary. In response to an apparent concern by taxpayers that the filing of delinquent returns or the voluntary disclosure of tax frauds will 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, guaranteee prosecution 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. Statement of Commissioner Mortimer M. Caplin, News Release IR-432, Dec. 13, 1963, *Fed. Tax Rep.* (P-H) ¶ 18,604(A) (1963).

Since the adoption of this informal policy, the voluntary nature of a disclosure is not merely one of many factors, but rather a major factor, in the decision whether to prosecute. A taxpayer's counsel who has no reason to believe that an investigation is in progress should seriously consider timely voluntary disclosure as a particularly effective means of precluding the imposition of criminal penalties upon his client.

The obvious, most immediate, danger presented by disclosure is that by bringing the matter directly to the attention of the Intelligence Division of the Service it becomes aware that the client has committed an act or made an omission which

makes him criminally liable. Furthermore, there is no guarantee of immunity, nonprosecution depending solely on administrative discretion based upon weighing the disclosure against the facts. Accordingly, although voluntary disclosure should be preferred in many cases, it must be made with extreme caution. Admissions made by the taxpayer or his counsel frequently form the basis for a criminal prosecution.

The Manner of Disclosure

Having decided in concert with the client to disclose voluntarily prior delinquencies, file the appropriate returns, and pay the requisite sums, the manner of disclosure must be considered. All the possible choices carry significant degrees of risks.

The mere voluntary filing of the delinquent returns may constitute a voluntary disclosure for purposes of any decision not to prosecute. The procedure has the advantages of simplicity and avoidance of direct involvement with the Intelligence Division by the taxpayer. However, if the returns are forwarded to the Intelligence Division, they might be used in a criminal prosecution as prima facie evidence of the facts stated therein, since no prior assurances of nonprosecution would have been obtained. If the filing of the return was, in fact, made after the commencement of a criminal investigation of the taxpayer, the disclosure itself would offer no protection from prosecution and might actually provide the Service with sufficient information to prove its case. The results could be disastrous.

An alternative method of making a disclosure is to obtain assurances from the Intelligence Division that no investigation is pending and that there will be no prosecution if disclosure is made. During this initial inquiry, no disclosures should be made other than the bare minimum necessary to determine the existence of any pending investigation. Of course, even the mere disclosure of the identity of the taxpayer, necessary to secure assurances, presents some risk, but the history of this procedure indicates that the risk is minimal. Only after the required assurances are received should the taxpayer disclose his delinquency and take the steps necessary to correct them.

Since, even under an assurance of no criminal prosecution, civil penalties and interest may be imposed, disclosure should be made in a manner that will minimize these civil penalties. The disclosures should also be as accurate as possible to prevent the escalation of what was a potential section 7203 failure-to-file misdemeanor into a section 7201 felony by false or inaccurate returns.

If the answer of the Service is that an investigation is, in fact, under way or that no immunity from

prosecution will be given, no disclosure whatsoever should be made, and steps should be taken to minimize the likelihood of a successful prosecution by the Government. *See* Tilzer, *Protecting Taxpayer's Rights During the Tax Fraud Investigation Process*, 41 J. Tax. 356 (1974); Boughnier, *How Practitioners Should Handle Willful Failure to File Cases*, 32 J. Tax. 46 (1970).

The decision whether to disclose voluntarily by a simple filing or to seek prior assurances of nonprosecution must be made with recognition of the relative risks and advantages 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.

In *United States v. Thompson*, 338 F.2d 997 (2d Cir. 1964), *aff'g.* 230 F.Supp. 530 (D. Conn. 1964), 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 make an income tax return for the taxable year in question;
- The defendant failed to make a timely income tax return; and
- The defendant's failure to make a timely income tax return was a knowing and willful failure.

If these elements are present and there are reasonable prospects of indictment, disclosure should be made only after securing appropriate assurances of nonprosecution.

Regardless of the method of disclosure, any filing should be made in the manner that is most likely to minimize the cost to the taxpayer of taxes and penalties. Of major significance, therefore, is a determination of the availability of any statute of limitations.

DEFICIENCIES AND REFUNDS

• Generally, a deficiency must be assessed within three years of the actual filing of the return or the due date, whichever is later. § 6501(a). The period is extended to six years if there has been an omission in excess of 25 per cent of gross income. § 6501(e). There is no limitations period on a fraudulent return. § 6501(c). The statute of limitations on the assessment of deficiencies does not begin to run until there is an actual filing; if no return has been filed, the tax may then be assessed at any time. § 6501(c)(3).

To be timely, a refund claim must be made not later than three years from the date of filing or two years from payment, whichever date is later. § 6511. If no return is filed at all, the two-year period applies. § 6511(a)(2). A late return limits any refund to payments made within the three years prior to filing or the

two years immediately preceding the claim. § 6511(a)(2). Both early returns and prepayments by withholding or otherwise are considered as having been made on their due dates. § 6513(a). The juxtaposition of these various limitations often works an enormous hardship upon those taxpayers who fail to file for several years, if some years contain overpayments and others, deficiencies.

To the extent that a refund claim for a nonfiling year is based upon prepayments, such as withholding or estimated tax payments, and three or more years have elapsed since the due date of the return, any refund would be barred by the statute of limitations despite a later filing of the delinquent return. If deficiencies exist for other nonfiling years, even if they predate the barred refund year, they would remain open. At best, the filing of the delinquent returns would start the statute of limitations running, with a minimum of three years being open thereafter on the deficiency.

Although the coexistence of barred refunds and open deficiencies may seem strange at first, it is relatively common, stemming from the delinquent taxpayer's reluctance to file even a refund claim while prior delinquencies and deficiencies are outstanding and the nature of the applicable statutes of limitations that are tolled against deficiencies until filing, but run against an overpayment during the same nonfiling period.

The mitigation provisions of sections 1311-1315 do not alter this result, as the situation is not one of the circumstances specified in section 1312. Neither would equitable relief appear to be available, since equity classically will act only to protect an innocent party against a culpable one. It is clear that the Service is not culpable in a failure-to-file case. Statutory authority does exist for the mitigation of excessive penalties, and it might be invoked in the barred-refund open-deficiency situation, but the question has yet to be presented to a court. § 7327; T.D. 5535, 1946-2 C.B. 194.

As a result, counsel should identify refund years immediately, taking whatever steps are possible to prevent the statute from closing during his handling of the case. Any filing for deficiency years or other years that present criminal prosecution potential should, of course, await the assurances of nonprosecution. Once assurances are received, no time should be lost in filing returns in order to prevent the running of the statute of limitations against open refunds and the accumulation of interest and penalties on any deficiencies.

CIVIL PENALTIES • Of major significance in the filing of delinquent returns are

the civil penalties that may be assessed. Being ad valorem penalties, they are determined as a percentage of any underpayment. In the absence of any deficiency, no civil penalty is payable. *Harris v. Commissioner*, 51 T.C. 980, 986-7 (1969). If a return is fraudulent, a penalty equal to 50 per cent of the underpayment is assessed. § 6653(b). In the absence of fraud, the penalties of section 6653(a) for "negligence or intentional disregard of rules and regulations" and of section 6651 for failure to file or pay the tax may be applicable concurrently. *Robinson's Dairy, Inc. v. Commissioner*, 302 F.2d 42 (10th Cir. 1962). These penalties may not be imposed concurrently with the 50 per cent fraud penalty. Treas. Reg. § 301.6653-1(b)(2).

Unlike the fraud penalty, where the Service must prove fraud, in the case of the negligence or delinquency penalties, the burden of proof is on the taxpayer to refute the Service's determination of their applicability. *Lee v. Commissioner*, 227 F.2d 181 (5th Cir. 1955), *cert. denied*, 351 U.S. 982 (1956). In order to avoid the negligence penalty of section 6653(a), which is 5 per cent of the underpayment, the taxpayer must prove only that the underpayment was not the result of negligence or intentional disregard of rules and regulations. *Marcello v. Commissioner*, 380 F.2d 509 (5th Cir. 1967). Most frequently, such proof involves a showing of "due care," in spite of which the underpayment arose.

Avoidance of the section 6651 delinquency penalties for failure to file or pay is more difficult; failure is also more costly. The penalty for failure to file is 5 per cent of the underpayment per month or part thereof, to a maximum of 25 per cent. § 6651(a)(1). For failure to pay, the penalty is ½ per cent of the underpayment per month, to a maximum of 25 per cent. § 6651(a)(2). Both penalties run concurrently, with the failure to file penalty reduced by the penalty applicable for failure to pay in any single month and may not aggregate more than 25 per cent of the underpayment. § 6651(c)(1)(A); Rev. Rul. 54-427, 1954-2 C.B. 42. The penalty is thus effectively 25 per cent 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, *id.*

Reasonable Cause for Failure

The penalties for failure to file or pay may be avoided by the taxpayer showing reasonable cause for the failure. Treas. Reg. § 301.6651-1(c); *Lee v. Commissioner*, 227 F.2d 181 (5th Cir. 1955). 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.

The requisite showing of reasonable cause should first 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. Treas. Reg. § 301.6651-1(c). If the Director determines that reasonable cause exists, the penalty is not assessed. Thus, Treas. 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. . . .

The Regulations, while setting forth in a general manner the standards to be used in determining reasonable cause, do not provide specific examples. Guidance in this area must be derived from applicable case law and other precedent. Regulations issued under section 3250 of the 1939 Code, providing for occupational taxes, state that reasonable cause exists:

> 1. Where the return was mailed in time (whether or not the envelope bore sufficient postage) to reach the collector's office, in normal course of mails, within the legal period. If the due date is a Sunday or holiday, the following business day is within the legal period.
> 2. Where the return was filed on time, but was filed in the wrong collection district or directly in the Commissioner's office.
> 3. Where the delay or failure was due to erroneous information given the tax-

payer by an internal revenue officer or employee.

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

5. Where the delay was caused by unavoidable absence of the taxpayer.

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

7. Where the taxpayer, prior to the time for filing 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 on or before its due date.

8. Where taxpayer personally visited the office of the district director 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 the representatives of the Revenue Service. 8 *Stand Fed. Tax Rep.* (CCH) ¶ 5524.356 (1979).

Decisional law would seem to indicate that several of these circumstances will constitute reasonable cause for a failure to file, but they are not the only grounds available for avoiding the penalties.

Any determination by counsel as to whether reasonable cause exists upon which to seek abatement of penalties under section 6651 can only be made 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 be reviewed in the light of the effect they might have had on the taxpayer's ability to meet his tax and filing 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 were decided in favor of the Government, the reason is that the Service 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 is 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, in and of itself, prevent the penalty from being imposed. "It is well settled that forgetting to file tax returns does not constitute reasonable cause." *West Virginia Steel Corp. v. Commissioner*, 34 T.C. 851, 860 (1960). Similarly, in upholding a penalty against a taxpayer who mistakenly believed that he was a resident of China and not required to file a return, the court stated 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." *Henningsen v. Commissioner,* 243 F.2d 954 (4th Cir. 1957).

Reasonable cause may be found, however, when 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." *William N. Dillin v. Commissioner,* 56 T.C. 228, 248 (1971). 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." Rev. Rul. 53-172, 1953-2 C.B. 226. *See Dexter v. U.S.,* 306 F.Supp. 415 (N.D. Miss. 1969).

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 him will not be sufficient reasonable cause. *Mayflower Inv. Co. v. Commissioner,* 239 F.2d 624 (5th Cir. 1956), *aff'g* 24 T.C. 729 (1955).

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.

In *Williams v. Commissioner,* 16 T.C. 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, the taxpayer 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 not only prevent the filing by the taxpayer, but a timely filing by others on the taxpayer's behalf should have been inappropriate. Only the statement of all these factors in a well presented and documented record will make elim-

ination of the section 6651 penalty likely.

The juxtaposition of these various elements seems most likely when the illness or incapacity is mental. It is clear that mental illness is as much a ground for reasonable cause as physical incompetency. *Estate of Gladys Forbes v. Commissioner*, 12 T.C.M. (CCH) 176 (1953). 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, they 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 Excuses

Other reasons that have succeeded in setting penalties aside are assertions that:

- Returns which were timely filled were inexplicably misplaced. *Bouvelt Realty, Inc. v. Commissioner*, 46 B.T.A. 45 (1942);
- Necessary forms were unavailable. *Millard D. Olds v. Commissioner*, 15 B.T.A. 560; *aff'd mem.*, 60 F.2d 252 (6th Cir. 1932); or
- Corporate officer was unavailable. *Bankers Dairy Credit Corp. v. Commissioner*, 26 B.T.A. 886 (1932).

The ability of the taxpayers in these cases to prove reasonable cause is the exception rather than the rule. Generally, taxpayers are unsuccessful in seeking to overturn a district director's initial unfavorable determination as to reasonable cause. It is, therefore, very important that a taxpayer present his case 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. Whether he is deciding how to minimize criminal risk or, having eliminated the risk, attempting to reduce the cost of belated compliance, counsel should always seek the course of action that is best for the client. Of course, a thorough understanding of the applicable law is required. Further, since this area of law is, at best, loaded with variables, intuition, discretion, and good judgment are as relevant to success as knowledge of the law.