REPRESENTING THE NONFILER

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I. INTRODUCTION AND OVERVIEW

The Internal Revenue Service estimates that approximately ten million individuals and businesses do not file tax returns annually, resulting in an annual revenue loss to the federal government of approximately $7 billion. In response to this problem, the IRS began a Nonfiler Program in 1992 to encourage nonfilers to voluntarily file delinquent returns and to re-enter the tax system.

Although the nonfiler program expired and has not been formally reinstated, the IRS is considering a similar program to encourage nonfilers to file delinquent returns. The IRS is also focusing on high income nonfilers and considering criminal referrals of these taxpayers.

The Service increasingly is effective in matching income information records such as Forms W-2 and 1099 against taxpayer accounts. The IRS also continues to identify nonfilers using traditional sources of information such as informants, state taxing authorities and other law enforcement agencies. Because the IRS is continuously improving its ability to identify nonfilers, individuals and businesses who have failed to file returns are at risk to be targeted. Practitioners can expect to be contacted by nonfilers seeking advice on how to deal with the IRS. To effectively represent the nonfiler, the practitioner must be familiar with the numerous criminal, civil and collection issues that arise out of the failure to file tax returns.

There are numerous reasons taxpayers fail to file tax returns. Frequently, taxpayers who do not have sufficient funds to pay a tax liability on the return due date conclude erroneously that it is better not to file the return than to file the return showing a tax due. The taxpayer may hope the problem can be resolved in the coming year, only to find that he or she owes even more when the next filing season arrives. Other taxpayers "drop out of the system" as a result of major

changes or events in their lives, including divorce, medical problems and loss of employment. In many cases, however, nonfilers have actually overpaid their tax liabilities and would be entitled to receive refunds upon the filing of their tax returns.

II. CRIMINAL ISSUES

A. Statistics on Numbers at Prosecutions

Although the IRS estimates the number of nonfilers at ten million individuals and businesses, as practical matter, the number of prosecutions for failure to file returns are limited. For the fiscal year ended September 30, 1996, the Department of Justice authorized 1,554 cases for criminal prosecution. Of these, only 202 cases involved prosecutions for failure to file.

B. Failure to File

The criminal consequences of failing to file tax returns are the most serious, and should be of greatest concern. A taxpayer who willfully fails to file an income tax return can be charged with a misdemeanor. Internal Revenue Code of 1986 (Title 26 USC) (hereinafter "IRC") § 7203. To establish the crime of failure to file a tax return, the government must prove beyond a reasonable doubt that (1) the taxpayer was required to file a timely tax return; (2) failed to do so; and (3) the failure to file was willful. United States v. Buras, 633 F.2d 1356, 1358 (9th Cir. 1980). The penalty for willful failure to file a tax return is up to one year in prison and a fine of up to $25,000 for each offense ($100,000 in the case of a corporation). As a practical matter, the overwhelming number of nonfilers are not prosecuted criminally, but are dealt with through the IRS's civil collection procedures.

C. Tax Evasion

In certain cases, a misdemeanor failure to file can be elevated to the felony of tax evasion. Certain affirmative acts may expose the nonfiler to a felony charge of tax evasion, such as the creation of false documents, making false statements, dealing in cash, and keeping double sets of books. Spies v. United States, 317 U.S. 492 (1943). To establish the crime of tax evasion, the government must prove beyond a reasonable doubt: (1) an attempt to evade or defeat a tax; (2) there is an additional tax due and owing; (3) the attempt to evade or defeat the tax was willful. United States v. Marabelles, 724 F.2d 1374 (9th Cir. 1984). The penalty for tax evasion is up to five years in prison and a fine of up to $250,000 for each offense ($500,000 in the case of a corporation). IRC § 7201; Title 18, USC § 3571.

D. Voluntary Disclosure

Prior to 1952, the IRS maintained a written policy that it would not prosecute taxpayers who voluntarily brought past tax crimes to the IRS's attention, including failure to file returns. Since abandoning the written policy in 1952, however, the IRS continued to follow an informal policy of considering a taxpayer's voluntary disclosure in determining whether to bring criminal charges.

Under the provisions of the Internal Revenue Manual, the IRS now considers the fact of a voluntary disclosure as only one factor to consider in determining whether to bring criminal charges for failure to file tax returns. IRM ¶9.5.3.3.1.2.1. Under these provisions, a disclosure is "voluntary" if it is truthful, timely, complete and demonstrates a willingness on the part of the taxpayer to cooperate with the IRS in determining his or her correct tax liability. On December 11, 2002, the IRS announced in IR-2002-135 revised and updated guidelines for the voluntary disclosure program.

In general, the practitioner representing a nonfiler should attempt to determine whether the IRS has opened an investigation of the taxpayer. This may be done by contacting a Revenue Agent with the Examination Division or preferably a Special Agent with the Criminal Investigation Division. If no investigation has been opened, the practitioner may proceed to make the voluntary disclosure.

E. Statute of Limitations

The statute of limitations on criminal tax offenses limits the time within which the government can bring criminal charges. IRC § 6531(2). In general, charges for tax crimes must be brought within six years. In the case of willful failure to file a tax return, the limitations period generally expires six years after the due date of the return plus the period of any extension to file the return. For example, assuming an extension was not granted, at this time the earliest year for which the government could bring criminal charges for failure to file would be 1997. Any charges for that year must be brought on or before April 15, 2004. In the case of tax evasion, the six-year limitations period expires six years after the date the return was filed. United States v. Habig, 390 U.S. 222 (1968).

F. Privileges for the Accountant or Attorney and How to Protect the Client's Interests

The tax practitioner should be aware that the government may attempt to obtain statements or admissions made by the client for use in a criminal prosecution. Because federal law does not recognize a privilege for communications between a client and non-attorneys in criminal tax matters, such as accountants, enrolled agents, and return preparers, the government can compel the non-attorney tax practitioner to reveal communications made to him by the client. Couch v. United States, 409 U.S. 322 (1973). Accordingly, if there is the potential for criminal

prosecution, the practitioner should ensure that any non-attorney professionals retained to assist the taxpayer are retained under the attorney-client privilege.

Communications between a taxpayer and his attorney are protected from disclosure by the attorney-client privilege. The privilege also protects communications between the client and a non-attorney tax practitioner when the tax practitioner has been retained by an attorney to assist in providing legal services to the taxpayer. United States v. Cote, 456 F.2d 142, 144 (8th Cir. 1972). If an attorney prepares returns or renders services that are in the nature of accounting services, his or her communications with the client are not protected by the attorney-client privilege and can be discovered by the government in a criminal investigation. Falsone v. United States, 205 F.2d 734 (5th Cir. 1953), cert. denied, 345 U.S. 864 (1954).

III. CIVIL ISSUES

Taxpayers who file delinquent returns will be faced with liability for tax, interest and penalties unless they had amounts withheld from their wage or made estimated tax payments sufficient to satisfy their income and/or self-employment tax liability.

A taxpayer has an obligation to file tax returns for all years in which he or she had sufficient income. IRC § 6012. If returns are not filed, there is no statute of limitations on assessment of taxes due. IRC § 6501(c)(3). In some cases, however, the IRS has taken the position that it will limit to six years the number of years that it will require the nonfiler to file delinquent returns. This is particularly true where the taxpayer does not have the ability to pay the amount owed or where the taxpayer lacks records to allow reconstruction of his or her income and expenses in prior years. Since it is common for the IRS and state tax authorities to share tax information, if the nonfiler lives in a state that imposes an income tax, it is also important to make a determination as to what the state's position is with respect to nonfiling.

A. Reconstructing Income and Deductions/Preparing the Returns

In representing the nonfiler, it is necessary to determine whether the taxpayer has sufficient records with which to determine his or her correct tax liability. Assuming the taxpayer has adequate books and records for the years in which he or she failed to file, the task of reconstructing income and deductions will be relatively simple. One should consider asking the client if he kept records with a software package such as Quicken or Microsoft Money or had some other means of recordkeeping.

As a practical matter, most nonfilers do not have adequate books and records to permit the tax practitioner to reconstruct income and deductions to prepare an accurate return. Where this is the case, information regarding sources of income can typically be obtained from third-party record keepers. For instance, income can be reconstructed with Forms W-2 obtained from employers and from Forms 1099 obtained from third-party payors, such as banks and brokerage firms.

To reduce the tax liability, the practitioner will also want to reconstruct expenses for deductions the taxpayer is entitled to claim. The amount of deductions for such items as mortgage interest, real estate taxes and medical expenses can be determined by obtaining information from third-party record keepers.

If sufficient information is not available from third-party record keepers, consider the IRS an alternate source of information. The practitioner can obtain income and deduction information from the IRS by filing a request for information under the Freedom of Information Act. Not only is a Freedom of Information Act request helpful in reconstructing the taxpayer's income and deductions, it ensures, at a minimum, that the return will include all income and deductions known to the IRS. Alternatively, a transcript of account obtained from the Service

Center or Taxpayer Services may serve as a less formal way of obtaining income information. If the representative is dealing with an agent, a simple request to the agent for income information should suffice.

If income and deductions cannot be reconstructed with information obtained from third-party record keepers or the IRS, the tax practitioner may need to resort to indirect methods of proof. Common examples of indirect methods of proof include bank deposits analysis, net worth and nondeductible personal expenditures, and source and application of funds.

These indirect methods of proof are recognized by the IRS and the courts as legitimate methods of reconstructing income. See, e.g., Holland v. United States, 348 U.S. 121, 125, reh'g denied, 348 U.S. 932 (1954) (net worth analysis); United States v. Soulard, 730 F.2d 1292 (9th Cir. 1984) (bank deposits method); Taglianetti v. United States, 398 F.2d 558, 562 (1st Cir. 1968), aff'd on other grounds, 394 U.S. 316 (1969) (source and applications method).

A bank deposit analysis totals all deposits into a taxpayer's bank accounts to arrive at the gross amount deposited. Deposits attributable to nontaxable sources such as gifts, inheritances, transfers from other taxpayer accounts and redeposits of cash previously withdrawn are then subtracted from the gross amount. The result is deemed to be taxable income received by the taxpayer.

Under the net worth method of proof, the IRS determines the taxpayer's net worth at the beginning of the taxable year. The taxpayer's net worth at the end of the year is then compared with the starting net worth, after subtracting any increase in net worth attributable to nontaxable sources.

The expenditures method of indirect proof is also known as the source and applications of funds method. It is closely related to the net worth method, but is normally used where the

taxpayer has spent income rather than using it to acquire investments or other property. The same issues arise with the expenditures method as with the net worth method, since the government must establish an opening net worth and must show a likely source of taxable income.

If it becomes necessary to resort to indirect methods of proof to reconstruct a taxpayer's income, it is normally advisable to retain a forensic accountant to do so. This ensures that the income reconstruction is done correctly and the work product is protected under the attorney-client privilege. Some accounting firms have accountants on staff who are qualified to reconstruct income using these methods of indirect proof.

B. Audit of Delinquent Returns

In most instances the IRS will accept delinquent returns as filed. However, the IRS may select a delinquent return for audit and propose adjustments. It is unclear whether delinquent returns are at greater risk of being selected for audit.

The tax practitioner should advise the taxpayer that the delinquent returns may be audited within three years of the date the returns were filed. IRC § 6501. However, where there has been a twenty-five percent omission of gross income on the return, additional tax may be assessed within six years of the filing date. IRC § 6501(e). In addition, the IRS may assess additional tax at any time in the case of fraud. IRC § 6501(c).

When the IRS proposes adjustments to the taxpayer's returns as a result of an audit and the taxpayer disagrees with the adjustments, the IRS may issue a 30-day letter. The taxpayer then has the opportunity to file a protest of the proposed adjustments and to settle the case with an Appeals Officer. If the taxpayer fails to respond to the 30-day letter, or if the case is not resolved in Appeals, the taxpayer will receive a Statutory Notice of Deficiency ("90-day letter") asserting a

deficiency based on the audit adjustments. IRC § 6213. If the taxpayer disagrees, it is imperative that he petition the Tax Court within ninety days to prevent an assessment from being made. If a Tax Court petition is not filed and an assessment is made, the taxpayer's remedy generally is to pay the tax in full and file a claim for refund. Flora v. United States, 362 U.S. 145 (1960).

C. Failure to Respond to Request for Tax Return

The nonfiler who does not come forward voluntarily may be contacted by the IRS and asked to file all delinquent returns. Some taxpayers may be tempted not to file delinquent returns even after being contacted. If the taxpayer does not voluntarily file returns after being contacted, the IRS has the authority to prepare substitute returns for the taxpayer. IRC § 6020(b). In addition, refusal to file returns after being contacted might increase the taxpayer's risk of criminal prosecution.

If the IRS prepares substitute returns, there is a significant risk that the tax liability will be greater than if the taxpayer voluntarily filed returns. In preparing substitute returns the IRS generally maximizes the tax liability by including all known sources of income, while allowing the taxpayer only one exemption and the standard deduction. In addition, the IRS will prepare the returns with a filing status of single or, if the taxpayer is married, married filing separate.

When the IRS prepares substitute returns the taxpayer may be deprived of certain administrative remedies, including the issuance of a 30-day letter and the right to an Appeals conference. However, the taxpayer will receive a Statutory Notice of Deficiency based upon the substitute return. The taxpayer must file a timely Petition with the Tax Court if he disagrees with the proposed deficiency.

If the taxpayer does not file a Petition to the Tax Court, the IRS will make an assessment of the proposed deficiency. If the amount of the assessment is incorrect and the taxpayer cannot fully pay the tax and file a claim for refund, the tax practitioner should consider requesting reconsideration of the assessment by the Examination Division. In the alternative, an Offer in Compromise based upon doubt as to liability may be submitted or the taxpayer may prepare and file returns and request an administrative adjustment.

D. Civil Penalties

A taxpayer who files delinquent returns will face significant liability for civil penalties in addition to the liability for tax. In recent years Congress has made substantial changes to the penalty provisions of the Internal Revenue Code. The tax practitioner advising the nonfiler must be aware of all possible penalties that the IRS may assert for each of the years for which delinquent returns are filed.

In 1989, Congress enacted legislation substantially revising the civil penalty provisions. The Improved Penalty Administrative Compliance Tax Act ("IMPACT"), Omnibus Budget Reconciliation Act of 1989, P.L.101-239, Title VII, Subtitle G (Dec. 19, 1989), applies to tax years for which the due date of a tax return, without consideration of extensions, is after December 31, 1989.

The IMPACT legislation did not significantly change the failure to file, failure to pay tax and estimated tax penalties, which are the penalties most frequently asserted when delinquent returns are filed (Exhibit D). IMPACT, however, revised the negligence and substantial understatement penalties, along with certain other penalties, by providing for a new accuracy-related penalty. IMPACT also created a new penalty for fraudulent failure to file tax returns.

1. **Failure to File Penalty**

The Internal Revenue Code imposes a delinquency penalty for failure to timely file a tax return. IRC § 6651(a)(1). The penalty is equal to five percent of the net amount of tax due on the return for each month the return is delinquent, up to a maximum of twenty-five percent. A minimum penalty equal to the lesser of $100 or one hundred percent of the tax required to be shown on the return will be imposed if the return is not filed within sixty days of the due date. IRC § 6651. The IRS may assess the penalty based upon the tax shown on the return without first issuing a Notice of Deficiency. However, if the IRS asserts the penalty based on an additional deficiency in tax, it must issue a Notice of Deficiency before the penalty may be assessed. IRC § 6665(b)(1).

A taxpayer seeking to avoid the failure to file penalty must establish the existence of reasonable cause and that the failure to file was not due to willful neglect. The primary consideration in determining whether reasonable cause exists for a failure to file a tax return is whether the taxpayer was unable to file the tax return on time notwithstanding the exercise of ordinary business care and prudence. Treas. Reg. § 301.6651-1(c)(1). Willful neglect is defined as a conscious, intentional failure or reckless indifference to the filing requirement. United States v. Boyle, 469 U.S. 241, n.3 (1985).

In general, ignorance of the law is not an excuse for failing to timely file a tax return. Logan Lumber Co. v. United States, 365 F.2d 846 (5th Cir. 1966). Nor does a taxpayer's reliance upon a professional to file a return constitute reasonable cause. United States v. Boyle, 469 U.S. 241 (1985). Reliance upon the advice a tax professional on a matter of law, such as whether a tax liability exists or a return is required to be filed, can constitute reasonable cause. See La Meres v. Commissioner, 98 T.C. 24 (1992).

A taxpayer seeking to avoid imposition of the failure to file penalty must submit a written statement under penalties of perjury setting forth specific facts demonstrating the existence of reasonable cause. Treas. Reg. § 301.6651-1(c)(1). The statement should be submitted either to the District Director or to the Service Center where the return was filed. It may be best to submit the statement with the return when it is filed rather than requesting the abatement of delinquency penalties after assessment.

2. **Fraudulent Failure to File Return Penalty**

Where the IRS determines that a failure to file was due to fraud, the failure to file penalty is increased from five percent per month to fifteen percent per month, up to a maximum of seventy-five percent of the tax due. Code § 6651(f).

3. **Failure to Pay Tax Penalty**

The Internal Revenue Code imposes a delinquency penalty for failure to pay tax shown to be due on a return. The failure to pay tax penalty is equal to one-half of one percent of the tax per month, up to a maximum of twenty-five percent. IRC § 6651(A)(2). For any month in which the failure to file and failure to pay penalties both apply, the amount of the failure to pay penalty reduces the amount of the failure to file penalty. Because the failure to pay tax penalty is based upon the amount of tax shown to be due on the return but not paid, the penalty cannot be imposed if no return is filed or if the IRS prepares a substitute return. Rev. Rul. 76-562, 1976-2 C.B. 430.

As with the failure to file penalty, the failure to pay tax penalty may be excused by establishing reasonable cause. The taxpayer must demonstrate that despite the exercise of ordinary business care and prudence he was nevertheless unable to pay the tax when due or would have suffered an undue hardship if the tax was paid on the due date. Treas. Reg.

§ 301.6651-1(c)(1). Undue hardship is something more than inconvenience to the taxpayer. Undue hardship exists, for example, if payment of the tax when due would have resulted in a substantial financial loss, such as the sale of property at a sacrifice price. Treas. Reg. §§ 6651-1(c)(1), 1.6161-1(b). The procedure for obtaining relief from the failure to pay tax penalty is identical to that for obtaining relief from the failure to file penalty.

4. Estimated Tax Penalty

If the taxpayer has not made sufficient prepayments of his tax liability, the IRS may assert a penalty for failure to make estimated tax payments. IRC § 6654. The penalty is computed in accordance with a formula that takes into account the amount and timing of estimated tax payments that were required to have been made. IRC § 6654(d). There is no reasonable cause exception to the imposition of the estimated tax penalty. However, the IRS may waive the penalty under certain circumstances. IRC § 6654(e)(3)(A).

5. Accuracy Related Penalty

In preparing delinquent returns, the tax practitioner must be concerned about penalties based on inaccurate information contained in the return. The IMPACT legislation created an accuracy-related penalty designed to replace a number of penalties, including the negligence and substantial understatement of tax penalties. IRC § 6662. The penalty is equal to twenty percent of the portion of the underpayment attributable to negligence or disregard of rules or regulations, or a substantial understatement of tax. IRC § 6662(a).

The accuracy-related penalty only applies where a return is filed with the IRS. Accordingly, the penalty does not apply when the IRS prepares substitute returns. In general, the accuracy-related penalty can be avoided upon a showing of reasonable cause. IRC § 6664(c)(1). The substantial understatement prong of the penalty can also be avoided if there is substantial

authority for the taxpayer's position or adequate disclosure. The IRS may impose the accuracy-related penalty in addition to the failure to file penalty, but may not consider the fact that the return was filed late in determining whether to impose the accuracy-related penalty. Treas. Reg. § 1.6662-2(a).

6. Fraud Penalty

In general, for all tax years since 1986 the civil fraud penalty is equal to seventy-five percent of the underpayment attributable to fraud. Former IRC § 6553(b)(1); IRC 6663(a). The term "fraud" means an "intentional wrongdoing on the part of the taxpayer motivated by a specific intent to evade a tax known or believed to be owing." Stolzfus v. United States, 398 F.2d 1002, 1004 (3rd Cir. 1968), cert. denied, 393 U.S. 1020 (1969). The IRS must establish fraud by clear and convincing evidence.

For post-IMPACT tax years, it is presumed that the entire underpayment is attributable to fraud unless the taxpayer can establish otherwise by a preponderance of the evidence. IRC § 6663(b). Also for post-IMPACT tax years, the IRS cannot impose the civil fraud penalty unless a return has been filed. IRC § 6664(b). However, the fraudulent failure to file penalty may be imposed if no return is filed. IRS § 6651(f).

E. Interest

The taxpayer's liability will be increased not only as a result of penalties, but also from the accrual of interest. Interest is required to be paid on any tax underpayment at a rate established on a quarterly basis under the Internal Revenue Code. IRC § 6601. Interest is compounded daily. IRC § 6621. Although the interest rate on underpayments is currently nine percent, the long time nonfiler may be faced with paying interest at higher rates for certain periods.

Taxpayers are rarely successful in obtaining an abatement of interest. However, where the accrual of interest results from an error or delay on the part of an IRS employee to perform a ministerial or managerial act, interest may be abated. IRC § 6404(e)(1).

Interest is computed not only on the amount of the underpayment of tax but also on penalties. As a general rule, interest on penalties begins to accrue if the taxpayer fails to pay within ten days after notice and demand for payment is made. IRC § 6601(e)(2)(A). However, interest accrues on certain penalties such as the failure to file penalty from the due date of the return. IRC § 6601(e)(2)(B).

IV. REFUNDS

It is extremely important that tax practitioners be aware that the Internal Revenue Code limits the time within which a taxpayer may obtain a refund of overpaid taxes. In general, a taxpayer must claim a refund of overpaid taxes within two years of the date the tax was paid or three years from the time the tax return was filed, whichever is later. IRC § 6511(a). In the case of withheld taxes and estimated tax payments, the tax is deemed to be paid on April 15th of the year following the tax year in question. IRC § 6511(b)(1) and (2).

If no return is filed, a refund claim must be filed within two years of the date the tax was paid. IRC § 6511(a). If a delinquent return is filed within three years of the due date, a taxpayer is entitled to claim a refund of any amounts paid in the preceding three years. Rev. Rul. 76-51, 1976-2 C.B. 428. If, however, the IRS issues a notice of deficiency for a year for which a return was not filed, the taxpayer will be entitled to refund or credit only of amounts paid within two years of the date of the notice of deficiency. R.F. Lundy v. Commissioner, 96-1 USTC ¶50,035. By way of example, in order to receive a refund of amounts withheld during 2000, a taxpayer ordinarily must file his 2000 tax return within three years of the due date of the return, or on or

before April 15, 2004. If the IRS issued a notice of deficiency for the 2000 tax year on June 1, 2003, before the delinquent return was filed, the taxpayer would be barred from claiming a refund for any amounts withheld or paid in excess of the tax liability.

V. COLLECTION ISSUES

After returns have been filed the IRS will assess the tax shown on the returns, together with interest and penalties. Frequently, in the case of a multiple year nonfiler the taxpayer does not have the ability to pay the substantial liability that results from the filing of delinquent returns. Since many nonfilers apparently do not come forward due to an inability to pay and fear of the collection process, as part of the Nonfiler Program, the IRS will consider resolving the collection case before returns are filed. Accordingly, the tax practitioner advising the nonfiler should calculate the anticipated liability and discuss the collection process with the taxpayer before filing any delinquent returns.

A. The Collection Process

After the assessment is made, the IRS will send the taxpayer a notice and demand for payment. If the taxpayer does not make full payment within ten days, a federal tax lien arises by operation of law and attaches to all property and rights to property of the taxpayer. IRC § 6321. The IRS is not required to do anything further to perfect the tax lien. However, until a Notice of Federal Tax Lien is filed, the lien does not have priority over certain other lien creditors such as judgment lien creditors, mortgagees, mechanics lienors and purchasers. IRC § 6323(a).

If the taxpayer does not respond to the initial notice and demand for payment, the IRS will normally send a second notice approximately five weeks later demanding payment. Thereafter, the IRS may send up to two more notices at intervals of four to six weeks. The final

notice the taxpayer will receive before the IRS can take enforced collection action is the Final Notice of Intent to Levy. If full payment of the liability is not made within thirty days of issuance of the Notice of Intent to Levy, the IRS may take enforced collection against the taxpayer, including levying on wages and bank accounts and seizing and selling property.

Generally, the IRS sends the full sequence of notices before issuing a Final Notice of Intent to Levy. However, in some instances the IRS may issue the Final Notice of Intent to Levy ten days after the initial Notice and Demand. Thus, the earliest the IRS can pursue enforced collection action against the taxpayer is 40 days after the date of the assessment.

The Internal Revenue Service Restructuring and Reform Act of 1998 made significant changes to the collection process. Included in these changes is the opportunity for a taxpayer to file a collection due process appeal within thirty days of the date on the Final Notice of Intent to Levy. IRC § 6330. If a timely collection due process appeal is filed, the taxpayer can present alternatives to the proposed enforced collection action. During the pendency of the collection due process appeal the IRS is barred from pursuing enforced collection action.

B. Resolution of the Collection Case

The tax practitioner should contact the IRS and attempt to resolve the collection case well in advance of the issuance of the Final Notice of Intent to Levy. Among the options available to the taxpayer are submission of an Offer in Compromise, entering into an installment agreement, convincing the IRS to write the account off as temporarily uncollectible ("53" procedure), filing bankruptcy, or waiting for the statute of limitations on collection to expire.

1. Installment Agreement

The taxpayer may be able to avoid enforced collection action by negotiating a written installment agreement for the payment of the liability. Generally, the IRS

will agree to an installment agreement only if the taxpayer is unable to pay the liability in full. In addition, the IRS will require the taxpayer to file all delinquent returns before considering an installment agreement.

In arriving at the amount of the monthly installment payment, the IRS will determine the amount by which the taxpayer's monthly income exceeds his monthly allowable living expenses. Since the amount of the liability may be significant and interest and penalties will continue to accrue during the term of the installment agreement, an installment agreement frequently does not result in a reduction of the taxpayer's liability.

2. Offer in Compromise

The IRS may compromise any civil tax liability based upon doubt as to collectibility. IRC § 7122. As part of the Compliance 2000 Program, the IRS publicized its updated Offer in Compromise Program. Collection Division personnel have been directed to advise taxpayers of the Offer in Compromise process and, if appropriate, to assist in the preparation of the offer. The taxpayer should be advised that the IRS may insist that installment payments be made while an offer is under consideration by the IRS.

In determining whether an offer is acceptable, the IRS calculates whether the amount offered reasonably reflects the taxpayer's ability to pay. Specifically, the IRS expects that the amount offered will include the amount of the taxpayer's equity in assets that are not exempt from levy, as well as the present value of the amount of anticipated future income over a five-year period. In determining equity in assets, the IRS generally considers "quick sale value," which is approximately 80 percent of fair market value.

If the IRS and the taxpayer agree on the appropriate amount of an offer, and the taxpayer pays that amount, the IRS will forgive the unpaid balance of the liability. The IRS will also

require that the taxpayer comply with all filing and payment requirements for five years from the date of the acceptance of the offer. The taxpayer's failure to do so will result in reinstatement of the entire tax liability with interest.

Interest will continue to accrue while the offer is pending. Also, the statute of limitations on collection will be suspended during the time the offer is under consideration, and if rejected, for thirty days thereafter and during the pendency of an appeal. Accordingly, if the offer is rejected, the IRS will have additional time to collect the liability.

3. <u>Bankruptcy</u>

Under certain circumstances, income taxes, interest and penalties can be discharged in a Chapter 7 bankruptcy proceeding. Generally, income taxes, interest and penalties are dischargeable if the bankruptcy petition is filed more than two years after a delinquent return is filed and the petition filing date is at least three years after the due date of the tax return. In addition, the IRS must have made the assessment for the taxes more than 240 days prior to the date the bankruptcy petition is filed. Bankruptcy Code, 11 USC §§ 523(a)(1) and 507(a)(7). A taxpayer considering bankruptcy should be aware that the 240-day period does not run during the time an offer in compromise is under consideration by the IRS and for 30 days after rejection or withdrawal of the offer.

The tax liability will not be discharged if the fraud penalty has been assessed. 11 USC § 523(a)(1)(C). Accordingly, it is important that the taxpayer not agree to the civil fraud penalty if bankruptcy is being considered as an option to resolve the collection case.

The bankruptcy courts strictly construe the timing requirements for dischargeability of taxes. A premature bankruptcy filing will not discharge taxes that are otherwise dischargeable.

Accordingly, before the taxpayer files a bankruptcy petition, a transcript of account should be reviewed to verify the filing and assessment dates for all years.

If the IRS has prepared substitute returns for the taxpayer, the tax liabilities are not dischargeable since the returns were not filed by the taxpayer. R.G. Guishue, BC-DC Pa., 91-1 USTC ¶ 50223. Where assessments have been made based upon substitute returns, the taxpayer should file delinquent returns to insure that the taxes will be dischargeable at the appropriate time.

As an alternative to a Chapter 7 bankruptcy filing, a filing under either Chapter 11 (reorganization) or Chapter 13 (individual bankruptcy) may be an option, particularly where the IRS is taking an aggressive position in pursuing enforced collection. Upon the filing of a bankruptcy petition, § 362 of the Bankruptcy Code acts as an automatic stay to prevent the IRS from taking further enforced collection action against the taxpayer. In either a Chapter 11 or 13 case the debtor-taxpayer must submit a plan for payment of creditors, including the IRS, and must obtain the court's approval of the plan.

4. Uncollectible Accounts

The IRS has the authority to temporarily suspend collection action if it determines that the taxpayer does not have assets which can be liquidated or has insufficient income to make periodic installment payments. This is commonly known as a "53" of the account. This does not result in a reduction or elimination of the tax liability, but only provides temporary relief from collection action. The IRS will, however, reevaluate the taxpayer's

financial condition periodically. If the taxpayer's ability to pay improves, the IRS will expect the taxpayer to work out terms for payment.

5. Statute of Limitations

The IRS may collect a tax liability at any time within ten years of the date of assessment. IRC § 6502. Accordingly, it may not be advisable for a taxpayer to negotiate a resolution of the liability with the IRS if the ten year collection period is about to expire. However, in the case of large tax liabilities, the Department of Justice may file suit in the United States District Court prior to the expiration of the statute of limitations seeking to reduce the liability to judgment. If the government prevails, a judgment will be entered allowing the government to continue to pursue collection action beyond the ten year period.

VI. CONCLUSION

Clearly, the criminal consequences of failing to file tax returns are the most serious, and the tax practitioner should advise his client of the possibility of prosecution. However, the risk of prosecution is generally remote in most failure to file cases.

If the tax practitioner decides to prepare delinquent returns, he will be faced with reconstructing income and expenses to prepare accurate returns. The tax practitioner should attempt to minimize the underlying tax liability and any possible penalties.

Once returns are filed, the taxpayer's greatest concern will be resolving the collection case. This is generally the most difficult issue to resolve in representing the nonfiler. The tax practitioner should review the taxpayer's financial condition and discuss the various collection options with the taxpayer before returns are filed.