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IRS NON-FILERS RISK CIVIL AND CRIMINAL SANCTIONS

by

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The system of taxation in the United States is based on the willingness of taxpayers to assess and pay their taxes on a voluntary basis. This system of voluntary compliance requires that taxpayers take reasonable, good faith steps to determine their tax and pay that tax in a timely manner. For various reasons, some individuals fail to file returns in a timely manner, if at all. Many people fail to file because of a personal problem, such as a divorce or a death in the family, or a business reversal. Some claim to be trapped into non-filing status because of past decisions. Others simply analyze optional strategies based on their view of the probability of audit and detection and the extent of the potential penalties, if discovered.

Since 1952, the IRS has made a practice of taking a taxpayer's voluntary disclosure into consideration when determining whether to recommend a criminal prosecution for a violation of the tax law. This voluntary disclosure practice is not an amnesty or a grant of immunity from prosecution. There is no guarantee that there won't be a recommendation of criminal prosecution of an individual who comes forward voluntarily to report the failure to file a return. However, the practice at the IRS has been to not do so where the person:

- a) informed the IRS that they have not filed tax returns for one or more tax periods;
- b) had only legal source income (no part of the income was earned from activities which are illegal under federal or state law.);
- c) made the disclosure prior to being contacted by the IRS;
- d) either filed a true and correct tax return or cooperated with the IRS in ascertaining the correct tax liabilities, and
- e) either paid the amount due in full or made a bonafide arrangement to pay the amount due.

In a test program, the IRS discovered that more than 60% of non-filers were self-employed people who dealt in cash or were wage earners who had little tax withheld from their wages. As a result, to improve tax compliance and bring non-filers back into the system, the IRS maintains an ongoing "non-filer program" which identifies non-filers through various methods, including an analysis of information reporting and past filing patterns. A "non-filer" is a taxpayer who fails to file their return before the deadline to file the following year's return. In 1992, the methods employed by the non-filer program produced about 4.6 million delinquent returns resulting in more than \$10 billion in assessments. From 1992 to 1994, the non-filer program generated a 6% increase in the receipt of delinquent returns from individual taxpayers.

The IRS is expending a substantial amount of time and effort implementing its major modernization effort referred to as Tax Systems Modernization ("TSM"). They are taking advantage of modern technology due to the growing population, development of a global economy, and the sophisticated technology utilized by taxpayers. Historically, there has been considerable publicity about the fact that the IRS physically "audits" less than about 2% of the individual income tax returns that are filed. In 1996, it is anticipated that approximately 209 million returns will be filed which means that less than 4 million returns may actually be audited. In calendar year 2002, it is estimated that 228 million returns will be filed. However, with TSM, the increased submission of tax information reporting documents to the IRS in computer useable form, and the passage of the Tax Reform Act of 1986, the need to physically audit individual tax returns has greatly decreased. With information matching, many itemized deductions can be verified by using third-party data and computer matching. Deductions not subject to matching, such as medical and dental expenses and miscellaneous itemized deductions, are subject to threshold floors that have significantly reduced the number of people eligible for those deductions.

Since most issues on individual non-business returns can be handled more efficiently by correspondence, the desirability for an audit by the IRS has substantially decreased. Changes in the nature of deductions and information reporting coupled with new technology have changed the nature of compliance and enforcement actions. Taxpayers have an incentive to be somewhat conservative in the treatment of otherwise questionable deductions and to fully report income since they can be assured that this information is being monitored through the computerization efforts of the IRS. Under its Information Reporting Program (IRP), the IRS cross-checks the failure to report an income source, such as interest or dividends, or overstating a deduction, such as taxes or mortgage interest paid. In 1993, the IRS sent out 2.7 million IRP underreporter notices to taxpayers, assessing an additional \$1.52 billion in additional tax, penalty, and interest. The IRS also sent 1.56 million notices to taxpayers, on the basis of third-party information, asking for the submission of a tax return in 1993. The non-filer notices led to an additional \$2.17 billion in additional tax, penalty, and interest assessments.

Most taxpayers do not want to discover the consequences of a potential audit and attempt to comply with the reporting requirements. Although contacting a taxpayer through correspondence is often adequate to establish an IRS presence, traditional enforcement methods remain the foundation of a high voluntary compliance rate. There are approximately 2,600 tax auditors who examine the relatively simple, less complex, individual and business returns and approximately 16,000 revenue agents who examine the more complex and sophisticated returns. In addition, there are approximately 3,200 special agents who perform criminal investigation functions on behalf of the IRS.

Before contacting a non-filer, the IRS attempts to summarize the non-filer's occupation, location of bank/savings accounts, sources of income, age, health, current address, last filed return, adjusted gross income of last filed return, taxes paid on last filed return - amounts and methods of payment (withholding or estimated tax), number of years delinquent, and the non-filer's standard of living. Public records, including real estate records, records of professional associations and business license bureaus, may be searched for evidence of additional unreported income. The last known employer may be contacted to determine if the non-filer is still

employed and the specific occupation of the non-filer. Determining the non-filer's specific occupation can lead to additional sources of information, such as labor unions, professional societies, and trade associations. During this investigation, the IRS will be alert to attempts by the non-filer to conceal or transfer assets to evade collection of any tax to be assessed. In these cases, a jeopardy (immediate) assessment may be considered.

During the investigation of a non-filer, the IRS will determine if related returns (corporate, partnership, and employment returns) have been filed as required. They will also search for spinoff cases - relatives, employees, employers, subcontractors, partners, and even return preparers and representatives who have not filed returns. If a non-filer is involved in a family business, the IRS may attempt to determine if the family members have filed their returns. If the non-filer is involved in a partnership, the IRS may determine if the partnership returns have been filed and determine if other partners have filed their returns. For delinquent corporate returns, the IRS may attempt to discover if the other shareholders have filed their returns.

Once identified, non-filers may be contacted by telephone, including calls to the home, work or third parties. The IRS can utilize various indirect methods to determine taxable income (such as industry standards or an analysis of the taxpayer's net worth, bank deposits, and expenditures). The new market segment specialization approach (whereby IRS agents have become specialized in various business practices and industries) streamlines the process of determining income for certain types of taxpayers. The IRS will generally determine the nonfiler's tax liability based upon the information obtained and will not search out allowable exemptions, deductions, or credits.

Typically, it is IRS policy to enforce the filing of returns for the prior six tax periods. In considering whether shorter or longer periods should be enforced, the IRS will determine the prior history of non-compliance, the potential existence of income from illegal sources, the effect on voluntary compliance, the anticipated revenue in relation to the time and effort required to determine the tax

due, and special circumstances that may exist with respect to the particular taxpayer or industry in which the taxpayer is involved.

The IRS is responsible for investigating possible criminal violations of the tax law. It was an IRS investigation that led to the conviction of Al Capone when traditional law enforcement efforts were not successful. Failure to knowingly file a return can be a criminal violation of the tax law subjecting the non-filer to a possible lengthy prison sentence. Depending upon the results of the non-filer investigation, there may be a referral directly to the Criminal Investigation Division of the IRS (CID). When there are firm indications of fraud, the initial contact may be from CID. In this event, the non-filer will not otherwise be contacted to solicit the delinquent returns.

CID will determine whether there is a history of non-filing (multiple non-filed years may provide a fraudulent pattern of behavior), whether there have been repeated contacts by the IRS, indications that the non-filer had knowledge of the return filing requirements, whether there is evidence of cash transactions (i.e., purchases by cash or cash deposits as evidenced by currency transaction reports), and whether there are indications of significant unreported income (i.e.

substantial interest and dividends earned, high mortgage interest paid, or stock and bond transactions). Each of these factors is not required for a successful criminal prosecution.

Although the IRS has a somewhat limited capacity to perform criminal investigations, a significant amount of time is not required to criminally investigate and prosecute a non-filer. The minimum thresholds for commencing a criminal investigation are generally in the range of about \$2,500 in unreported income or overstated deductions. Approximately 97% of the individuals indicted for tax-related crimes are convicted since the IRS does not need to demonstrate the exact amount of the underreporting or overstated deductions to obtain a conviction. In 1993, the average prison sentence for tax-related crimes was 28.5 months. Under the Federal Sentencing Guidelines, an individual is generally required to serve a prison term equivalent to 85% of the sentence imposed.

It is not the goal of the non-filer program to prosecute ordinary people who simply made a mistake. In fact, some may benefit by filing delinquent returns - tax refunds may be lost if returns are not filed within three years from the due date of the return. Also, self-employed non-filers could become ineligible for social security retirement or disability benefits. If the situation warrants, IRS will negotiate an acceptable payment arrangement for any resulting liability. The majority of non-filers that come forward and file returns prior to being notified that they are under investigation, will not be pursued through a criminal investigation. However, it has been discovered that many non-filers that returned to the system following prior contacts by the IRS failed to file returns for subsequent tax years. These individuals can anticipate a somewhat unfriendly contact by CID- the criminal enforcement arm of the IRS.

As TSM progresses, non-filers should not delay in seeking counsel regarding the preparation of delinquent returns. The next "knock on the door" may be an IRS agent or criminal investigator. If contacted, a non-filer should promptly seek the assistance of counsel. Full compliance in the timely filing and reporting of tax-related information remains the best policy.