

Practice

By Charles P. Rettig

Nonfilers Beware: Who's That Knocking at Your Door?

The Senate Finance Committee recently held hearings entitled "A Closer Look at the Size and Sources of the Tax Gap." Since the "Tax Gap" represents unpaid taxes, any estimate is, at best, a WAG (wild-guess), although most believe the current federal net Tax Gap approximates \$257-298 billion dollars (based on data for tax year 2001), representing a noncompliance rate of 15–16 percent. The Tax Gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. It represents, in dollar terms, the annual amount of noncompliance with our tax laws.

Few other countries can boast of a tax compliance rate of approximately 84 percent! However, all agree that a noncompliance rate of 15-16 percent, amounting to several hundred billion dollars, is clearly unacceptable in our self-assessment tax system.

The Tax Gap is mostly comprised of under-reporting of income, underpayment of reported taxes, and the nonfiling of returns. It is believed that 82 percent of the Tax Gap is associated with under-reporting on filed returns; 8 percent is associated with nonfiling; and 10 percent is associated with the nonpayment of tax. The majority of the Tax Gap appears to relate to individual income tax (\$197 billion, or approximately 57 percent—principally nonbusiness income and business income) and employment tax (\$39 billion, or approximately 11 percent—principally self-employment tax). The balance relates to corporate tax, estate tax and excise taxes.

Amounts subject to withholding (e.g., wages and salaries) have a net misreporting percentage of only 1.2 percent. Amounts subject to third-party information reporting, but not to withholding (e.g., interest and dividend income) have a slightly higher net misreporting percentage of 4.5 percent. Amounts



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subject to partial third-party reporting (e.g., capital gains) have a still higher net misreporting percentage of 8.6 percent. Amounts not subject to withholding or information reporting (e.g., Schedule C income and “other income”) are the least visible, with a much higher net misreporting percentage of 53.9 percent.

Commissioner Mark W. Everson has often stated that the complexity of our current tax system is a significant reason for the Tax Gap and that fundamental reform and simplification is necessary to achieve significant reductions. The IRS is committed to finding ways to increase compliance and reducing the Tax Gap within our current system of taxation. Congress and the IRS must determine the appropriate level of tax enforcement resources, taking into account the balance between taxpayer service and enforcement activities, and competing federal priorities.

The Government Accountability Office (GAO) issued a Tax Compliance Report on July 26, 2006, stating that the Tax Gap may be reduced through: (1) tax code simplification and fundamental tax reform, noting that for tax year 2001, errors in claimed tax credits and deductions contributed \$32 billion to the Tax Gap; (2) providing IRS with more enforcement tools, noting that increased withholding and information reporting would help uncover the largest contributor to the Tax Gap—underreported income; (3) increased IRS enforcement resources, enabling it to contact millions of potentially non-compliant taxpayers it has identified but currently cannot contact given various resource constraints, and; (4) utilizing multiple approaches, setting Tax Gap reduction goals and measuring progress against these goals, leveraging technology to enhance IRS’s efficiency, periodically measuring noncompliance and its causes, optimal allocation of resources, and evaluating the results of any initiatives designed to reduce the Tax Gap.

The Department of the Treasury released its Tax Gap report “A Comprehensive Strategy for Reducing the Tax Gap” on September 26, 2006. The Treasury is focused on reducing the Tax Gap through: (1) reducing the opportunities for evasion throughout the system; (2) making a multi-year commitment to research measuring the effectiveness of the IRS

activities and initiatives; (3) ongoing technology improvements designed to improve compliance through early detection, better case selection and better case management; (4) improved compliance activities (document matching, examination and collection activities, etc. designed to improve compliance among those directly contacted by IRS, as well as others who would be deterred from noncompliant behavior as a consequence of more visible IRS enforcement

presence); (5) enhanced taxpayer services helping avoid unintentional taxpayer errors; (6) proposals to simplify the tax law; (7) enhanced coordination with state and foreign governments and providing information to bar and accounting practitioner organizations. The IRS

will continue to seek ways to make its operations more efficient, thereby freeing resources to fund new compliance initiatives.

The IRS has significantly enhanced its ongoing enforcement efforts since being unjustly attacked by Senator Roth and others in Senate Hearings held in 1997–1998. Increased information reporting to the IRS and expedited reporting by the IRS with state and foreign governments will have a significant impact on the federal and state versions of the Tax Gap. As a result of their matching programs, the government can better identify taxpayers who have underreported or not reported income, or have otherwise failed to file returns. With Congress now involved, hunting for under-reporters and nonfilers will likely become the trophy sport for the IRS!

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Nonfilers

A “nonfiler” is a taxpayer (or someone who ought to be a taxpayer) who does not file their return before the deadline to file the next year’s return. A “late filer” is taxpayer who misses the deadline for the year in question, but files the return within the following year. Many nonfilers analyze optional strategies, given the probability of audit and detection and the extent of penalties if discovered. Others claim to be trapped into nonfiling status because of poor past decisions. Typically, nonfilers fall into three categories:

(1) Procrastinators—They know they should file, but need assistance and/or prompting. They will

typically respond to IRS and always indicate that they will cooperate. However, information is generally slowly provided in a piecemeal fashion.

- (2) Uncooperative Nonfilers—They refuse to acknowledge and respond to correspondence and/or phone calls and state up front that they will not cooperate.
- (6) Tax Protestors—They advocate and/or use tax protestor's schemes (*i.e.*, refusal to file because of alleged constitutional reasons).

The IRS has identified at least 10 million delinquent returns and is pursuing a cross-functional National Non-Filer Strategy to identify noncompliant taxpayers and design methods to encourage their compliance. Before contacting a nonfiler, the IRS will often attempt to identify the nonfiler's occupation, location of bank/savings accounts, sources of income, age, current address, last file returned, adjusted gross income of last file returned, taxes paid on last filed returned—amounts and methods of payment (withholding, estimated tax, pre-payments), number of years delinquent and the nonfiler's standard of living. They will search public records for evidence of additional unreported income, tax assessor and real estate records for assets held by the nonfiler, and records of professional associations and business license bureaus for information on businesses being operated by the nonfiler. They will also search sales tax returns and the state records to disclose corporate charter information, including principals of any businesses that have failed to file returns. They will contact the last known employer to determine if the non-filer is still employed and the specific occupation of the nonfiler.

Determining the specific occupation of the nonfiler can lead to additional sources, such as labor unions, professional societies, trade associations, *etc.* They will also determine whether there is a history of non-filing (multiple nonfiled years provide a pattern of behavior), whether there have been repeated contacts by the IRS, indications that the nonfiler had knowledge of filing requirements (*i.e.*, professional with an advanced education, person who works directly in the tax field), whether there are a large number of cash transactions (*i.e.*, purchases by cash, cash deposits as evidenced by currency transaction reports, *etc.*) and whether there are indications of significant unreported income (*i.e.*, substantial interests and dividends earned, investments in IRA accounts, stock and bond transactions, high mortgage interest paid, *etc.*). When contacting the taxpayer, the IRS will at-

tempt to gather as much information as possible to arrive at a substantially correct tax assessment. They will also attempt to establish reasons for the non-filing by asking specific and direct questions (*i.e.*, Why were returns not filed? Did you know that you were required to file returns?).

If a nonfiler is contacted by the government, the examiner will determine the cause (does the non-filer lack records, ability to pay, lack of education, *etc.*) and may offer necessary information or assistance (preparation of returns, payment arrangement information, *etc.*) to secure full cooperation. If the nonfiler is uncooperative (won't respond or refuses to cooperate), third-party contacts will be made to determine the non-filer's income. Summons will be used, where appropriate. If the examiner discovers subsequent acts of tax evasion (false statements, refusal to make records available, *etc.*), they will consider whether the case should be referred for a criminal investigation. The examiner will also be alert to attempts by the nonfiler to conceal or transfer assets to evade collection of tax later assessed. In these cases, a jeopardy (immediate) assessment may be considered.

During nonfiler examinations, the examiner will determine if related returns (corporate, partnership, employment and excise tax returns) have been filed as required. They will also search for spin-off cases involving relatives, employees, employers, subcontractors, partners and even return preparers! If a nonfiler is involved in a family business, the examiner should determine if all family members have filed returns. If the nonfiler is involved in a partnership, the IRS should determine if partnership returns have been filed and determine if all partners have filed returns. For delinquent corporate returns, they should determine if all shareholders have filed returns. Penalties are not typically or easily waived in nonfiler cases without reasonable cause.

If the taxpayer does not respond to government inquiries, the IRS may independently prepare a tax return and the related assessments under Code Sec. 6020(b). These assessments are generally based on very limited information, such as that gathered from Forms W-2 and 1099. For these cases, the IRS assesses the maximum potential tax owed based on gross receipts since they don't have access to potential deductions, exemptions or credits available to the taxpayer. By failing to file a return, a taxpayer may also lose a refund of any amounts withheld. The failure to file and pay self-employment tax by self-employed individuals could cause them to be ineligible for social security retirement or disability benefits.

Generally, the role of IRS Criminal Investigation (IRS-CI) in the National Non-Filer Strategy is the enforcement of the tax laws for individuals who are not responsive to outreach efforts. IRS-CI has devoted resources to identify these individuals, and in the most flagrant cases, criminal prosecution has been, and will continue to be, recommended. IRS-CI has developed and investigates high-impact investigations of nonfilers in various occupations and industries, as well as those who file nonprocessable returns or employ frivolous arguments, which the courts have repeatedly rejected. The majority of people who come forward and file returns prior to being notified by IRS are not pursued through a criminal investigation. However, a nonfiler should not wait since the “first knock on the door” may be that of a special agent from IRS-CI.

The objective of the nonfiler strategy is to bring nonfilers back into the tax system by securing a substantially correct delinquent return.

Voluntary Disclosure

Practitioners often struggle with the issue of whether a taxpayer can avoid a criminal tax investigation by making a disclosure to the IRS. A “voluntary disclosure” is generally the process of voluntarily reporting previously undisclosed income (or false deductions) through an amended return or the filing of a delinquent return. A taxpayer’s timely, voluntary disclosure of a significant unreported tax liability is an important factor to the IRS in considering whether the matter should be referred to the U.S. Department of Justice for criminal prosecution. Properly resolving this issue can mean the difference between a taxpayer being criminally excused of a tax crime or being convicted on the basis of admissions derived from the voluntary disclosure itself.

Certainly, the IRS has a somewhat limited capacity to perform criminal investigations. However, a significant amount of time is not required to criminally investigate and prosecute a nonfiler, particularly one who files delinquent or amended returns following an IRS inquiry. Without adequate representation, the perceived light at the other end of the voluntary disclosure tunnel may be the IRS train coming straight at the taxpayer!

The informal IRS voluntary disclosure policy creates no substantive or procedural rights for taxpayers, but rather is a matter of internal IRS practice, provided

solely for internal guidance to IRS personnel. Taxpayers cannot rely on the fact that other similarly situated taxpayers may not have been recommended for criminal prosecution. A timely voluntary disclosure will not guarantee immunity from criminal prosecution, but a true voluntary disclosure will normally result in the IRS not even recommending a criminal prosecution to the Department of Justice.

A voluntary disclosure must be truthful, timely and complete, and the taxpayer must demonstrate a willingness to cooperate (and must in fact cooperate) with the IRS in determining the correct tax liability. The taxpayer must make good faith arrangements with the IRS to pay in full, the tax, interest and any penalties

determined by the IRS to be applicable. Additionally, the policy only applies to income earned through a legal business—so called “legal source” income. Al Capone could not take advantage of the policy.

To be timely, the disclosure must be received before: (1) the IRS has initiated a civil examination or criminal investigation of the taxpayer, or has notified the taxpayer that it intends to commence such an examination or investigation; (2) the IRS has received information from a third party (e.g., informant, other governmental agency or the media) alerting the IRS to the specific taxpayer’s noncompliance; (3) the IRS has initiated a civil examination or criminal investigation which is directly related to the specific liability of the taxpayer; or (4) the IRS has acquired information directly related to the specific liability of the taxpayer from a criminal enforcement action (e.g., search warrant, grand jury subpoena).

Any taxpayer who contacts the IRS regarding a voluntary disclosure will likely be directed to IRS-CI for an evaluation of the disclosure. To determine whether the disclosure is truly voluntary, IRS will review the actual status of any prior interest in the taxpayer, the taxpayer’s potential knowledge of such interest and the taxpayer’s fear of some potential trigger that could have alerted the IRS. A voluntary disclosure cannot be made anonymously. Any plan by a taxpayer, or their representative, to resolve a tax liability, file a correct return or offer payment of taxes for an anonymous client is not to be considered a voluntary disclosure.

A voluntary disclosure does not occur until IRS has actually been contacted. As such, it is imperative that

the disclosure occur as quickly as possible. The IRS will rarely recommend prosecution if there has been a timely voluntary disclosure. Since returns filed pursuant to a timely voluntary disclosure have significant audit potential, they should be “bulletproof” in correctly reflecting the taxpayer’s income and expense items. Due to various federal-state information sharing agreements, any applicable state returns should be contemporaneously filed or amended with the federal returns. Returns for related entities should also be contemporaneously filed or amended. Questions or doubts should likely be resolved in favor of the government. If a return filed pursuant to a voluntary disclosure is less than accurate, the taxpayer is compounding—not helping the problem.

How many returns must be filed or amended?

While there is certainly no well-established rule as to how many returns must be filed in making a voluntary disclosure, the general consensus is probably six tax years since the applicable statute of limitations for most tax-related crimes is six years. The disclosure should eliminate any government concern that there might be any potential issues with respect to a particular tax year for which the applicable statute of limitations for criminal prosecutions has not already expired. Additional returns could be in order since the statute of limitations for a criminal prosecution is tolled for the period of time a taxpayer is outside of the United States or is a fugitive from justice.

Typically, in a civil context, it is also the IRS policy to enforce the filing of returns for the prior six tax years. In considering whether shorter or longer periods should be civilly enforced, the IRS will determine the prior history of noncompliance, the possible 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 existing in the case of a particular taxpayer, and class of taxpayer or industry, which may be particular to the class of tax involved. The objective of the nonfiler strategy is to bring nonfilers back into the tax system by securing a substantially correct delinquent return. The focus is the nonfiler’s tax liability as a whole, rather than the considerations of individual income and expense issues.

Counsel must determine whether to contact the IRS before submitting a voluntary disclosure and actually filing the delinquent or amended tax returns. Some practitioners prefer to submit a Freedom of

Information Act request seeking income information already in the possession of the IRS before filing the returns. Some simply choose to file the delinquent or amended returns, with payment, with the appropriate IRS service center (now referred to as a “campus”) by certified mail, return receipt requested. Filings are often sent in separately for each tax year, spaced out over a brief time period. Such filings occur during the typical tax return filing season (around April 15 and October 15 for individual returns).

Some prefer making the voluntary disclosure in a meeting with the Special Agent in Charge of the local IRS-CI where the investigation would be conducted. At this meeting, the potential voluntary disclosure would initially be discussed in a hypothetical format. Counsel would generally outline the facts in hypothetical form (probably in writing) and would request whether IRS-CI would consider the return filing to be a voluntary disclosure in order to avoid recommendation of a criminal prosecution. Counsel may also attempt to secure an IRS waiver of all applicable penalties before revealing the taxpayers identity. In the event that IRS-CI responds affirmatively, counsel would then disclose the client’s identity and taxpayer identification number. However, IRS will assert that there has not been the requisite “disclosure” until the taxpayers information has been provided to the IRS.

Enforced collection and CDP

Before IRS assesses the taxes, it will usually issue several notices apprising the taxpayer of their right to file a return or to file an appeal. Once the assessment occurs, the IRS-enforced collection process will begin. The later enforcement activities begin, the less likely IRS will be able to collect the full amount due from the taxpayer. As such, it is imperative that IRS quickly (i) identify and notify noncompliant taxpayers and (ii) commence collection activities.

IRS has streamlined its collection process and is attempting to expedite appropriate collection enforcement actions—issue tax liens, levy financial and bank accounts and refer cases to IRS Revenue Officers in the field. A taxpayer has a right to a Collection Due Process (CDP) hearing by the IRS Office of Appeals if the they timely file a *Request for a CDP Hearing* (Form 12153) regarding a specific tax period within 30 days following: (1) the first Notice of a Federal Tax Lien Filing; (2) before the IRS sends the first Final Notice—Notice of Intent to Levy; (iii) Notice of Levy on Your State Tax Refund; or (4) when

IRS issues a Notice of Jeopardy Levy. The IRS notices regarding these actions, and referenced publications, explain how to request a collection appeal if the taxpayer does not agree. The taxpayer must file a Form 12153, *Request for a Collection Due Process Hearing* and send it to the address shown on the IRS notice within 30 days from the date of the letter in order to appeal the proposed action with the Office of Appeals. Taxpayers may obtain a copy of Form 12153 by contacting the IRS office that issued the CDP Notice, by downloading a copy from the IRS Internet site, www.irs.gov/pub/irs-pdf/f12153.pdf, or by calling, toll-free, 1-800-829-3676.

The Pension Protection Act of 2006 (HR 4) amended Code Sec. 6330(d)(1) by providing that all adverse CDP appeal determinations must proceed to the United States Tax Court, regardless of whether the Tax Court would have jurisdiction over the underlying tax liability. If the taxpayer does not agree with the CDP determination by Appeals, they can request judicial review in the Tax Court (by filing a Petition for Re-determination within 30 days following the Appeals determination) only if they have timely filed the Form 12153. The Tax Court decision is final and binding on both the taxpayer and the IRS. The Tax Court has developed an expertise in handling collection appeals and this amendment to Code Sec. 6330(d)(1) resolves prior confusion that has existed regarding the proper judicial forum for resolving CDP appeals.

A taxpayer is entitled to one CDP hearing with respect to the tax and tax period covered by a CDP-enforced collection action. If the CDP request

is not received within 30 days of the IRS notice re enforced collection, the taxpayer is still entitled to an Appeals hearing. However, if they still disagree with the Appeals determination they cannot go to Court. As an alternative to CDP, a taxpayer can file a *Collection Appeal (CAP) Request* (IRS Form 9423), which provides an expedited procedure but does not afford an opportunity for judicial review of the determination by the IRS Office of Appeals. In a typical nonfiler criminal tax evasion case, the federal court often imposes a "restitution order" as part of the plea agreement or an ultimate sentence. It is not unusual for a federal judge to fix the amount of the restitution order at the amount of taxes the defendant has failed to pay.

"Do The Right Thing"

Tax laws cannot be administered by solely relying on enforcement because the government simply does not have resources to react after-the-fact to compliance concerns. Instead, tax advisors must educate their clients and others regarding their tax obligations and encourage everyone to "do the right thing." Complex tax rules tend to be the oil fields into which the "perennial loophole seekers punch holes looking for a gusher." With the increased electronic submission of tax information to the government, the need to audit individual tax returns has greatly decreased. The smartest strategy is full compliance with the filing and reporting requirements by all. Don't wait to find a stranger knocking on the door!

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