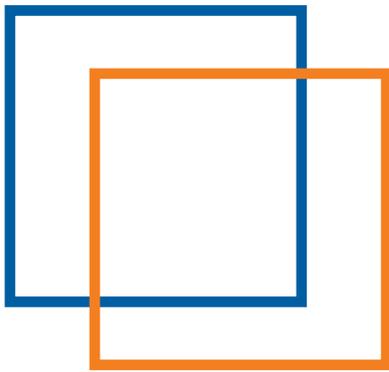


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# Beating IRS Penalties

## Your Guide to Reducing or Avoiding IRS Penalties

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An Exclusive Special Report from  
**BradfordTaxInstitute.com**

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# Hit with IRS Penalties? Pay \$0 with IRS Mercy

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If you have an IRS penalty bill, don't pay it until you read this article.

If you've recently paid an IRS penalty bill, read this article—and you might get a refund of what you paid.

Under the tax law, you can face big-dollar penalties if you (or your corporation) file your tax return late or fail to pay your taxes on time.

We'll give you a road map to IRS mercy for these common penalties. We'll explain the key words that you need to use. And we'll help you get the IRS to remove the penalty noose from your neck.

## Expensive Mistake

The IRS charges steep penalties for failing to file tax returns on time:

- For your individual or C corporation return, the penalty is generally 5 percent of the total tax owed on the return for each month the return is unfiled, up to a maximum penalty of 25 percent of the total tax owed.<sup>1</sup>
- For your partnership or S corporation return, the penalty is \$200 per partner or shareholder per month, up to a maximum of 12 months.<sup>2</sup>

Integrated with the late filing penalty is a late payment penalty. The late payment penalty is 0.5 percent of the tax owed on the return for each month the tax is unpaid, up to a maximum of 25 percent of the total tax owed.<sup>3</sup>

**Example 1.** You forgot to file an extension and then filed your Form 1040 tax return on May 20. You owed \$3,000 on the return and paid it in full when you filed it on May 20, two months late. The IRS hits you with \$300 in penalties—\$270 for late filing and \$30 for late paying.<sup>4</sup>

**Example 2.** You forgot to file your S corporation tax return. You filed it on March 20, only five days late. If your S corporation has 10 shareholders, that's a whopping \$2,000 penalty.

## Quick Relief Is Possible

Your penalty relief could take only minutes. That's true IRS mercy: (1) just minutes on the phone and (2) forgiveness of your penalty.<sup>5</sup>

You just need to know how to ask for relief and what buzzwords to use with the person on the phone.

If the IRS forgives your \$2,000 penalty in 15 minutes, you are paying yourself for this effort at the rate of \$8,000 an hour in after-tax dollars!

### ***Strategy 1: First-Time Abate***

If the IRS has never hit you with a failure-to-file penalty or a failure-to-pay penalty, simply ask for a first-time abate. The IRS will remove your penalty, provided you have no other tax compliance issues, such as unfiled returns.<sup>6</sup>

Beware, though: this is a one-time grace; you get only one first-time abate per return type.<sup>7</sup>

First-time abate is the easiest way to get a penalty removed since you don't have to give the IRS a reason or explain why it happened.

First-time abate usually is your first line of attack against IRS late filing and late payment penalties. In fact, the IRS tells its employees to look for this relief first before considering other reasons.<sup>8</sup>

### ***Strategy 2: Partnership Relief***

The IRS carved out a little-known loophole over 30 years ago for late-filed partnership returns. It still works.

The IRS will abate your partnership late filing penalty if<sup>9</sup>

- the partnership has 10 or fewer partners, and
- all the partners reported their shares of partnership tax items on their timely filed tax returns.

To qualify, you and your partners must be individuals or estates, and you must allocate all partnership items according to the partnership interest.<sup>10</sup>

When you call the IRS, tell them you want relief under Rev. Proc. 84-35. It's that easy.

### ***Strategy 3: Reasonable Cause***

If you don't qualify for first-time abatement or partnership relief, penalty removal gets trickier because you now have to give the IRS a legitimate reason and a clear explanation for why you failed to file and/or pay on time. The tax code calls this "reasonable cause."<sup>11</sup> You can make your reasonable cause pleading on the phone, at least to start with.<sup>12</sup>

Your idea of legitimate reasonable cause likely differs, perhaps even greatly, from what the IRS considers legitimate reasonable cause. To get a penalty removed using reasonable cause, you need to make your plea for mercy specific and use key words that the IRS likes.

The IRS lists a few specific situations that are often reasonable cause, provided you can give specific details:

- **Death or serious illness—yours or an immediate family member’s.** Assuming the death is not your death, be prepared with the relationship of the person, the date of death or dates of illness, how the situation prevented you from meeting your tax requirements, how the death or illness impacted your life negatively, and whether you promptly resolved your tax matters once a reasonable amount of time passed.<sup>13</sup>
- **Fire, casualty, natural disaster, or other disturbance.** If you were located in an officially declared disaster area, that’s important to disclose; however, it is not a requirement. Here, you need to describe the timing of the event, the effect on your personal life or business, how you attempted to comply, and how you complied as soon as possible.<sup>14</sup>
- **Inability to obtain records.** You’ll need to explain why the records were important, why they were unavailable, what steps you took to acquire the records, why you weren’t able to use an estimate, and whether you promptly filed the return and paid the tax once you secured the records. Any documentation you have that shows your efforts to get the information is also helpful.<sup>15</sup>

If none of the above apply, you’ll need to provide detailed information showing that you exercised ordinary business care and prudence but still weren’t able to meet your filing and payment requirements.<sup>16</sup> Be ready to give a clear reason with a timeline, an explanation of how you complied with the law after you resolved the issue, why that time frame was reasonable, and why you could not have anticipated the issue in advance.<sup>17</sup>

Avoid saying things like “I forgot,”<sup>18</sup> “I just made a mistake,”<sup>19</sup> or “I wasn’t aware of the law.”<sup>20</sup> These statements don’t make your case.

And don’t try to blame your tax preparer for your failure to file or pay. The Supreme Court has held this is not reasonable cause.<sup>21</sup> It boils down to this: you are responsible for your tax filings and payments—period.

## Big-Dollar Complications

If your penalties exceed a certain dollar threshold, the IRS may require that you put your request in writing. If this is the case, the IRS representative will tell you that on the phone, as the IRS doesn’t publish the threshold amount.<sup>22</sup>

**Note.** First-time abate doesn’t have an oral threshold. You should get your first-time abate relief on the phone regardless of the size of the penalty.<sup>23</sup>

## Don’t Take “No” for an Answer

If the IRS initially denies your request for penalty relief, you have options to pursue it further if you feel you have a strong case.

When the IRS denies your request for penalty relief, it sends you that denial in writing.<sup>24</sup> The denial letter explains how you can challenge the decision with the IRS Appeals Office.<sup>25</sup>

## Already Paid? It's Not Too Late

Did you recently pay off an IRS penalty? Don't worry—you can still get your money back.

You can request abatement of your penalty and a refund using Form 843.

Just be sure your claim for refund is timely. Generally, you need to file your refund request by the later of<sup>26</sup>

- three years from the date you filed the return, or
- two years from the date you paid the penalty.

## Takeaways

The IRS forgives both large and small failure-to-file and failure-to-pay penalties for those who know they can ask for relief, particularly those who know how to ask (as you now do).

**Step 1.** See whether you qualify for first-time abate. Remember, this means that you have not suffered failure-to-file or failure-to-pay penalties previously. If you qualify here, the IRS has mercy on you automatically. Automatic penalty relief—wow, that's big!

**Step 2.** If your partnership return is late, see if you can get relief under Rev. Proc. 84-35.

**Step 3.** If you (or your business) are not eligible for automatic relief under Step 1 or 2, then you need to go the reasonable-cause route. This is not a difficult road, but you do need good reasons for your reasonable cause that you can prove to the IRS.

And the fact that you can often obtain relief with a simple telephone call is huge. Be sure when you make the telephone call that you are clear, on script, armed with detailed facts, and persistent.

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<sup>1</sup> IRC Section 6651(a)(1).

<sup>2</sup> IRC Section 6698(b); IRC Section 6699(b); Rev. Proc. 2017-58.

<sup>3</sup> IRC Sections 6651(a)(2); 6651(a)(3).

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<sup>4</sup> IRC Section 6651(c)(1). If both the failure-to-file penalty and the failure-to-pay penalty apply to any month, the failure-to-file penalty for that month (5 percent) is reduced by the failure-to-pay penalty for that month (0.5 percent). Thus, the \$270 and \$30 for the combined rate of 5 percent per month (10 percent total).

<sup>5</sup> IRM 20.1.1.3.6.1 (11-21-2017).

<sup>6</sup> IRM 20.1.1.3.3.2.1, para. 2 (11-21-2017).

<sup>7</sup> Ibid.

<sup>8</sup> IRM 20.1.1.3.3.2.1, para. 11 (11-21-2017).

<sup>9</sup> Rev. Proc. 84-35, Section 3.01.

<sup>10</sup> Rev. Proc. 84-35, Section 3.02.

<sup>11</sup> IRC Section 6651(a).

<sup>12</sup> IRM 20.1.1.3.1, para. 2 (11-21-2017).

<sup>13</sup> IRM 20.1.1.3.2.2.1 (11-25-2011).

<sup>14</sup> IRM 20.1.1.3.2.2.2 (11-21-2017).

<sup>15</sup> IRM 20.1.1.3.2.2.3 (12-11-2009).

<sup>16</sup> Reg. Section 301.6651-1(c)(1).

<sup>17</sup> IRM 20.1.1.3.2, para. 5 (11-21-2017).

<sup>18</sup> IRM 20.1.1.3.2.2.7 (8-5-2014).

<sup>19</sup> IRM 20.1.1.3.2.2.4 (12-11-2009).

<sup>20</sup> IRM 20.1.1.3.2.2.6 (11-25-2011).

<sup>21</sup> U.S. v Boyle, 469 U.S. 241 (1985).

<sup>22</sup> IRM 20.1.1.3.1.

<sup>23</sup> IRM 20.1.1.3.3.2.1, para. 8 (11-21-2017).

<sup>24</sup> IRM 20.1.1.3.5.3, para. 4 (11-21-2017).

<sup>25</sup> IRM 20.1.1.3.5.3, para. 5 (11-21-2017).

<sup>26</sup> IRC Section 6511(a).

# Five Ways You Can Fight the IRS When Your Tax Debt Is Too Big to Pay

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If your tax bill has exploded beyond what you can pay, you're probably already feeling the hot breath of the IRS. At this point, you need to consider your options for how to reduce or eliminate your tax bill.

If you have thought about bankruptcy, you need to be aware of its limitations. Tax debts are particularly sticky—many of them stay with you even after the bankruptcy process is complete.

And it's important to know that bankruptcy is not your only recourse. The IRS gives you four avenues of relief to help you get out of tax debt. Depending on your circumstances, one or more of these IRS methods could entirely eliminate that horrible tax cloud hanging over your head.

## The IRS on Your Trail

There is no better debt collector in the country than the IRS—it has tools and techniques in its arsenal that many private collection agencies would drool at the thought of using.

But here's the good news—unlike some fly-by-night debt collectors, the IRS must stay within the bounds of the law.

Even though it may not seem like it, the IRS is primarily interested not in making your life miserable but in collecting its debt. So if you follow the procedures and relief formulas the IRS allows you to use, you can pay off your debt and get the IRS off your back.

## Four IRS Alternatives to Bankruptcy

The IRS gives you four avenues of relief when your tax debt is too big for you to pay.

**Offer in compromise.** If you cannot pay your full tax liability—or if doing so would create a hardship—you may qualify to reduce your tax bill through an offer in compromise. Under this process, you determine an amount that you can pay using an IRS formula that considers your income and assets. You then submit this offer to the IRS and, pending IRS approval, you have up to 24 months to pay off the reduced amount, satisfying your debt in full.<sup>1</sup>

**Installment agreement.** An installment agreement or payment plan gives you up to 72 months of extra time to pay your tax debt. If you owe less than \$50,000 in combined taxes, penalties, and interest, you can make this request using a simplified one on the IRS website.<sup>2</sup>

**Abatement of penalties.** You can use this strategy to abate (eliminate) the penalties the IRS dumped on you in addition to the taxes you owe. There are a number of grounds you can use to

make this claim, such as undue economic hardship, the loss of property in a natural disaster, or a recent death in the family. There is also a special abatement for those with a good history of compliance called the “first-time abate.”<sup>3</sup>

**Innocent spouse relief.** Normally, both spouses are equally responsible for the payment of taxes on a joint return, but innocent spouse relief will remove much or all of your liability and pin it solely on your misbehaving spouse (or ex-spouse).<sup>4</sup> This might apply, for example, if your spouse operates a business that you do not participate in, and your spouse incorrectly reports that business’s income and losses.

## The Bankruptcy Option

Bankruptcy is not a simple process and has many lingering effects, such as the potentially decade-long hit to your credit. However, bankruptcy can be the perfect tool in the right situation—and it can permanently eliminate some of your income tax liabilities, including penalties and interest.

The following rules determine whether you can discharge your income tax debt in bankruptcy. You have to meet all three rules to qualify:<sup>5</sup>

1. **Debts must be more than three years old.** You have to wait at least three years after the filing deadline for the tax years at issue (normally April 15 for calendar year taxpayers) before you file your bankruptcy petition. In other words, if you file your petition on April 15, 2016, you can discharge tax debts for tax years 2013 and earlier. But note that an extension pushes your filing deadline to October 15. So if you got an extension in 2013, you must wait until October 15, 2016, to file your bankruptcy petition before you can discharge tax debts from 2013.
2. **You must file all tax returns.** You have to wait at least two years after you filed your tax return before you file your bankruptcy petition. So what happens if you didn’t file a return for a year? To discharge that debt, you must file that return now and then wait for two years before you file for bankruptcy.
3. **Wait eight months after IRS assessment.** You must wait at least 240 days after the IRS assessed your taxes before you file the bankruptcy petition.

As you can see, timing is important. If you want to ensure that the bankruptcy proceeding will clear your tax debts, you must

1. make sure you have filed all of your returns; and
2. wait until enough time has passed so that you qualify for relief.

**No fraud.** Bankruptcy will not discharge your debt if you committed fraud or willfully evaded taxes.

## Takeaways

If your tax debt is out of control, don't give up hope. You have options, and you can qualify for debt relief, through both the IRS and bankruptcy.

The IRS options are easier on you and can provide excellent relief, depending on your circumstances. There are four major avenues of relief:

1. **Offer in compromise.** This can reduce your tax burden and give you additional time to pay.
2. **Installment agreement.** This can give you additional time to pay.
3. **Abatement of penalties.** This can eliminate your penalties.
4. **Innocent spouse relief.** This can free you from liability if your spouse (or ex-spouse) is the reason for your tax problems.

If none of these options work, then you should consult a bankruptcy advisor to see if bankruptcy is the right choice for you. To make sure that bankruptcy will discharge your income tax debt, be sure you

1. file your tax returns for prior years; and
2. wait before filing your bankruptcy petition until your tax debts qualify for discharge.

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<sup>1</sup> IRS Form 656 Booklet, *Offer in Compromise*, 2017.

<sup>2</sup> <http://www.irs.gov/Individuals/Payment-Plans-Installment-Agreements>.

<sup>3</sup> IRM 20.1.1, August 5, 2014.

<sup>4</sup> IRS Publication 971, *Innocent Spouse Relief*, dated October 20, 2014.

<sup>5</sup> 11 U.S.C. Section 507(a)(8).

# Three Ways to Defeat Audit Penalties and Save Thousands

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If the IRS audits you and says you owe more tax, obviously you aren't happy. But it gets worse: the IRS will often impose an accuracy-related penalty on top of the tax.

This penalty is a whopping 20 percent of the additional tax owed. For a \$10,000 audit assessment, that's an additional \$2,000 you have to send to Uncle Sam.

In this article, we discuss when an accuracy-related penalty might apply and how you can potentially save yourself thousands of dollars by avoiding the penalty using one of three different strategies.

## Imposing the Penalty

There are several bases on which the IRS can impose an accuracy-related penalty. The two most common are:

1. Negligence or disregard of rules and regulations<sup>1</sup>
2. Substantial understatement of income tax<sup>2</sup>

Negligence is the failure to make a reasonable attempt to comply with the tax laws and/or exercise ordinary and reasonable care in the preparation of a tax return.<sup>3</sup>

Disregard is a careless, reckless, or intentional disregard of the tax law.<sup>4</sup>

For the accuracy penalty on the substantial underpayment of tax, the underpayment amount is the amount of tax that should have been on the return less the amount of tax actually shown on the return.<sup>5</sup> For the accuracy penalty on the understatement to apply, that understatement has to exceed the relevant threshold below:

- For individual taxpayers, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the higher of (a) 10 percent of the tax required to be shown on the return for the taxable year or (b) \$5,000.<sup>6</sup>
- For C corporations (which aren't personal holding companies), the lesser of (a) 10 percent of the tax that should have been on the return (but no less than \$10,000) or (b) \$10 million.<sup>7</sup>

**Example.** John files his Form 1040 showing a total tax of \$6,000. The IRS audits his return and proposes an additional \$4,000 of tax, for a total tax of \$10,000.

**No penalty.** The greater of 10 percent of the \$10,000 required tax (\$1,000) or \$5,000 is \$5,000. The understatement of \$4,000 is less than \$5,000 (the greater amount), so John does not have an accuracy penalty due to a substantial underpayment of tax.

**Note.** John may still have to pay a 20 percent penalty if the IRS proves negligence or disregard of rules and regulations. The substantial understatement is just one of the two possible accuracy penalties we are discussing in this article.

## Beating the Penalty

If an IRS examiner proposes an accuracy-related penalty, or if you want to request an abatement of a penalty already assessed, you may qualify to beat the penalty.

In general, the IRS can't impose a penalty if there was a reasonable cause for the understatement of tax and you acted in good faith.<sup>8</sup>

Below are three specific strategies that you can use to defeat the IRS if it attempts to impose an accuracy-related penalty on you.

### Strategy 1: Reliance on a Tax Advisor

You hired a tax professional to prepare your tax returns, but now you've received an audit bill. It doesn't seem fair—does it?

Luckily, reliance on a tax advisor can be reasonable cause to escape an accuracy-related penalty.<sup>9</sup> But just using a tax professional doesn't cut it—it's more complicated.

The Tax Court has a three-pronged test to determine whether reliance on a tax advisor constitutes reasonable cause.<sup>10</sup> The taxpayer must prove the following by a preponderance of the evidence (i.e., more likely than not):

- The advisor was competent, with sufficient expertise to justify reliance.
- The taxpayer provided necessary and accurate information to the advisor.
- The taxpayer actually relied in good faith on the advisor's judgment.

### Strategy 2: Disclosed Position and Reasonable Basis

This is a proactive strategy. If you know a position on your tax return has a high risk of examination and/or is a large dollar amount, you can take actions in advance to prevent the imposition of a penalty due to understatement of tax.

First, the tax return must adequately disclose the position.<sup>11</sup> In general, this requires that the return have a properly completed Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement).<sup>12</sup>

Second, the position has to have a reasonable basis in the law.<sup>13</sup> Reasonable basis is more than being “not frivolous,” “not improper,” or “merely arguable;” it has to be reasonably rooted in relevant tax authority.<sup>14</sup>

### **Strategy 3: Substantial Authority**

If you can show there was substantial authority for a position that led to an understatement of tax, then the IRS cannot penalize you on that understatement.<sup>15</sup>

Substantial authority is less stringent than preponderance of the evidence (more than 50 percent likelihood of the position being upheld) but higher than the reasonable basis standard described above.<sup>16</sup>

The IRS outlines the types of authority considered to be substantial authority, including, for example:<sup>17</sup>

- applicable provisions of the Internal Revenue Code and other statutory provisions;
- proposed, temporary, and final regulations interpreting such statutes;
- revenue rulings and revenue procedures;
- tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties;
- court cases;
- congressional intent as reflected in committee reports;
- joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill’s managers;
- General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);
- private letter rulings and technical advice memoranda issued after October 31, 1976;
- actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin);
- IRS information or press releases; and notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin.

You can also use the authorities above in a reasonable basis determination.

### **Civil Fraud Penalty: This Is Bad**

The IRS can impose a civil penalty of 75 percent if the IRS asserts that the understatement of tax on a return was due to fraud.<sup>18</sup> That is enough to almost double what you owe!

Besides the hit on your wallet, there are several other reasons you don’t want the IRS to consider a civil fraud penalty:

- There is *no* statute of limitations on assessment for a fraudulent return.<sup>19</sup>

- The tax on a fraudulent return cannot be discharged in a bankruptcy proceeding.<sup>20</sup>
- IRS examiners can refer returns with indicators of fraud to the Criminal Investigation Division for possible criminal prosecution.

To impose a civil fraud penalty, the IRS has to prove fraud by clear and convincing evidence, which is a higher standard than a preponderance of the evidence.<sup>21</sup>

The IRS and courts look to see whether “badges of fraud” are present and to what extent.<sup>22</sup> Some examples are:

- Understatement of income
- Fictitious or improper deductions
- Accounting irregularities (e.g., two sets of books)
- Obstructive actions by the taxpayer (e.g., false statements, record destruction)
- Engaging in illegal activities or attempting to conceal the same

If you think you are at risk for a civil fraud penalty, then you need to consult an experienced tax attorney immediately.

## **Already Paid It? Read This**

If you are reading this article and wishing you had contested a prior accuracy-related penalty, it’s not too late!

Provided that the penalty was not part of a closing agreement or in a Tax Court decision, you can file IRS Form 843 to request an abatement.<sup>23</sup> If you already paid the penalty, you can get a refund of the penalty payment if you submit the abatement request within two years of the date you paid the penalty.<sup>24</sup>

## **Takeaways**

An audit where you owe more tax is painful, but having to pay more penalties on top of that additional tax is a nightmare.

You can defeat accuracy-related penalties by any of the following:

- Showing you exercised reasonable cause for the deduction and acted in good faith, which you enhanced with reliance on your tax advisor.
- Showing you properly disclosed the position and had a reasonable basis for it.
- Showing that there was substantial authority for the disallowed position.

Make sure to look at penalty relief techniques before filing your return, during an IRS audit, and as a basis for a refund if you’ve already paid a penalty.

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<sup>1</sup> IRC Section 6662(b)(1).

<sup>2</sup> IRC Section 6662(b)(2).

<sup>3</sup> Reg. Section 1.6662-3(b)(1).

<sup>4</sup> Reg. Section 1.6662-3(b)(2).

<sup>5</sup> IRC Section 6662(d)(2)(A).

<sup>6</sup> IRC Section 6662(d)(1)(A).

<sup>7</sup> IRC Section 6662(d)(1)(B).

<sup>8</sup> IRC Section 6664(c).

<sup>9</sup> Reg. Section 1.6664-4(c)(1).

<sup>10</sup> *Neonatology Assocs., PA v. Comm.*, 115 T.C. 43 (2000).

<sup>11</sup> IRC Section 6662(d)(2)(B)(ii)(I).

<sup>12</sup> Reg. Section 1.6662-4(f).

<sup>13</sup> IRC Section 6662(d)(2)(B)(ii)(II).

<sup>14</sup> Reg. Section 1.6662-3(b)(3).

<sup>15</sup> IRC Section 6662(d)(2)(B)(i).

<sup>16</sup> Reg. Section 1.6662-4(d)(2).

<sup>17</sup> Reg. Section 1.6662-4(d)(3)(iii).

<sup>18</sup> IRC Section 6663(a).

<sup>19</sup> IRC Section 6501(c)(1).

<sup>20</sup> 11 U.S.C. Section 523(a)(1)(C).

<sup>21</sup> *Kellet v. Commissioner*, 5 T.C. 608 (1945).

<sup>22</sup> IRM 25.1.6.3.

<sup>23</sup> Form 843, Claim for Refund and Request for Abatement (Rev. August 2011); Instructions for Form 843 (Rev. December 2013).

<sup>24</sup> IRC Section 6511(a); *Kuznitsky v U.S.*, 17 F.3d 1029 (1994); Instructions for Form 843 (Rev. December 2013).

# Unfiled Tax Returns? Back Taxes? IRS Penalties? Do This!

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We all know the annual ritual: once January rolls around, you gather your tax documents to file your tax returns by the deadline.

Sometimes (or maybe all the time!) you need an extension. And maybe you don't meet the extended deadline, and now your return is late and unfiled.

Then the next tax season rolls around, and you still haven't filed last year's return—so you don't want to do the current one either, out of fear of the IRS or because you need last year's data.

Now your problem is snowballing—and if you let fear grip you, it can continue for years . . . before the IRS decides to do you in. Don't let this problem get ahead of you. Let us give you a road map for achieving peace of mind by getting right with the IRS.

If you have late, unfiled tax returns, you have an urgent problem that you should start to fix ASAP. The possible consequences include:

- The IRS preparing and filing a return for you<sup>1</sup>—and almost always overstating the tax you owe by a lot!
- Criminal prosecution.<sup>2</sup>

The truth is that the IRS rarely criminally prosecutes people for not filing tax returns, but this can and does happen, especially in egregious cases and those of celebrities and public figures, such as Wesley Snipes.<sup>3</sup>

The best way to avoid criminal prosecution is to come forward and voluntarily file any delinquent returns. The IRS has a time-honored policy that, in general, it will not criminally prosecute for failure-to-file those taxpayers who come forward and file their past-due tax returns.<sup>4</sup>

## How Far Back Do I Go?

If you have a long-standing problem, the IRS usually shows you some mercy. In general, the IRS requires you to file the most recent six years of tax returns to be in current compliance with your tax return filings.<sup>5</sup>

**Example.** Nancy Nonfiler hasn't filed individual income tax returns since 2006. Under the six-year rule and because the deadline for the 2014 tax return has passed, Nancy can file her 2009 through 2014 tax returns and the IRS will consider her in compliance with her tax return filings. And the IRS generally won't request her individual tax returns for tax years 2006 through 2008.

The IRS could require you or Nancy Nonfiler to file tax returns beyond the six-year period. But this is not common and requires approval from an IRS manager.<sup>6</sup> Another consideration: the six-year policy is merely an IRS policy and not actual law.

Once you file a tax return, the general three-year statute of limitations on assessment of tax starts to run.<sup>7</sup> If you never file a tax return, you give the IRS open season with no time limits to assess tax for that unfiled tax year.<sup>8</sup>

**Example.** Henry Nonfiler did not file a 1961 tax return. The law allows the IRS to collect the taxes for 1961.<sup>9</sup>

In certain circumstances, you may find it advantageous to file a return beyond the IRS's six-year requirement even if you aren't required to.

**Example.** Paul Procrastinator didn't file a tax return for tax year 2008. The IRS eventually decided to do a 2008 return for Paul that showed \$20,000 in taxes due, plus thousands of dollars in interest and penalties. But if Paul had filed an original 2008 return, that return would have shown \$4,000 in actual taxes due. By filing an original return, Paul would have saved \$16,000 on his tax bill and reduced his penalties and interest by about 80 percent!

## **Payroll Tax Returns? Read This!**

If your business has unfiled payroll tax returns but made all of its required tax deposits, and the returns show no tax owed, go ahead and file those delinquent returns.

But if you made only some or none of the required tax deposits, and your payroll tax returns show that you owe the IRS money, you need to take special care before you file them. If you run your business as a limited liability company or corporation, you are not personally liable for the payroll tax balances; only your entity is.<sup>10</sup>

But the IRS can potentially transfer liability for the "trust fund" portion of payroll taxes to you as the person responsible for allowing the business entity to fail to pay the IRS.<sup>11</sup>

What are "trust fund" taxes? They are the taxes that you collect on behalf of your employees and send to the IRS—namely, the employees' federal income tax withholdings and their half of FICA taxes.

If you have unpaid trust fund taxes, it is in your best interest to pay off the trust fund portions first. To do this, you send a designated payment to cover the trust fund taxes. The IRS honors such designations.<sup>12</sup> If you don't designate the payment, the IRS applies the payment to the non-trust fund taxes first!<sup>13</sup>

## **Foreign-Sourced Income or Foreign Assets? Read This!**

The IRS has been hammering international tax compliance for several years. Now, using the tools available in the Foreign Account Tax Compliance Act, the IRS is getting information from

foreign financial institutions on United States taxpayers. (See [Has Your Swiss Banker Betrayed You to the Feds?](#))

If you have foreign assets, such as bank accounts or securities accounts, or foreign-sourced income, and you haven't filed your United States tax returns or your FBARs (Foreign Bank Account Reports), if required to do so, do not file your tax returns by simply mailing them.

You likely need to use a special IRS compliance program to file your tax returns.<sup>14</sup> In this circumstance, you need professional assistance from a tax attorney or tax professional who specializes in international tax-compliance issues. A misstep could lead to severe penalties or even criminal prosecution.

## **After I File—What Then?**

Once you file those late returns, you'll feel a big sense of relief that you've started on the path to getting this behind you. It'll take several months for the IRS to process those returns. Here are a few things to keep in mind:

- The IRS will send you a notice for each tax return it processes. Check the notice to make sure it matches the return as you filed it. If it doesn't, and if you don't agree with the change, call the telephone number on the notice to speak to an IRS representative about it.
- If any of your late returns show a balance owed, the IRS will likely hit you with penalties and interest for one or more years. Read [Facing IRS Penalties? Avoid Them with IRS Mercy; Here's How](#) to see whether you can get some of those IRS penalties removed. Look at the earliest year you just filed to see whether you can get "first-time abatement" for that one year.
- If, after the dust clears, you are going to owe money to the IRS for your individual tax returns, see [Owe Back Taxes? Try Deals That the IRS Accepts](#) for ideas on how you can manage that painlessly. (Well, relatively painlessly, because nothing with the IRS is ever trouble-free!)
- If you are filing returns that are more than three years past their due dates, and the returns show refunds due you, you are likely filing after the statute of limitations for refunds.<sup>15</sup> If the statute of limitations has passed, the IRS removes any amount payable to you and puts your refund money in the U.S. Treasury, and you simply say good-bye to that money.

## **Takeaways**

Unfiled tax returns make a very uncomfortable noose around your neck! Remove that noose and get past the problem by following the strategies in this article.

First, you need to come forward and voluntarily file your returns. You likely want the help of a tax professional who knows the rules of the road. As you learned above, doing this right makes this process less expensive and less painful.

Keep the special six-back-years rule in mind if you have unfiled returns for more than six years. It's likely that you can qualify for the IRS six-year favorable treatment, assuming that you are filing voluntarily and filing before the IRS has caught up with you.

If you have back payroll taxes and/or returns, get those cleaned up now. If you can't pay the full amount due, make sure that you designate your payment to apply to the trust fund portion first.

Your unpaid, unfiled, and unreported foreign bank accounts and foreign assets present a particularly difficult tax (and possibly criminal) problem that you need to deal with. If you have this problem, make sure to hire a lawyer or tax professional now and get this solved.

Here's the real deal on all these problems: If you voluntarily take care of the tax problem, you save money and heartache. If you wait for the IRS to come to you with the problem, you lose money and suffer heartache.

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<sup>1</sup> IRC Section 6020.

<sup>2</sup> IRC Section 7203.

<sup>3</sup> U.S. v. Snipes, 611 F. 3d 855 (2010).

<sup>4</sup> IRM 9.5.11.9.

<sup>5</sup> IRM 1.2.14.1.18.

<sup>6</sup> Ibid.

<sup>7</sup> IRC Section 6501(a).

<sup>8</sup> IRC Section 6501(c)(3).

<sup>9</sup> Ibid.

<sup>10</sup> Reg. Section 301.7701-2(c)(2)(iv).

<sup>11</sup> IRC Section 6672.

<sup>12</sup> Rev. Proc. 2002-26; IRM 5.1.2.8, para. 1.

<sup>13</sup> IRM 5.19.14.1.6, para. 3.

<sup>14</sup> <https://www.irs.gov/Individuals/International-Taxpayers/Options-Available-For-U-S--Taxpayers-with-Undisclosed-Foreign-Financial-Assets>

<sup>15</sup> IRC Section 6511(a).

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