# Three Common Questions Asked By Advisors of Non-Filing Taxpayers

Oregon Law Institute CLE:
Civil Discovery and White-Collar Criminal Investigations
October 25, 2013

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Lawyers in every area run into clients who admit that they have not filed their tax returns. Among the many questions raised by this information are the following three, which come up nearly every time. This outline gives lawyers a 10,000 ft. perspective on each.

**I. What happens when a taxpayer doesn't file a tax return?**

**II. Can the IRS collect a taxpayer's unpaid taxes from more than 10 years ago?**

**III. Is tax-related information provided by a client privileged?**

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## I. What happens when a taxpayer doesn't file a tax return?

### A. IRS Assessment Generally

1. Before the IRS can take collection action against a taxpayer (e.g., lien, levy, or sue), the IRS must "assess" the taxpayer for a certain amount of liability. *See* Sections 6321, 6331, and 6303[1]. The assessment fixes the amount of liability that the taxpayer owes, much like a judgment entered in favor of a creditor.

2. The IRS is required, as a condition of collection, to assess "all taxes determined by the taxpayer or by the [IRS] as to which *returns* are made" under the Code. Section 6201(a)(1) (emphasis added).

3. When a taxpayer files his return, he is treated as consenting to an assessment in the amount shown on the return. *See Millsap v. Comm'r,* 91 T.C. 926 (1988). Therefore, the IRS can assess the taxpayer for that amount without further action.

4. The IRS cannot assess the taxpayer for a greater amount than what is shown on the return until 90 days (150 for taxpayers outside of the country) after mailing a Notice of Deficiency to the taxpayer (and, if the taxpayer petitions the U.S. Tax Court, until the Court makes a final determination). Section 6213(a).

5. Before sending out the 90-Day Notice of Deficiency, the IRS typically sends the taxpayer a 30-Day letter that(1) states the IRS' position, (2) requests that the taxpayer agree, and (3) informs the taxpayer that he may appeal to the IRS Office of Appeals. The IRS is not required to send a 30-Day letter, however.

[1] All "Code Section" and "Section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

**B.** IRS Assessment of Non-filers

1. If a taxpayer fails to file a timely return, the taxpayer (1) is not treated as having delivered a return from which an assessment can be made, and (2) the taxpayer has not consented to be assessed in any amount. The IRS may contact such a taxpayer and encourage him to file a delinquent return.

2. If the taxpayer does not agree to file a delinquent return, the IRS may (1) prepare a return on the taxpayer's behalf (a "substitute return"), (2) send the taxpayer a 30-Day letter, and, (3) if the taxpayer does not consent to the IRS' position or contact the IRS Office of Appeals within 30 days, send the taxpayer a 90-Day Notice of Deficiency. Much of the time, the IRS' Automated Substitute for Return (ASFR) Program prepares the substitute return based on computer-based information gathered from past filings and information returns or other information from third parties. See Internal Revenue Manual 5.18.1. Substitute returns for higher-income earners appear to be prepared with less automation.

3. A substitute return will not favor the taxpayer. For example, the return will not include itemized deductions.

4. The taxpayer has a number of options at this point. Among these are the following:

    a. Agree with the IRS' position.

    b. Contact the IRS Office of Appeals.

    c. File an amended return and challenge the deficiency in the U.S. Tax Court, asserting a different filing status, itemized deductions, etc. *Millsap v. Comm'r,* 91 T.C. 926 (1988) ("In view of the foregoing, we hold that in situations where deficiency procedures are availed of and a taxpayer has not filed a return, the taxpayer may file a return and contest respondent's filing status determination, even though respondent has 'filed' a substitute return under section 6020(b), in which filing status has been 'elected' by respondent.").

**C.** Interest

1. Interest accrues on amounts not paid at a rate equal to 3% plus the Federal short-term rate. Section 6601(a); Section 6621(a)(2).

**D.** Penalties

1. The IRS can assert a failure-to-file penalty, for each month after the return was due, equal to 5% of the tax required to be shown on the unfiled return, up to an aggregate of 25%. Section 6651(a)(1). The IRS' filing of a substitute return does not constitute a filing for purposes of avoiding this penalty.

2. The IRS can assert a failure-to-pay penalty, for each month after the taxpayer was required to make payment, equal to 0.5% of the unpaid tax shown on the taxpayer's return, up to an aggregate of 25%. The IRS' filing of a substitute return is used for purposes of determining the unpaid tax shown on the taxpayer's return. Section 6651(g).

3. However, the combination of these two penalties in any month will not exceed 5%. Section 6651(c)(1).

4. The IRS can assert a penalty for underpayments of estimated taxes, for each month after the taxpayer was required to make payment, equal to the amount of the underpayment multiplied by the Federal short-term rate plus 3%. Sections 6654, 6621.

## II. Can the IRS collect a taxpayer's unpaid taxes from more than 10 years ago?

**A.** Before the IRS can take collection action against a taxpayer (e.g., lien, levy, or sue), the IRS must "assess" the taxpayer for a certain amount of liability. *See* Sections 6321, 6331, and 6303. The assessment fixes the amount of liability that the taxpayer owes, much like a judgment entered in favor of a creditor.

**B.** In general, the IRS cannot assess a taxpayer for taxes for a tax year more than 3 years after the date that the return for that tax year was filed (or 6 years after the return for that tax year was filed if the return included a "substantial omission"). Section 6501(a). A "substantial omission" is an omission of gross income that exceeds 25% of the gross income required to be stated in the return (or greater than $5,000, if the gross income omitted is attributable to certain foreign assets). Section 6501(e).

**C.** Often, if a taxpayer does not file a return, the IRS will file a "substitute return" on behalf of the taxpayer. The filing of a substitute return does not start the 3- or 6-year period of assessment. Section 6501(b)(3).

**D.** In general, the IRS cannot collect tax from the taxpayer by either levy or court proceeding more than 10 years after the assessment of the tax (unless the collection period is enlarged by an extension agreement between the IRS and the taxpayer). Section 6502(a).

## III. Is tax-related information provided by a client privileged?

**A.** IRS' Power to Investigate

1. The IRS may summon and "examine any books, papers, records or any other data which may be relevant or material" to a particular tax inquiry." Section 7602. However, certain privileges and the work product protection may prevent the IRS from accessing client information.

**B.** Lawyer-Client Privilege, in General

1. In general, information provided to an attorney is privileged if (1) the information is provided to an attorney in his capacity as an attorney, (2) the information is relevant to the attorney's ability to provide the client legal advice, and (3) there is an expectation that the information will be kept confidential.

2. Information Provided to a Person in His or Her Attorney Capacity

   a. If the information is provided to the attorney in a capacity other than as an attorney, the privilege may not apply. *Olender v. United States,* 210 F.2d 795 (9th Cir. 1954) (attorney consulted in capacity as accountant); *Colton v. United States,* 306 F.2d 633, 639 (2nd Cir. 1962), *cert. denied*, 371 U.S. 951 (1963) ("Attorneys frequently give their clients business or other advice which, at least insofar as it can be separated from their essentially professional legal services, gives rise to no privilege whatever.").

   b. Generally, the attorney-client privilege extends to communications with a client's accountant when the accountant is acting as a facilitator of communications to assist the taxpayer's attorney in rendering legal advice to the client. *United States v. Kovel,* 296 F2d 918, 922 (2d Cir. 1961).

3. Expectation of Confidentiality

a. Information provided to an attorney solely for the preparation of tax returns is not privileged because there is no expectation that the information will be kept confidential. *United States v. Abrahams,* 905 F.2d 1276 (9th Cir. 1990). Likewise, documents created to prepare a return, or for use in audit to substantiate an item on a return, may not be privileged. *United States v. Cote,* 456 F.2d 142 (8th Cir. 1972); *United States v. Frederick,* 182 F.3d 496 (7th Cir. 1999).

b. However, information provided to an attorney (or his agent) with the understanding that the attorney will make a determination as to what and how such information should be included in a client's tax return may be privileged information. *United States v. Abrahams,* 905 F2d 1276 (9th Cir. 1990) ("Although communications made solely for tax return preparation are not privileged, communications made to acquire legal advice about what to claim on tax returns may be privileged.").

c. In *Cote*, the taxpayer had filed returns using an accountant. The accountant then suggested that the taxpayer hire legal counsel, who in turn hired the accountant to audit the taxpayer's books and records. Based on the accountant's audit, counsel advised the taxpayer to file amended returns that reported a greater amount of income. The IRS summoned the accountant to testify and produce all work papers. The Eighth Circuit held that (1) although the attorney-client privilege attached to the accountant's work papers that were prepared in connection with the audit, (2) the taxpayer had waived the privilege to the extent the accountant transcribed the information on those papers onto amended returns that were filed with the government.

**C.** CPA-Client Privilege

1. By statute, a privilege similar to the attorney-client privilege may apply to communications between taxpayer and federally authorized tax practitioners (e.g., CPAs and enrolled agents) in connection with tax advice except (1) in criminal matters and (2) with respect to "tax shelters." Section 7525. This privilege will not prevent the disclosure of information to any person other than the IRS.

**D.** Work Product Protection

1. Generally, documents written in preparation for litigation are immune from discovery. Fed. R. Civ. Proc. 26(b)(3) through (5); *Ratke v. Comm'r,* 129 T.C. 45 (2007).

2. However, where documents are prepared for other purposes as well (e.g., in connection with the preparation of financial statements or documents required by regulatory bodies), the work product doctrine may not apply. *United States v. Textron, Inc. and Subsidiaries,* No. 07-2631 (1st Cir. Aug. 13, 2009) (en banc).

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