Dealing with Nonfilers

About the Panel

Eric L. Green, of Green & Sklarz LLC, moderated the panel. **Walter Pagano**, forensic accountant at EisnerAmper LLP; **Joel Crouch**, partner at Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP; and **Steven I. Hurok**, forensic accountant at Citrin Cooperman, were the panelists.

The comments below represent the speakers' own views and do not necessarily represent those of their partners, affiliates, or employers, nor do they represent official policy of the government or any government agency.

One of the panels conducted at the 2016 IRS Representation Conference concerned the myriad issues confronting CPAs whose clients have simply not filed their tax returns, sometimes for decades. Topics included assessing fact patterns, the intersection of ethical standards and the *Kovel* privilege, the effect of whistleblower programs, and the use of voluntary disclosure procedures.

What to Do When a Client Admits Not Filing

Green started the panel off by speaking about chronic nonfilers, who may not have filed for years or even decades. "How did we get here?" he asked. "Sometimes it can be greed. Sometimes it can be stupidity. What I see most often goes something like this: I can't pay the tax, so I won't file, because if I don't file, then [the IRS] doesn't know. But don't worry, I'll make it up next year.' This rarely works, as Green outlined for the audience; simply not filing imposes an immediate penalty, and the IRS will investigate further, as will the state, which can sometimes be even more aggressive and unforgiving.

Turning to Crouch, Green asked what the options were for CPAs who encounter extreme cases of nonpayment or evasion. "You've got to develop your facts," Crouch said. Under one option, which he called "quiet disclosure," the taxpayer simply files the missing information. This is not generally considered a voluntary disclosure and opens up the possibility of penalties and criminal exposure. On this point, Hurok asked if any of Crouch's cases had ever risen to the level of criminal charges. Both Crouch and Green agreed that the IRS generally does not do so when the disclosure is about matters that have not yet come to its attention; that is, when the taxpayer is owning up to his own mistake. Green did note the case of a taxpayer who was prosecuted for making an *incomplete* quiet disclosure; the lesson there is that such disclosures should contain everything.

Pagano noted that, while preparers have no obligation to verify each item on an original tax return, in the case of failure to file or the need to file an amended return, "it is absolutely incumbent upon us to go beyond the mere compiling of information." The other option, Green continued, is a formal voluntary disclosure.

Crouch noted that nonfilers often have other problems. "When a client comes in and tells you about a problem, it's about the best the story is going to get, because after that it's going to go downhill. You start digging deeper, you start finding all these problems." As more issues are revealed, CPAs need to ask themselves who their client is: Is it the owners or the business? A married couple or an individual spouse? CPAs should decide whom they can represent before the matter goes to the IRS and everyone starts pointing fingers. This is the point where Crouch recommends hiring legal counsel because "you may not have a privilege with this client."

Crouch shared advice that he received when he began practicing: "When they close the jail cell door, make sure you're on the outside." Green agreed, saying, "If they're on a sinking ship, I see no reason to jump on and go down with them."

Due Diligence and the *Kovel* Privilege

Green then asked Pagano about a CPA's responsibilities with nonfilers. "My advice is we have an obligation to do due diligence," Pagano noted, "but we also have an obligation to do two other things: not to harm our clients and put them in an adverse situation and not to do harm to ourselves." Pagano also referred to Circular 230 and the AICPA standards, agreeing that at a certain point, CPAs' ethical obligations require them to refer the client to legal counsel. They may also need to consult their own counsel.

Green reminded the panel that attorneys can bring in accountants under the *Kovel* privilege, and that the CPA who originally handled the case may be able to stay on it in that capacity if he was able to stop the client from divulging the incriminating information. This requires developing a sense of whether a case may be headed in a criminal direction from just the initial information. "It's human nature," he said, "to want to know what happened, but you really want to not know if you can avoid it." He also noted that, even with *Kovel*, CPAs still have the obligation to file a complete and accurate return.

Hurok asked about the advantages and disadvantages of using the original accountant as the *Kovel* accountant. "I don't love the idea," Green admitted, saying that it makes the accountant a target of inquiry and weakens the privilege. Crouch agreed, asking rhetorically, "if the *Kovel* accountant turns around and prepares the returns, is there some sort of waiver at that point of your privilege?" Hurok followed up by saying that in his experience, serving as the *Kovel* accountant limits the degree of scrutiny a CPA will face.

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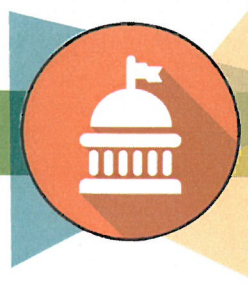
Pagano returned to the subject of due diligence, saying that intent often makes a big difference in cases of inaccurately filed returns. In cases of error, he said, CPAs have an obligation to determine the tax liability consequences and disclose them to the client. What to do about the error, however, is the taxpayer's decision. "Sometimes accountants will have this knee-jerk reaction to prepare a draft amended return," which he advises against. He also said that accountants must have a good-faith belief that the violation was unintentional.



On the subject of *Kovel* privilege, Pagano noted that the *Kovel* accountant is an agent of counsel and must take direction from counsel. He also cited a recent case where a *Kovel* accountant had prepared draft amended returns without advising counsel; the returns were determined to be discoverable and are now with the IRS's Criminal Investigation Division. As a ground rule, he said, *Kovel* accountants should inform and obtain authorization from counsel before taking any such steps.

Whistleblower Cases

Hurok brought the issue of whistleblowers into the discussion by citing a case where a junior business partner who was bought out of the company blew the whistle on his former senior partner's wrongdoing after a personal conflict arose between them. He noted that law firms have sprung up specializing in whistleblower cases, and that the incidence of such cases is likely to increase. Green noted that while revenge is a frequent motive for whistleblowing, it often redounds to the whistleblower, who is usually also complicit in the wrongdoing.

Hurok continued with the observation that the IRS encourages businesses to reform flawed accounting methods that lead to errors on returns, sometimes even preferring this to filing an amended return. He illustrated his point with an example where a client's flawed method for estimating inventory was identified when the client was already under examination, but not actually identified by the IRS. The CPA firm advised the client to reform the method after the examination was completed (as it could not be done while the investigation was ongoing), but the client then reconsidered and decided not to make the change because of the expense involved. This created an ethical dilemma; even after the client dropped the firm, was it obligated to disclose this flawed method, since it had previously advised that the client would engage them to review their compliance? Ultimately, the firm elected not to volunteer the information, reasoning that the client might change his mind again in the future. "Sometimes you can't do everything," Hurok said.

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Green also noted that when CPAs advise clients to file amended returns, they should document such meetings in case such evidence is needed during a later examination.

Formal Voluntary Disclosure

Green asked Crouch to outline the process of formal voluntary disclosure. Crouch said that the two important things are to meet the criteria for voluntary disclosure (i.e., the income must be from a legal source) and to make the disclosure in a timely manner (i.e., before the IRS becomes aware of the deficiency). "You're going to have to cooperate with them in determining how much the tax liability is," he added, "and then make a good-faith effort to pay."

Crouch also noted that, in the case of an offer in compromise, the required form asks if the taxpayer has filed all tax returns; this is not always the case, as the upper limit in voluntary disclosure is generally six years, and the taxpayer may be delinquent for a period well beyond that (panelists cited examples of 17 and 26 years). In such a case, Crouch recommends letting the IRS know about the other outstanding years, and to cite from the relevant manual section regarding the six years requirement. "I don't want somebody thinking we're making a false statement," he said, "so a lot of times we either disclose it on our form or we don't check the box one way or the other. I think the safer approach is to disclose it."

Hurok shared a case regarding the foreign bank account (FBAR) voluntary disclosure program wherein the taxpayer's noncompliance for a small amount in two years out of six could have led to severe penalties for all six years due to IRS guidance and the large balance of the foreign account. In the interests of full disclosure, the filing included the representation of the small noncompliance. The IRS ultimately did not challenge the filing or assess any penalties, but Hurok was still glad to have made the disclosure, saying, "We felt comfortable that we had disclosed it by saying it was an interpretation." He concluded by noting that he reads the "Did you file every return?" question as applying to the six required years, and not all returns throughout history. ❑