Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Assessments of additional tax and fraudulent failure to file return penalties after the Service has assessed tax based on I.R.C. § 6020(b) substitutes for returns

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

A =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =
Year 9 =
Year 10 =
Year 11 =
Year 12 =
Year 13 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Date 11 =
Date 12 =
Date 13 =
Date 14 =

Amount 1 =
Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =

ISSUES

1. Whether the Service had the authority to reverse the abatement of tax for the assessment made for tax year 2 pursuant to an I.R.C. § 6020(b) substitute for return?

2. Whether the Service had the authority to assess the additional tax shown on delinquent original returns filed for tax years 2 and 3?

3. Whether the Service has the authority to assess a fraudulent failure to file penalty under I.R.C. § 6651(f) for tax years 1 through 12?

CONCLUSIONS

1. The Service did not have the authority to reverse the abatement of tax for tax year 2. The abatement should be reinstated because the collection statute of limitations on the tax assessed pursuant to the substitute for return had expired before that tax could be collected.

2. The Service properly assessed the additional tax shown on the delinquent returns filed by the taxpayer for tax years 2 and 3.

3. The Service has the authority to assess the I.R.C. § 6651(f) fraudulent failure to file penalty for tax years 3 through 12.

FACTS

The taxpayer, A, failed to file timely income tax returns for each of the years from 1 through 12. The Service executed substitutes for returns under I.R.C. § 6020(b) for several of these years. After the taxpayer failed to respond to notices of deficiency, the Service made assessments based on the tax shown on those substitutes for returns. Specifically, the Service made assessments for (1) tax years 1 and 2 on Date 1; (2) tax years 3 and 4 on Date 2; (3) tax year 5 on Date 3; and (4) tax year 6 on Date 4. For each of these tax years, the Service also assessed an I.R.C. § 6651(a)(1) failure to file penalty.

In addition to executing substitutes for returns, the Service also investigated the taxpayer for potential criminal violations of the Internal Revenue Code. The taxpayer was ultimately convicted of one count of I.R.C. § 7201 tax evasion for tax years 1 through 7. On Date 5, after the taxpayer completed his prison sentence, he filed delinquent tax returns for tax years 1 through 12. At the same time, the taxpayer filed a timely return for tax year 13. The Service accepted all of these returns as filed. For tax years 1, 4, 5, and 6, the taxpayer's delinquent returns showed a total tax liability less than that assessed pursuant to the substitutes for returns. For tax years 2 and 3, the taxpayer's delinquent returns showed a tax liability greater than that assessed pursuant to the substitutes for returns.

The Service processed the taxpayer's delinquent returns and associated accounts in the following manner:

(1) For tax year 1, the Service abated tax liability in the amount of Amount 1, the amount due on the account as of Date 6.
(2) For tax year 2 the Service initially abated tax in the amount of Amount 2, the amount due on the account as of Date 6. However, the Service reinstated this balance, and then assessed an additional tax of Amount 3, the amount by which the tax shown on the delinquent return exceeded the amount shown on the substitute for return.
(3) For tax year 3, the Service made an assessment in the amount of Amount 4, the amount by which the tax shown on the delinquent return exceeded that shown on the substitute for return.
(4) For tax years 4 through 6, the Service abated tax in the amounts of Amount 5; Amount 6; and Amount 7, respectively, the amounts by which the taxes shown on the substitutes for returns exceeded that shown on the delinquent returns.

(5) For tax years 7 through 12, the Service assessed the amounts of tax shown on the delinquent returns, as well as an I.R.C. § 6651(a)(1) penalty for failure to file a return.
(6) For tax year 13, the Service the assessed the amount of tax shown on the timely filed return.
(7) For tax years 1 through 12, the Service has now requested Counsel approval to assess the I.R.C. § 6651(f) fraudulent failure to file penalty.

LAW AND ANALYSIS

Assessments from the Substitutes for Return

I.R.C. § 6501(a) provides that the amount of any Internal Revenue tax shall be assessed within 3 years after the tax return is filed. There are exceptions to this three year period of limitations. Specifically, if the taxpayer fails to file a return, the tax may be assessed at any time. I.R.C. § 6501(c)(3). I.R.C. § 6502 provides that the assessment of any tax may be collected by levy or by a proceeding in court only if the levy is made or the proceeding begun within 10 years after the assessment of tax.

The Service may execute a return for any taxpayer who fails to make a return required by any internal revenue law or regulation at the time prescribed, or who makes, willfully or otherwise, a false or fraudulent return. I.R.C. § 6020(b). The execution of a section 6020(b) return will not start the running of the period of limitations on assessment and collection without assessment. I.R.C. § 6501(b)(3). Accordingly, until the taxpayer files his own return, there will be no deadline by which the Service must assess the tax or file a suit to collect without assessment. Once the Service chooses to assess the tax, however, a 10-year period of limitations on collection of that assessment begins. I.R.C. § 6502(a)(1).

The Supreme Court considered the predecessor assessment and collection statutes, with respect to a non-filer taxpayer, in United States v. Updike, 281 U.S. 489 (1930). In Updike, the taxpayer had failed to file a required return, but an assessment was made. The United States filed suit against the transferees of the taxpayer to collect the assessment more than 6 years after the assessment had been made. To decide whether the suit was timely, the Court examined § 278 of the Revenue Act of 1917. Similar to current I.R.C. §§ 6501 and 6502, § 278 provided: (1) that "in the case of a failure to file a return a tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time" and (2) "where the assessment . . . has been made . . . within in the statutory limitation properly applicable thereto, such tax may be collected by distraint or by a proceeding in court . . . but only if begun within six years after the assessment of the tax." Updike, 281 U.S. at 491-92 (emphasis added). The Court interpreted this statute to mean that once the Service assessed a liability against a taxpayer, even where the taxpayer did not file a return, the six-year statute of limitations on collection began. Id. at 495. Because in Updike more

than six years had elapsed before the government filed a collection suit, that suit was untimely. Id. at 495-96. In reaching this conclusion, the Court noted that "to allow an indefinite time for proceeding to collect the tax would be out of harmony with the obvious policy of the act to promote repose by fixing a definite period after assessment within which suits and proceedings for the collection of taxes may be brought." Id.

Similarly, in a case where the Service executes a substitute for return under I.R.C. § 6020(b), there is no deadline by which tax shown on that return must be assessed. Once an assessment is made however, the § 6502 collection statute is triggered, and the Service will have ten years within which to collect the assessed tax by administrative means or through a collection suit. Further, any payment of the assessment after the collection period expires would be a statutory overpayment under I.R.C. § 6401. Section 6401 provides that the term "overpayment" includes that part of the amount of the payment of any internal revenue tax which is assessed or collected after the expiration of the period of limitations properly applicable thereto. This principle applies to both collection by the Service and voluntary payments from the taxpayer. See Rev. Rul. 74-580, 1974-2 C.B. 400. Any such payments would have to be refunded to the taxpayer, or used to offset another outstanding tax liability under I.R.C. § 6402(a).

In sum, the Service was correct to abate the tax from the substitute for return for tax year 1 that remained unpaid as of Date 6, the date the 10 year collection statute of limitations expired. On the other hand, the Service should not have reinstated the abatement of tax for tax year 2 that remained unpaid as of Date 6, the date that the collection statute of limitations expired for that year. This amount should be abated once again.

Additional Tax Shown on Returns filed by the Taxpayer

When a taxpayer files a delinquent return after an assessment has been made pursuant to a substitute for return, the Service may assess any additional amount of tax shown on that return under I.R.C. § 6201(a)(1). Such an assessment would not be barred by I.R.C. § 6501. Unlike the collection statute of limitations, the assessment statute of limitations is triggered by the filing of the return by the taxpayer. As stated above, the Service's execution of a substitute for return does not start the running of the period of limitations on assessment. I.R.C. § 6501(b)(3). The additional tax must be assessed within the three year period of limitations provided by I.R.C. § 6501(a), if the delinquent returns were not themselves false or fraudulent. See Bennett v. Commissioner, 30 T.C. 114 (1958), acq. 1958-2 C.B. 3; Rev. Rul. 79-178, 1979-1 C.B. 435. The collection statute expiration date for the additional tax shown due on the delinquent returns will be ten years from the time the additional tax was assessed.

In this case, the Service was correct to assess the additional tax shown on the Year 2 and Year 3 returns. For tax year 2, even though the Service must abate the previously-assessed taxes, it was proper to assess the additional tax shown on the return that was never assessed before. The taxpayer filed these returns on Date 5; therefore, the

assessment statute of limitations was open when the assessments for Year 2 and Year 3 were made on Date 7 and Date 8, respectively. The collection statute will expire for these assessments on Date 9 and Date 10.

The I.R.C. § 6651(f) Fraudulent Failure to File Penalty

I.R.C. § 6651(a)(2) provides that when a taxpayer fails to file any required return, a penalty of up to 25 percent of the amount required to be shown on a return can be imposed. If taxpayer's failure to file a return is fraudulent, the penalty rate increases to a maximum of 75 percent of the tax required to be shown on the return. I.R.C. § 6651(f). The filing of a delinquent non-fraudulent return will not prevent the Service from assessing additions to tax such as the fraudulent failure to file penalty. Bennett, 30 T.C. at 122-23; Weber v. Commissioner, T.C. Memo. 1995-125 ("Late filed returns do not negate a preexisting fraudulent failure to file."). The additions must be assessed within three years of when the non-fraudulent return was filed. Rev. Rul. 79-178, 1979-1 C.B. 435. The Service is not required to follow the deficiency procedures of I.R.C. § 6211 to assess the I.RC. § 6651(f) penalty for fraudulent failure to file, if the penalty is based on tax shown on a delinquent return. See I.R.C. § 6665(b). Taxpayers may, however, be able to challenge an assessed § 6651(f) penalty in a Collection Due Process case. See, e.g., Dingman v. Commissioner, T.C. Memo. 2011-116 (reviewing de novo the fraudulent failure to file penalty assessed without a notice of deficiency, because the taxpayer did not have a prior opportunity to dispute that penalty).

In this case, the taxpayer filed delinquent returns for tax years 1 through 12 on Date 5. The Service accepted these delinquent returns as filed. It then assessed a § 6651(a)(1) penalty for tax years 7 through 12. The § 6651(a)(1) penalty had already been assessed for tax years 1 through 6 after the substitutes for returns for those years were executed. The delinquent returns, although themselves not fraudulent, did not cure the taxpayer's fraudulent failure to file. In our view, the Service has the authority to assess the § 6651(f) penalty for tax years 3 through 12, but should not do so for years 1 and 2.

For tax years 7 through 12, no penalty assessment was made prior to the taxpayer filing his delinquent returns. The statute of limitations on assessment remains open until Date 11, based on the filing date of the delinquent returns. Between now and then, the Service may abate the § 6651(a)(1) penalty and assess the I.R.C. § 6651(f) penalties instead. For tax years 3 through 6, the Service may also abate the pre-existing I.R.C. § 6651(a)(1) penalties and assess I.R.C. § 6651(f) penalties. [redacted]

Finally, assessing the § 6651(f) penalty for tax years 1 and 2 would be inconsistent with our prior conclusion that the previously-assessed tax for those years must be abated. Included in that previously-assessed were I.R.C. § 6651(a)(1) penalties for failure to file a return. In our view, it would not be equitable to require abatement of the earlier uncollected penalty, but allow for the assessment of an additional, more punitive penalty after the expiration of the original collection statute.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

In deciding whether to impose the I.R.C. § 6651(f) fraudulent failure to file, the Service should be certain that it has adequate evidence of the taxpayer's fraud. The Service bears the burden of demonstrating fraud by clear and convincing evidence. I.R.C. § 7454(a). If a taxpayer has been convicted of tax evasion under I.R.C. § 7201, he will be collaterally estopped from denying he committed fraud for tax years covered by the conviction. In this case, the taxpayer should be estopped with respect to tax years 1997 through 2003. For tax years 2004 through 2008, additional evidence of fraud will be required if the taxpayer contests the penalty, as we anticipate he will. Failure to file income tax returns, even over an extended period of time, does not per se establish fraud. Grosshandler v. Commissioner, 75 T.C. 1, 19 (1980); Coulter v. Commissioner, T.C. Memo. 1992–224. An extended pattern of failing to file income tax returns, however, may be persuasive circumstantial evidence of fraud. Marsellus v. Commissioner, 544 F.2d 883, 885 (5th Cir.1977), affg. T.C. Memo.1975–368. In addition, a consistent failure to report substantial amounts of income over a number of years is, standing alone, highly persuasive evidence of fraudulent intent. See Temple v. Commissioner, T.C. Memo. 2000–337, aff'd. 62 Fed. Appx. 605 (6th Cir. 2003).

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