11FCLE

SAMUEL L. BRAUNSTEIN
AND CAROL F. BURGER

TAXING CONSEQUENCES

The Costs Add Up Fast for Individuals Who Fail to File or Pay

ILLUSTRATIONS BY
HARRY CAMPBELL

PERHAPS THE BEST EXPLANATION FOR TAX delinquency is human nature.

Put yourself in the place of a taxpayer facing an all-too-common dilemma, and fast-forward to, say, April 10. You (Mr. or Ms. Taxpayer) are broke. You realize the deadline for filing your income tax return is fast approaching, but you also know your withholding won't cover the amount of tax you owe. You have a sneaking suspicion that ignoring the deadline isn't such a great idea, but you wishfully reason that if you just let it pass, somehow your problems will solve themselves.

Accounting for human nature, it's no surprise that many individuals employ an avoidance strategy to deal with their tax problems. But it's not much of a solution.

The tax collector doesn't like to be ignored. And if you have any kind of history as a tax-

payer, the Internal Revenue Service tends to notice when you haven't checked in by filing a return. Moreover, the web of interest and penalties that apply to unpaid taxes can quickly spin out of control.

For the 2005 tax year, the IRS estimates that it collected some $37 billion in delinquent income taxes, including penalties and interest, from individuals. That amount reflects a gradual increase in delinquent taxes, penalties and interest in recent years. Also, in 2005, the IRS filed 522,887 notices of federal tax liens, actually a slight decrease from 2004 and 2003. (The figures are in the *IRS Data Book*, FY 2005; see www.irs.gov/pub/irs-soi/ 05databk.pdf.)

Of course, biting the bullet and filing the return isn't a perfect solution for a taxpayer who doesn't have the money to cover a tax obligation, but it's likely to be the one that hurts the least in the long run. Tax debts are rarely forgiven, but the Internal Revenue Code does make provisions for structuring payment arrangements and, in some cases, negotiating reductions, especially if a taxpayer is well-prepared to make his or her case.

THE GREATER SIN

IN THE CONTEXT OF THE INternal Revenue Code, failure to file a tax return when taxes are owed is a greater sin than failing to pay taxes. That order of priorities is reflected in the tax rules.

Consider, for instance, that the statute of limitations on assessment—the process through which the IRS imposes additional tax liability—never runs for individuals who don't file returns. So the IRS can assess and collect the tax at any time.

The IRS' collection powers are extremely broad, with the rules generally working as follows:

You (again, the generic Mr. or Ms. Taxpayer) will first be contacted by letter regarding the missing return. If you don't voluntarily file a return, the IRS may estimate your income and issue a notice of deficiency based on that estimate.

You may respond by filing a petition in U.S. Tax Court arguing that the amount the IRS says you owe is wrong. Your petition must set forth what you claim is the correct amount of taxes due, which means that you must prepare a return before you can file your petition.

If you don't file a petition in Tax Court, the IRS will assess the tax. If the IRS believes that collecting the tax may be jeopardized by delay, it can bypass normal procedures and issue a jeopardy assessment.

Once the tax is assessed, the IRS will send a notice and demand for payment. If you don't pay the tax after receiving the notice and demand, a tax lien arises in the amount of the tax, plus interest and penalties, and attaches to all of the property you own at the time. The lien also applies to property you acquire after the lien is issued.

Although the tax lien is very broad, some classes of creditors, such as those with perfected security interests or who hold judgment liens, do have priority over the IRS' claim to your assets.

A tax lien is not a levy, which is an action to obtain money owed through the seizure and sale of the debtor's property. The lien only means the IRS is given certain rights that it may use to enforce its claim.

Once the IRS is ready to enforce its lien, it may levy your property or file a lawsuit. Either way, it has 10 years from the date of assessment to collect the tax.

Levies are the more common route. Generally, the IRS will file suit when other parties also have claims on the property so those claims can be decided in a single action.

The IRS may levy against almost all of your assets, including bank accounts and wages, leaving you with minimal assets and income on which to live. It even may go after assets, such as pensions, that generally are exempt from claims of other creditors. And pursuant to the U.S. Supreme Court's ruling in *United States v. Craft*, 535 U.S. 274 (2002), the IRS may be able to attach your residence, even if it is held by you and your spouse as tenants by the entireties, which generally protects the interests of one owner from claims against the other own- er. (See also Notice 2003-60, 2003-39 IRB 643, which addresses collection issues arising from *Craft*.)

(Another aspect of joint liability—the innocent-spouse rule—is discussed below.)

THE METER IS RUNNING

ANYONE FAMILIAR WITH CREDIT CARD DEBT WILL EASILY understand how interest and penalties accelerate the amount due on unpaid taxes. Interest starts to accrue on the due date of the tax payment, regardless of whether any filing extensions apply, and the interest compounds daily. (For individuals, interest is calculated at the federal short-term rate plus 3 percentage points.)

In addition, if you don't meet deadlines for filing a return (including extensions), the failure-to-file penalty kicks in. That penalty, set forth in IRC § 6651(a)(1), adds another 5 percent of the tax required to be shown on the return (the correct tax, as determined after any IRS examination) for each month or fraction thereof during which the return is not filed, up to a maximum of 25 percent.

Once the penalty hits 25 percent of the tax due, it remains frozen at that amount, although interest continues to accrue. The penalty does not apply, however, if you can show that the failure to file was due to reasonable cause and not willful neglect.

(The burden of proof is on the taxpayer to establish reasonable cause, but it is not easy to meet. Courts have held, for instance, that reliance on a tax professional to file a return on time does not satisfy the standard, although relying on advice from a competent tax professional that no return is required has been held to meet the standard. Illness sometimes has been held to meet the standard if there was a showing that the taxpayer truly was unable to file on time and did file after recovering sufficiently.)

The tax required to be shown on a late-filed return is reduced by the amount of tax paid on or before the due date.

So, for example, if your late return shows a tax liability of $50,000, but $60,000 was withheld from your wages, the failure-to-file penalty doesn't apply because the tax required to be shown on the return, reduced by the tax paid, is $0. If nothing was withheld from your wages, however, the penalty would start at $2,500 for the first month the return is late, then increase by another $2,500 every month until it reaches a maximum of $12,500.

If the return is filed more than 60 days late, a minimum penalty is assessed, equal to the lesser of $100 or 100 percent of the tax required to be shown on the return reduced by what was timely paid.

Determining fractions of months for penalty purposes can be a bit tricky. For that purpose, a month runs from the due date for filing the return through the same date in the following month. So, for example, if April 15 is the due date, the first month ends on May 15. If April 15 falls on a Sunday, the month still runs to May 15, even though you could have filed timely on April 16. But if May 15 is a Sunday, you may file on May 16 without being considered two months late.

If the failure to file a return is fraudulent, the monthly penalty is increased to 15 percent, and the maximum penalty jumps to 75 percent. In appropriate cases, the IRS may also assert criminal penalties.

If you file your return on time but don't pay the tax shown on it, the IRS may assess the tax immediately. The IRS may then send a notice and demand, and follow the same steps to collect the tax as it would if you had never filed.

The failure-to-file penalty does not apply, of course, but you could be subject to a failure-to-pay penalty, described in IRC § 6651(a)(2).

The failure-to-pay penalty equals 0.5 percent of the tax shown on the return per month or fraction of a month, up to a maximum of 25 percent, unless you can show that your failure to pay was due to a reasonable cause and not willful neglect. The penalty kicks in on the date taxes are due—April 15 for individuals.

The failure-to-pay penalty is based on the amount of tax actually shown on the return, rather than what is ultimately determined to be the correct tax amount. (Separate penalties related to the accuracy of the return may apply to additional amounts due.) But if the amount shown on the return ultimately winds up being higher than the tax actually due, the penalty only applies to the lower amount. So if you file a return that indicates you owe $4,000 without paying anything, and it turns out that you actually only owed $2,000, the penalty is imposed on $2,000.

If you pay a portion of the tax shown on the return, that amount is deducted from the amount due before computing any monthly penalties. If, for example, your return shows $50,000 due in taxes but there was $10,000 withheld, the penalty initially applies to $40,000. If you pay another $5,000 within the first month, the penalty for that month still is based on $40,000, but the penalty for the next month will be based on $35,000.

If you file your return late without paying the tax shown, both the failure-to-file penalty and the failure-to-pay penalty would appear to apply. But under IRC § 6651(c)(1), the failure-to-file penalty is reduced by the amount of the failure-to-pay penalty when both apply during the same month, except that you don't reduce the failure-to-file penalty below the minimum of $100 or 100 percent of the tax shown on the return.

In addition to the failure-to-file and failure-to-pay penalties, there is a third penalty that may apply after you receive an IRS notice and demand. Under IRC § 6651(a)(3), this penalty is imposed for failure to pay any tax not shown on a return even though it is required to be. This is a penalty for not paying an assessed deficiency, and it kicks in 22 days after a taxpayer's receipt of an IRS notice and demand (or 11 business days if the tax amount equals or exceeds $100,000). This penalty equals 0.5 percent per month or any portion of a month, up to a maximum of 25 percent, unless the failure to pay is due to reasonable cause and not willful neglect.

This penalty and the failure-to-pay penalty are doubled to 1 percent per month once the IRS begins collection action.

Further evidence of the IRC's emphasis on filing returns is the fact that it takes 50 months for the 0.5 percent failure-to-pay penalty to reach the maximum 25 percent of taxes owed, while it only takes five months for the 5 percent failure-to-file penalty to reach that same level. As a result, your total penalty is likely to be lower if you file timely, even if you pay late.

THE INNOCENT SPOUSE

MOST MARRIED COUPLES FILE JOINT INcome tax returns, even if only one of them has income, because typically joint returns result in lower taxes. The other side of that coin, however, is that both spouses are liable for payments, even if one of them failed to file a return or make payments. Additionally, the IRS is not bound by the agreement of one of the spouses to pay the tax liability, and the other spouse is not relieved of liability.

All is not necessarily lost, however, for the spouse who was not a willing participant in filing an incorrect return. Depending on the circumstances, the "innocent" spouse may be granted full or partial reduction of taxes, penalties and interest attributable to the wrongdoing. Spouses must file claims for relief within two years after the date on which the IRS initiates collection efforts.

The key requirements for obtaining full relief are that the spouse must establish that he or she did not know or have reason to know of an understatement of tax liability by the other spouse; and that it would be inequitable to hold the innocent spouse liable.

To obtain allocable relief—which allocates the deficien- cy on a joint return between the spouses—the spouse claiming relief must meet the requirements for full relief, and also establish that he or she is no longer married to—or is legally separated from—the other spouse, and has not been a member of the same household as that spouse for at least 12 months from the date of filing the

ABA Connection

CONNECTION TELECONFERENCE CLE

PROGRAM

Begins at 1 p.m. (ET) Nov. 15 and discusses problems resulting from late filing or nonpayment of income taxes.

CO-SPONSORS

- The Section of Taxation
- The ABA Journal, the Center for CLE, and the Membership and Marketing Division

REGISTRATION INFORMATION

Turn to page 53.

claim for relief. In addition, the spouse claiming relief must offer proof on what the proper allocation should be.

If the "innocent" spouse cannot qualify for full or allocable relief, the IRS still may relieve the spouse of all or part of the joint tax obligation if, considering all facts and circumstances, it would be inequitable to hold the spouse liable.

FEW WAYS OUT

FAILING TO FILE TIMELY RETURNS OR PAY YOUR TAXES ON time does not put you entirely at the mercy of the federal tax system.

You may use Form 4868 to obtain an automatic six-month filing extension. But the form must show the full amount of taxes due for the year, even if the taxes are not paid at the time the form is filed.

With limited exceptions for taxpayers living outside the United States, a filing extension under Form 4868 does not change the deadline for paying your taxes, and interest and penalties still will apply to taxes paid after the due date.

IRC § 6161 authorizes the IRS to extend the income tax payment deadline for as many as 18 months or more in the case of deficiencies, but these extensions are rarely granted. You must show that payment would cause undue hardship, such as requiring the sale of property at a sacrifice price. The filing requirements (see Form 1127) also are extensive.

If you don't have sufficient resources to cover your tax liability, there are three primary avenues available to you: installment agreements, offers in compromise or bankruptcy. Due to the complexities of taking the bankruptcy route without the advice of experienced counsel, especially since Congress adopted major changes in 2005, this article focuses on the first two options.

An installment agreement should be considered if you have adequate income to pay the full tax liability (including interest and penalties) over a period of time, but can't borrow money to pay it immediately.

In limited circumstances—primarily that the individual's tax liability does not exceed $10,000 (excluding penalties and interest) the IRS is required to enter into an installment agreement. In other cases, it may consider requests for installment agreements. The IRS also is authorized, but not required, to enter into installment agreements for partial collection of outstanding tax liabilities.

If it's unlikely that you can pay your tax liability, even over time, an offer in compromise is a possible alternative.

The IRS will compromise tax liabilities when: (1) there is doubt as to the amount or existence of a tax liability; (2) there is doubt that the total amount due can be collected; or (3) there is not doubt as to the liability or that it can be collected, but collection of the liability would create economic hardship, or compelling public policy or equity considerations provide a sufficient basis for compromise.

The primary reason for submission of an OIC is "doubt as to collectibility."

Doubt as to collectibility exists where your assets and income are less than the amount required to pay the entire assessed liability. In making such a determination, the IRS considers your ability to pay after retaining sufficient funds to pay basic living expenses, generally defined as what is necessary for health and welfare or necessary for the production of income.

When the IRS determines collectibility, it generally does not consider the assets and income of an innocent spouse. But the incomes of the spouse and other household members are taken into account when determining monthly cash flow. In most instances where there are multiple parties sharing expenses, there must be an appropriate allocation in order to determine what the appropriate expense deduction is for the taxpayer, which may require financial disclosures to the IRS by other household members even though they are not parties to the OIC.

Effective with OICs received on or after July 16, 2006, several new provisions were enacted, including a 20 percent nonrefundable down payment for "lump sum" offers, which are paid in five or fewer installments.

For deferred offers (payments made in six or more installments), the taxpayer must send in the first installment payment with the offer and pay additional installments while the offer is examined. Another change provides that the IRS will deem an OIC "accepted" if it is not withdrawn, returned or rejected within 24 months after the IRS receives it.

The IRS relies on Form 433 to determine an individual's ability to pay tax liabilities under an installment agreement or an offer in compromise. There are several versions of Form 433, each of which relates to a different taxpayer status (wage earner, self-employed, business owner and such). The taxpayer uses the form to list assets, liabilities and other pertinent information, as well as a schedule of monthly income and expenses, supported by appropriate documentation.

ALLOWABLE EXPENSES

OF SPECIAL IMPORTANCE IS THE COMPUTATION OF "MONTHLY cash flow"—monthly income minus monthly allowable expenses. This is the key factor that will determine whether a taxpayer is qualified for an installment agreement or OIC.

In efforts to provide a uniform method of establishing what is allowable, the IRS publishes schedules of national and local living expense standards. Under these schedules, there are two basic types of expenses that are allowed in the computation of monthly cash flow: necessary and conditional.

Three categories of expenses are deemed necessary by the IRS: national standards that provide specific allowable amounts for food, housekeeping, apparel and services, personal care products and services; local standards that provide specific allowable amounts for housing, utilities and transportation; and other expenses if necessary and reasonable in amount.

Conditional expenses are those that do not qualify as necessary but may be otherwise allowable if the tax liability can be paid in full within five years.

Many ordinary expenses may not qualify as allowable, such as tuition for private school, charitable contributions, credit card debt, payment of other types of unsecured debt and payment of legal fees. In addition, the IRS only will allow expenses to the extent that the taxpayer can prove them, even if that amount is below the allowable ceiling. If, for example, a taxpayer qualifies for a rent/housing allowance of $2,000 per month, but can only prove actual expenses of $500 per month, then $500 is the amount that will be allowed.

The IRS may not levy against a taxpayer: (1) while a request for an installment agreement or OIC is pending; (2) for 30 days after an offer is rejected; (3) while an installment agreement is in effect; (4) for 30 days after termination of an agreement; or (5) while an appeal is pending on a rejection or termination.

Dealing with tax deficiencies is never simple, and the process can be full of anxiety for taxpayers. But the most important underlying principles can be simply stated: Pay on time if you can, but file on time no matter what. ■

Samuel L. Braunstein, a member of Braunstein & Todisco in Fairfield, Conn., is a member of the council for the ABA Section of Taxation. Carol F. Burger is a member of Troutman Sanders in New York City.