IRS Collection Weapons

Guide 2 of 7 Tax guides

Robert G. Nath, Tax Attorney

Concentrating in IRS and State Tax Controversy Matters

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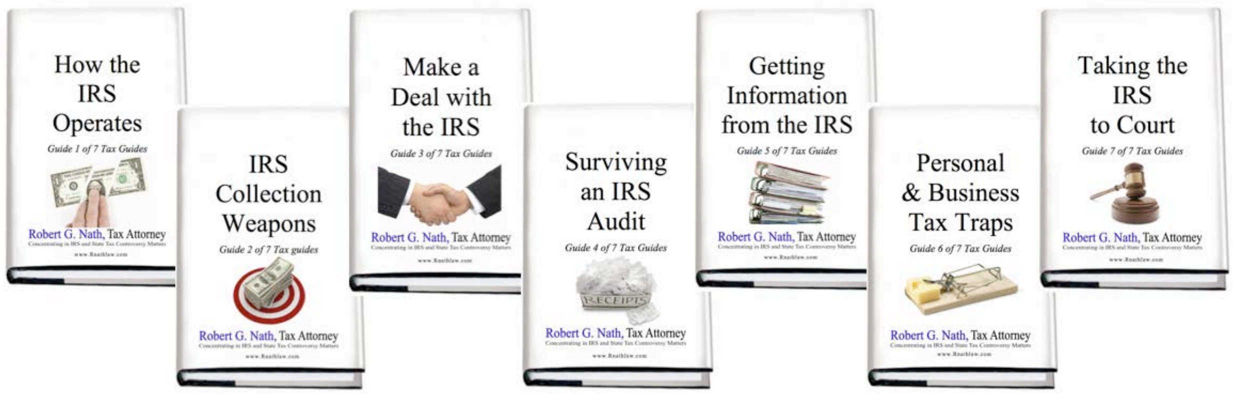

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2 of 7 Tax Guides

Written by

Robert G. Nath, Tax Attorney

Concentrating in IRS and State Tax Controversy Matters

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Contents

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1

The Federal Tax Lien

*How the lien arises…What the lien attaches to…Overcoming the lien...
Releasing the lien in full…Discharging property from the lien…
Suing the IRS over lien releases.*

The federal tax lien is no more and no less than a legal charge or encumbrance on a taxpayer's property to secure the eventual payment of the tax debt. In this sense it is similar to a mortgage on your house or a lien on your car. You can think of the tax lien as a legal ball and chain that attaches to property you own. The more you owe, the heavier the ball and chain. The biggest difference is that this ball and chain attaches to everything you own – all property and rights to property.

As we will see, the federal tax lien does not usually cause problems until the IRS files public notice of it. But once filed, that notice can damage your credit, cause embarrassment, endanger your credit relations, and hamper your efforts to buy or sell property. The IRS is fully aware of this impact. Agents know the tax lien filing is a big club they carry around and use often. If the tax you owe is large enough, and if you pay slowly enough, the IRS will almost always file a Notice of Federal Tax Lien to "protect the revenue." Translation: The agency will file the notice to make sure you do not sell property out from under its claim. The IRS files hundreds of thousands of lien notices each year.

Once the IRS files notice of the lien, generally there is little you can do with your properties unless you get the IRS' input and consent. Later on, this chapter will tell you how to deal effectively with the federal tax lien even when notice of it has been filed.

Tip: The IRS filed 707,768 notices of federal tax lien in fiscal 2012, down from over 1 million in 2011. This increased level of collection shows the "kinder, gentler" IRS of recent years has begun to show more teeth. If you owe more than $5,000, filing a notice of federal tax lien is SOP.

How the Lien Arises

When you file a tax return of whatever the type - income, employment, estate, or other - the IRS enters the tax you report as an "assessment" on its computer system in an electronic document called the Master File. The same is true when the IRS assesses a tax after an audit, or where it makes an "assessment" without your knowledge or consent. The IRS keeps track of Individual

Master Files by Social Security number, Business Master Files by employer identification number.

This "assessment" is simply the act of officially recording your tax liability on the IRS' computers. A specifically delegated officer signs the assessment document. At the point of signing, you officially have a tax "assessment." The computer also logs in payments. Since most people pay their taxes in advance (with payroll deductions), by estimated tax payments, or at the latest when they send in their return, the self-assessment on the return is considered fully paid when it is made, since it balances against the payments ("credits") in your account.

However, millions of people file returns with a "balance due." These are usually income, employment, or estate tax returns. Of course, the IRS immediately assesses the taxes on these "balance due" returns and sends "notice and demand for payment." The IRS collected $44 billion that way in 2012.

If ten days pass with no payment, the federal tax lien arises-automatically by law-and the IRS need do nothing further at this time. At this point, you don't actually see that the lien has arisen, since notice of it is neither filed publicly nor sent to you; but that's what the law provides. It's a "secret" lien, known only to the IRS and the taxpayer (who is presumed to know the law). The lien lasts until it is paid or becomes unenforceable because of lapse of time.

Tip: The Internal Revenue Manual requires agents to give you an opportunity to make payment or other security arrangements before a notice of lien is filed. Agents must also explain the effect of the lien on business operations or credit rating.

If you still do not pay, the IRS sends a series of notices demanding payment in ever more threatening tones. Individuals typically suffer through four notices; businesses, sometimes only two. Then the IRS really gets rough. Agents call; they threaten to file a notice of lien, seize assets, or levy on wages. They give you a fighting chance, but if you can't pay it in full or by an acceptably short installment agreement, at this point the IRS files a "Notice of Federal Tax Lien."

The 1998 IRS reform act requires that some agents get their supervisor's approval before filing the lien notice, but only "where appropriate." Who decides that? "The IRS," said Congress. But at least, Congress asks the IRS to review the taxpayer's information, verify the balance due, and affirm that the lien filing is appropriate, considering the taxpayer's circumstances and value of the equity in the taxpayer's property.

The notice is a one-page form filed in the land records of your city or county and also sometimes in another office that state law requires (for example, the Office of the Secretary of State in your state). IRS Form 668-A is the Notice of Federal Tax Lien. It lists your name and address, the tax periods involved, the type of tax involved (by form number), and the amounts owed (as of a recent date before the date of filing). These days the IRS files most lien notices electronically.

What the Lien Encumbers

The federal tax lien is not a laser-guided smart bomb, zeroing in on a precise piece of property. It's more like nerve gas, contaminating everything in its path. By law, it attaches to everything you own: all of your" right, title, and interest" in every piece of property, wherever located throughout the world. This surprising feature of the tax lien makes it different from every other creditor's rights to your property. Sometimes a taxpayer will say, "The IRS has put a lien on my house." Yes, it has, and everything else the taxpayer owns-automatically. Your mortgage and other liens attach to specific pieces of property; the federal tax lien is comprehensive. The best way to conceptualize the reach of the lien is this: Whatever you own, that's what the lien attaches to. Many a sad businessperson has discovered this fact after buying the assets of a failing business. The buyer thought she got a bargain, only to find that the federal tax lien followed the assets right into her hands.

Tip: Consider conducting a lien search when you are thinking of buying some types of property. In buying a home, this is routine. For business lenders this should be routine as well.

Some important examples of the federal tax lien's reach are these: it encumbers real property, including every home you own, wherever located. (But the IRS has to file public notice of the lien in the city or county where the property is located to make it enforceable against third-party claims. If it does not, the tax lien will not attach to that property if the property is sold.) The lien also attaches to money you might have on deposit as escrow with a court, a real estate agent, or elsewhere.

The lien attaches to your bank account, brokerage account, insurance policies, and other near-cash property. It also attaches to lawsuits or claims you may have against other people, licenses (such as liquor licenses), certain property you transfer in a divorce, property you transfer to third parties, stolen property held by the police, partnership interests, and interests held in trust. The lien also attaches to the vested portion of your retirement plans such as a pension plan or IRA, and to your vested share of a profit-sharing plan. The IRS may not be able to get at that money right away (if you can't), but it's still valuable property, and, as such, the lien attaches to it. (After a 2002 Supreme Court case, the federal tax lien also reaches the "tenancy by the entirety" interest of one tenant, even if the other tenant does not owe taxes.)

> Example: James, John, and Joseph went into business together as Jim's Boutique. Joseph was the silent partner who supplied start-up money. Everything went great until they didn't pay some payroll taxes. The IRS filed a notice of lien and levied on the partnership's bank account. The partners went straight to court, screaming that the money belonged to them individually. "You're right, guys, that's not the partnership's money," said the court. "It belongs to James and his silent partner, Joseph." But, no matter. The lien still attaches to it, because the partners were personally liable for the debts of their partnership.

> Example: Jordan and his wife, Jodie, were happily married for many years. Unfortunately, their financial life was not as blissful. Jordan had to file for bankruptcy.

> At the time, the couple owed $13,000 in back taxes, and the IRS had filed a Notice of Federal Tax Lien. Jodie had filed a claim for disability compensation with the Social Security Administration, then unfortunately passed away. Five days after Jordan filed his bankruptcy petition, Social Security granted Jodie's claim and issued a check for $14,000, payable to Jordan and Jodie. The money was exempt from all normal creditors' claims. Twenty days later, the IRS levied on it, claiming the funds were subject to the federal tax lien.
>
> So here's the picture: Jordan's wife had died; Jordan was destitute and had to file for bankruptcy. To add insult to injury, the IRS claimed Jodie's disability money. Who won? The IRS, of course. By law, the tax lien attached to "after acquired" property, including Jodie's disability windfall.
>
> Example: Chad was merrily driving along a Kentucky road one day. Then, out of nowhere a monster eighteen-wheeler plowed into him. The inevitable lawsuit followed. The trucking company set up a settlement fund for Chad. That's the good news. The bad news is that at the time Chad owed federal taxes, and a lien had arisen. Who got the money? The IRS, of course.

Examples like these litter the casebooks. Time after time, the government has enforced the federal tax lien against all types of property: alimony payments, accounts receivable, loans, condemnation awards, military pensions, reserve accounts, trust accounts, and just about anything else reducible to cash. Even assets that are exempt in bankruptcy (such as retirement accounts) cannot avoid the reach of the tax lien (though the IRS normally waits until the bankruptcy is over to make this claim).

Still, despite its pervasiveness, the lien filing does not steamroll everything in its path. The "first in time, first in right" principle applies, and the IRS respects that rule. So a properly recorded first mortgage on your home takes precedence over the federal tax lien. The same is true for personal property subject to a prior lien. So the lien filing poses no problem for your lender, who almost always records its interest first.

Tip: Lien searches are becoming highly computerized. Paralegals and staff at title companies routinely search for these. In more and more states and counties, you can now check court records for liens (of any type, not just tax liens) through the Internet.

If you don't borrow against property but simply sell it before the tax lien is recorded, that lien does not attach to the property because it is not yours when the lien notice is filed. This important principle is really common sense: If you don't own property at the time the tax lien arises (because you have sold it, transferred it, made a gift of it) there's nothing to which the lien can attach. But if you conveyed it in an effort to defeat the government, that's fraud. The long arm of the IRS can then reach the property in the hands of your transferee.

"Superpriorities"

Despite the power of the tax lien, sometimes you don't have to worry about it even if it is on record. Eight types of property sales can go through without a second thought about the tax lien due to a special law that declares the lien tax lien does not attach to the asset you are selling, no matter when the lien is filed. The rationale in each of these cases is that commerce would grind to a quick halt if every buyer had to conduct a lien search before buying property from a seller.

The first of these "superpriorities" is securities. When you buy and sell stocks, bonds, notes, and other securities, you don't have to worry about the seller's tax debts. (The financial markets would quickly clog if you did.)

The second type of sale involves a motor vehicle. This exception protects the buyers of new and used vehicles from the tax lien, unless they in fact know that the tax lien exists. Unaware of the lien, they should not have to check in advance of every sale.

A third exception is property you buy at retail. No one checks to see whether the Big Pricebreak Store has a tax lien on file before buying a television or refrigerator, nor should they have to. But if you buy the store's inventory in bulk, or if you buy to help someone evade or hinder the collection of taxes, then the tax lien does attach to what you buy. That's rare, but it occasionally happens.

The fourth exception is a casual sale such as a garage or yard sale, but the property has to be sold for less than $1,000 and the buyer must not "actually" know there is a lien on file.

The remaining exceptions protect "repair people," mechanics' liens, some attorneys' liens, and some commercial and real estate financing. Also protected are some insurance, endowment, and annuity contracts. Finally, banks that make deposit-secured loans are also protected.

You are always better off convincing the IRS not to file a notice of lien. But if you own realty, or if you owe more than $5,000, the IRS will almost always do so.

Overcoming the Federal Tax Lien

In the real world, the tax lien causes people major heartburn in two main ways: (1) It ruins your credit when you want to buy or borrow, and (2) it sabotages the sale of your property. If you want to refinance or sell property, any title search will reveal the lien. Many mortgages contain "no lien" clauses, which trigger technical defaults if you allow a lien to be recorded in the chain of title, even if you are up to date in your payments. The same is true for many security interests in personal property.

<u>Credit Rating</u>. Your credit rating usually remains intact until you try to borrow more money or the credit reporting agency has some other reason to check your debts. Credit rating companies are private corporations. They store millions of data files. But they do not sit down each month and say "OK, this month let's check ten thousand people to see if a tax lien has been filed." They normally check only when one of their clients, like a mortgage or title company, asks them to

check, or when someone or some computer sends them credit information. Only then will they discover the notice of lien. Even then, they may not always check every place the lien has been filed. However, that condition is beginning to change. These days credit reporting agencies are "connected" to many courthouse record systems, so they get actual notice of lien filings, judgments, etc. very quickly.

Still, if your goal is to borrow more money, or to sell or refinance an asset, it does not matter whether the credit reporting agency finds out about the lien. Loan applications typically require full disclosure of all debts. That includes the tax debt.

Tip: Get a current IRS transcript to determine the balance due on the tax debt. The IRS does not regularly update its tax liens, so your old one on file may inaccurately fail to reflect payments, or accruals of penalty and interest. To do this, call the IRS at 1 (800) 829-1040 and work through the phone tree.

A Drag on Selling Property. The second biggest complaint people make about the federal tax lien is that it undermines their ability to sell their property. Unquestionably, that is true in some cases. Lenders get nervous at a minimum, and sometimes run far and fast, when they discover you have a federal tax lien on file.

One thing the IRS could not do (until 1996) to solve this problem was to "unfile" the notice of lien. Once a notice was filed, that was it, like a fire-and-forget missile. (But you could do many things to avert its worst effects.) Following many complaints, in 1996, as part of the Taxpayer Bill of Rights, Congress gave the IRS the authority to "withdraw" a Notice of Federal Tax Lien.

The agency can withdraw the notice if the filing was premature or against agency procedures, or if you already entered into an installment agreement to pay your taxes. It can withdraw to "facilitate the collection" of the taxes or promote the best interests of you and the government. These rules leave it mostly up to the IRS, so no one should expect wholesale withdrawals of liens. The IRS views the filing of a notice of lien as one of its most powerful weapons. Still, the new authority is there, and you may ask for it, particularly if you want to sell property. In the real world, such lien withdrawals are very rare.

If the IRS refuses to withdraw the notice, can you sue? In the past, no, but now you can. The law allows several agency-level and court challenges for "unauthorized" collection actions and failures to "release" a federal tax lien. Beware though; these are virtually untested in real life.

Still, a filed notice of lien should never prevent a sale. Within limits, the law gives you flexibility to get around this lien.

Releasing the Lien in Full

In most cases, outright" release" of the filed notice of lien is next to impossible. However, you can ask for such a release, and the IRS must give it, if (1) you pay the full liability (including penalties and interest), (2) the statute of limitations on collection expires, or (3) you give a bond to secure payment of the taxes. In the real world, few people can buy these bonds. (If they could, they would have paid the tax.) This option is so rarely used that most revenue officers don't even know where to send you to buy a tax payment bond acceptable to the IRS.

The first two possibilities – full payment and expiration of the statute of limitations – are more realistic. Some people outlast the tax collector, usually a ten-year wait from the first assessment. If you haven't signed an extension of the time for collection or taken some action that extends it by law (such as filing for bankruptcy or making an offer in compromise, among other things), you can ask for a certificate of release of the federal tax lien once it expires. Most liens are "self-releasing," with language in the body of the lien notice itself stating the lien is automatically deemed "released" unless notice has been refiled by a stated date.

If you think your tax debt is beyond the ten years, call your local IRS office or the toll-free number (1-800-829-1040) and ask for an "account transcript" or "record of account" to be sent to you. Ask the technician whether the liens in your name have expired.

A transcript will tell you how old the assessment is. Once you are sure the assessment is more than ten years old and its life has not been extended, write the IRS Service Center or the Office of Technical Services (sometimes called the "Lien Desk", phone: 800-913-6050, fax: 859-669-3805), asking for a certificate of release to be filed. The IRS is normally prompt about filing these releases. If it delays, you can appeal the delay within the IRS and even sue for damages if the delay is too long.

The third way to get a release is to pay the liability. Usually this is not an option for most people; if they could have paid, they would have.

You are considered to have "paid in full" if the IRS accepts an offer in compromise and you have paid the offer amount. An accepted offer "settles" the old debt for a lesser sum, which you then pay. In fiscal 2012, the IRS accepted 24,000 offers in compromise for a total of $195 million.

But circumstances change. People borrow money, they come into an inheritance, or they make more money and decide they want to pay the taxes. The problem with this "solution" is that by the time they decide to pay, the payoff is loaded down with megapenalties and interest.

> Example: Sudden Sam had a federal tax lien going back to 1977; the lien had been extended into 1994 for various reasons. The IRS was threatening to sell his property. After all that time, he had made some money and bought valuable property. Now he was in a position to borrow against the property and liquidate some retirement accounts to fully pay the liability. In that way, he protected the value of his major properties against the discount that would have resulted from a forced tax sale.

There is one other, minor, way you can have a lien released. If you don't owe taxes in the first place but the IRS erroneously files a notice of lien in your name, it must issue a certificate of release stating that the lien filing was erroneous.

Discharging Specific Property from the Lien

Short of a release, there are still plenty of ways to sell your property out from under that federal tax lien. The tax lien may be "discharged" if:

1. The IRS is paid in full.

2. The IRS is paid the value of your (net) interest in the property.

3. The tax lien has no value as to your specific property.

4. A bond is posted.

5. Certain other property will remain subject to the lien even if it is released.

1. Let's say you want to sell a crane you have been using in your construction business for five years. The crane is worth $100,000. You've paid down the debt on it to $20,000, but you owe the IRS $50,000. If the IRS seized and auctioned the crane, it might get $60,000. After the IRS paid the $20,000 debt, $40,000 would be left for the government. You would still owe $10,000 in taxes. But in the open market, you could get $100,000, fully paying the IRS and the old debt, and leaving you with $30,000 to lease a new crane. The IRS has procedures that allow you to sell the property free and clear of the lien. The office of Technical Services issues a certificate that "discharges" the crane from the federal tax lien so the buyer can have it free and clear. The proceeds of sale are then put in a special fund subject to the lien, usually at a bank. Then that money is divided, with $20,000 going to the first lienholder, $50,000 to the IRS, and $30,000 to you.

2. A variation of this scenario is even more common. You find a buyer for the crane, call the revenue officer, and schedule a settlement. The revenue officer attends, bringing a certificate discharging the crane from the federal tax lien in exchange for a certified check for $50,000. Again, no muss, no fuss.

Tip: In these discharge applications, try to get your expenses of sale, attorneys' fees, etc. paid ahead of the IRS. To do that, list each expense clearly on your application. If the priority of an expense is in doubt, ask your professional advisor.

The same technique works, every day, in real estate sales. In fact, if you want to sell a house, a building, or land and a federal tax lien is on file against you as the owner (in the county where the real estate is located), you can't sell unless you give the IRS its share of the equity at settlement. The process is the same. Put the property up for sale, get your best price, and insert a line for the IRS at the settlement table. It does not even have to be for the full amount you owe. As long as the IRS gets all your equity (after paying the superior liens), it will be happy.

> <u>Example</u>: Tim owes the government $70,000 in taxes. His house is worth $110,000. The first mortgage is $40,000. He sells it, and, after commissions, the amount available for distribution is $100,000. The settlement agent pays $40,000 to the First Mortgage Bank and $60,000 to the IRS. Even though Tim will still owe $10,000 in taxes, the revenue officer will come to the settlement armed with a certificate of discharge of property from the federal tax lien.
>
> This type of release makes economic sense to the IRS. After all, by releasing the property the Service gets every last dime out of it. If it didn't let the sale proceed, it would get nothing. So it's in the agency's interest to issue the release, and it normally does.

3. In the above example, what if the first mortgage were $150,000, not $40,000. That scenario happened depressingly often in the 1990. In the 1990's, the values of people's homes went through the roof and they merrily borrowed-also through the roof-against that value. Then the recession set in, plunging values through the floor. In such a case, the IRS' lien is valueless because the first mortgage exceeds the market value. There's nothing in the sale for the IRS, so the agent might as well let it go. The agent will therefore still issue the release. These days, "short sales" are common. The IRS does not resist such sales because its lien is valueless with respect to the property being sold.

4. Another way to get a discharge of property is extremely rare, but it has probably occurred somewhere in the universe. The government can, in its discretion (read: if it wants to), discharge one piece of property if all the other property you own is worth at least twice the unpaid taxes plus all other liens on that property.

> <u>Example</u>: You own two pieces of land, the first worth $10,000, the second worth $100,000. There is a $5,000 mortgage on the second piece. You owe $10,000 in taxes. The IRS can discharge the first piece of property from the tax lien so you can sell it, because it has plenty of equity in the second piece. Specifically, that second piece is worth $100,000, but two times the other debts on it, including the tax debt, comes to only $30,000 (two times $5,000 plus $10,000). Will the Service release the first piece? Maybe not. After all, the release is discretionary; it goes against a revenue officer's training and experience to release your valuable property without getting something for it. But the law does allow this remedy.

How to Get that Release

To put these property discharges in motion, send for Publication 783, Certificate of Discharge of Property from Federal Tax Lien (or search irs.gov under "Publications"). This publication tells you what you'll need. Make the application for the discharge by letter and Form 14135. In general, you will need to include a description of the property, how you will be divested of your ownership, and who the buyer and seller are. Also include information on the tax liens, the amount of federal taxes, costs of sale, value of the property, and the holders of prior liens. You will also have to certify that you are selling the whole property, or at least all of your interest in it.

5. Sometimes, there is a fifth way to deal with the lien: You can ask the IRS to “subordinate” its lien to some other claim. The Service will normally subordinate if it can make more money in the short or long run. As an example, let's say a builder owes taxes. He is in the middle of a construction project that will net a big profit. But the bank won't release the money necessary for completion because the revenue officer has filed a notice of lien. Here, the IRS can subordinate its lien to the bank's fresh capital. To get this subordination, ask or write the revenue officer or the local Collection Advisory Group, providing the information specified in Publication 784 (Application for Certificate of Subordination of Federal Tax Lien and use Form 14134, which requires the same information). The IRS will consider the application, and, if it agrees, sign a certificate of subordination, filed in the same office as the lien notice.

   The 1998 tax reform act also created a new right for third-party owners of property, against which property a tax lien has been filed, to obtain a release as a matter of right. It involves posting a bond or making a deposit, refundable after investigation reveals that the taxpayer had no rights in the property.

Withdrawing a Notice of Lien

6. The 1996 Taxpayer Bill of Rights allows the IRS to “withdraw” the notice of lien (akin to “unfiling” the notice). One reason would be if the withdrawal will "facilitate the collection" of the taxes. Let's say you want to sell some property to which the lien has attached. This provision of law allows the IRS to withdraw the notice of lien. It will certainly be in the IRS' interest to do so if the agency will be included at the settlement table. This could work as follows: You negotiate the deal and arrange for the settlement. At the settlement table, the settlement agent draws a check to the IRS, in exchange for which the IRS will supply a formal withdrawal of lien. The settlement agent will then file the lien withdrawal in the land records, so that clear title to the property may be transferred.

   The lien may also be withdrawn if the filing was premature or in violation of the IRS’ procedures; the taxpayer has entered into an installment agreement to full-pay the liability, a bankruptcy case has been filed, or withdrawing the notice will otherwise be in the best interest of the taxpayer AND the government.

   Caution: The withdrawal does not release the lien. It merely withdraws public notice of the lien. The underlying lien remains in place, though now third parties may gain a priority over the IRS.

7. Be a True American – Sue!

   Now, you can. The IRS Restructuring and Reform Act of 1988 granted a right to a post-lien filing hearing before an "impartial" IRS officer. That translates to the Office of Appeals, the same office that considers appeals from income tax audits.

Caution: The deadlines are short, the agent must give you notice within 5 days of the lien filing. You then have 30 days from the day after notice to request a hearing. The hearing office must consider whether the law or administrative procedures were followed, spousal defenses, the appropriateness of collection actions, and, most important, "collection alternatives." These include substituting other assets, an installment agreement, an offer in compromise, or posting a bond.

If you lose there, you can go to court.

All of these fine-sounding procedures do not apply in the special case where the IRS has made an official finding that collection of the tax is in “jeopardy,” or where the IRS has levied on a state to collect a refund. Also while the IRS must give you notice of the lien filing, there is no legal requirement that you actually receive it!

"Persuading" a Determined IRS Agent to Release a Lien

All of this is fine in theory, but sometimes a hostile or stubborn agent just doesn’t "get it." When logic fails, go to the boss, the "Group Manager." Then go to *his* boss, the "Area Manager" or “Territory Manager.” In theory you can keep going past that, but it’s usually futile.

Instead, look to the IRS Restructuring and Reform Act of 1998.

Failure to release a federal tax lien is actionable in court under two statutes. One Code provision makes the IRS liable for certain "unauthorized" collection actions. This may be read to include any time an agent negligently, recklessly, or intentionally disregards any provision of the Internal Revenue Code, or any regulation. There are few reported cases interpreting this statute.

Another part of the 1998 Act requires the IRS Commissioner to develop procedures for reviewing when the filing of a lien notice is appropriate. The standard is required to include an "appropriateness" determination given the taxpayer’s circumstances, the amount due and the value of the taxpayer’s interest in the property.

You can also consider the beefed-up request for a Taxpayer Assistance Order if the IRS refuses to release the lien. (See Guide 3 for details.) And, a really nasty agent may now be fired if he or she refuses to issue release for retaliatory or harassing purposes.

Helpful Hints

1. Always try to convince the IRS agent not to file a notice of federal tax lien in the first place.

2. Consider appealing the agent’s filing of the lien notice--a right granted in the 1998 Act.

3. Retain or get copies of all tax liens filed against you, as well as of other, non-tax, liens.

4. To release the lien, arrange for a payment plan or make an offer in compromise.

5. Failing such a release, you may still sell property by asking for a discharge of the property from the lien.

6. Consider "subordination" of the tax lien in appropriate circumstances.

2

IRS Levies: Can They Really Do That?

The enormous power of the IRS levy…What can the levy capture?...
What's beyond its reach…Beat the levy without beating yourself…
How the IRS sells property it seizes

Imagine buying a television or a new suit, and, if you don't pay, the seller can seize your bank account or paycheck. Imagine also that the seller needs no court order, no hearing, no judge, and no jury to do this. In its starkest form, that's the power the Internal Revenue Service has to seize your property when you fail to pay taxes. The IRS almost never uses this seizure power in such an arbitrary fashion, but the authority is solidly entrenched in the law.

Note well: In fiscal 2012, the IRS issued over 2.9 million levies and made 733 additional property seizures. The levy activity is a large increase from several years ago. The yield from these and all other collection actions was over $44 billion.

A "levy" is simply the act of seizing your property to pay a back tax. It should not be confused with its collection cousin, the federal tax lien (Chapter 3). When you fail to pay a tax for the IRS has billed you, a "lien" (a legal charge on property), arises by law automatically. That lien is secret; at first no one knows about it except you and the IRS. Only when the IRS files notice of the lien in the local courthouse or land records does the public "know" that you owe taxes and that the IRS has a lien on your property to secure payment. This notice of lien is not a levy; it seizes nothing. It merely encumbers your property.

The levy is the actual seizure. In fact, the IRS does not even have to file a notice of lien before seizing your property. Legally all it must do is bill you for the taxes, demand payment, and wait thirty days.

Helpful Hint: As a result of the IRS Restructuring and Reform Act of 1998, the IRS' levy powers have been somewhat curtailed. This Chapter explains how.

Choose Your Poison: Varieties of the Levy

The IRS levy comes in three main varieties. (1) The "wage levy" which captures most of your paycheck, the commissions you've earned, and just about any other compensation due to you. The wage levy is continuous as to each paycheck until the levy is released or the taxes paid.

(2) The second is a nonwage levy, a one-time seizure of specific property such as your home, car, real estate, bank account, or insurance policy. (3)The third type, rarely used, is a jeopardy or termination levy, a hurry-up version of the nonwage levy. Reserved mostly for gambling, drug, and money-laundering cases, the jeopardy or termination levy is almost instantaneous. In fact, sometimes IRS officials will authorize revenue officers, by telephone, to make these levies.

Special Case: The Federal Levy Program

The IRS can and does levy on federal payments where the recipient also owes federal taxes. By this authority the IRS can continuously siphon off up to 15% of your federal payments, such as retirement benefits, contract payments, travel advances, salaries, and some Social Security payments. Some federal insurance payments, and hardship payments such as for bankruptcy debtors, are exempt. For this purpose unemployment benefits are not exempt.

If the IRS' levy power sounds ominous, it should. Many people have challenged this power in court; few have succeeded. In case after case over many decades, the Supreme Court and dozens of lower courts have rejected challenges to the levy power, ruling that this power to seize property without a court order or judgment is completely constitutional, indeed necessary to the proper functioning of government.

> Example: Abelard had a habit of violating the tax laws and accumulating back tax bills. In fact, he owed the government $925,000. As luck would have it, he violated his state's criminal laws as well and was arrested and thrown in jail. Heloise, his good friend, came to the rescue by lending him $5,000 for bail money. The IRS found out about it and immediately levied on the clerk of court for the bail money. "You can't do that," screamed both Heloise and Abelard's lawyer (who also claimed the money for his legal fees). "Yes, they can," said the court. Once Heloise loaned the money to Abelard, it became his, and the court bailiff was holding it only in trust. So the IRS got it.

This levy power stands a world apart from a private creditor's rights to collect money. Normal creditors are subject to dozens of state and federal laws that regulate and restrict their right to dun you by telephone, write you nasty letters, and otherwise take steps to collect their money. With limited exceptions, none of them can simply seize your bank account.

Not so the IRS (though starting in 1998, it too must obey a part of the Fair Debt Collection Practices Act). Ordinary creditors must also go to court to get a judgment if all else fails. Even the most far-reaching creditors' rights, the "confessed judgment" and the right of creditors to seize property that is pledged as collateral for a loan under the Uniform Commercial Code, are less powerful than the IRS levy. They must give the judgment to a sheriff to be served on you to seize your wages or your property in others' hands. Not so the IRS. You can usually file bankruptcy to foil most creditors, but bankruptcy often merely slows down the IRS. In short, there's very little shelter from this nuclear bomb of the tax levy once it is dropped.

> Example: Frank ran afoul of the IRS, which made a quick assessment of taxes, interest, and penalties for more than $100,000. The IRS quickly levied on money that Joe was holding in trust for Frank, but Joe refused to hand over the money. What did the IRS do?

Nothing. It sat around until eight years later, and then sued Joe for the money. The result? The IRS won.

Example: Andrew certainly had his problems with the U.S. government. One arm of the Department of Justice filed a multimillion dollar claim against him and sued him for it. That division threatened to seize his assets, so Andrew agreed to escrow some money, awaiting the outcome of the suit. In the meantime, the IRS filed a notice of lien against Andrew and levied on the account. It levied again three years later, and again the following year. Andrew threatened the bank. The Justice Department threatened Andrew, and the IRS threatened everyone. Naturally, a lawsuit followed. The bank ran to federal court, asking for protection. Who won? The IRS, of course. What about the agreement between the Justice Department and Andrew to keep the money in escrow? "That was another division," said the judge. "That's not binding on the Tax Division; and besides, the agreement doesn't say that the money must be held, only that the division would use its 'best internal efforts' to make sure no other government agency levies on the funds." So, the IRS won the money.

Example: Theodore bought an annuity contract from the Big Umbrella Life Insurance Company. For years, he dutifully made contributions of more than $13,000. In the meantime, four years into the contract, the IRS made an assessment against Theodore totaling $55,000. Then the IRS levied on the insurance company. "No go," said the insurance company. "The annuity is not in our possession or custody." The court disagreed. The insurance company had to cut a check to the IRS for the cash withdrawal value of the annuity. To add insult to injury, the court held the insurer liable for a 50 percent penalty as well. Congress intended that the IRS should be able to reach "every interest in property a taxpayer might have," said the court. The right to withdraw the cash value is itself a valuable property right, so the IRS could reach it by levy.

Before the IRS Levies

Because the levy is so powerful, the IRS voluntarily restrains its routine use except when collection is deemed to be “in jeopardy.” (The 1998 tax reform act imposed some important additional restrictions on the levy powers.) In almost every case, you get plenty of warning before a levy hits. Like an oncoming freight train, you can see it and hear it, often in time to get out of the way. For example, you get a bill from the IRS if you file your tax return with a balance due, or you owe more tax after an audit, or you fight the IRS in tax court and lose. All of these bills are called "assessments;" they tell you to pay, or else. The "or else" includes the threat of a levy.

The IRS normally sends up to four notices of tax due to individuals, and as few as two to businesses. Each new notice is more urgent than the one before. The final notice arrives by certified mail. After waiting thirty more days, the IRS is legally free to seize any property it can find. This final notice is entitled Final Notice of Intent to Levy, to resolve any lingering confusion about the agency's intentions. Before the IRS levies, the case must also be reviewed. The IRS must re-check the taxpayer’s information, recheck the balance due and the value of the property, and affirm that the levy or seizure is "appropriate" given the taxpayer's value of the property and circumstances.

Tip: These procedures were in place at the agency even before they became law in 1998. In some cases, made famous in Congressional hearings, the IRS went overboard in its zeal to seize. The new law won't affect most cases, but now that these procedures are law, you can, in theory, sue in court if the IRS violates these laws by failing to conduct a proper review.

Example: Your worst nightmare: A husband and wife come into the office, both in tears. The boss has fired the husband. Why? The IRS levied his wages, and he hadn't told his boss he owed taxes, much less that he was having trouble paying them. (The firing is illegal under federal law, but it happens in the real world.) As the story unfolded, the IRS had matched a Form 1099 with the husband's return and found an error. The Service sent a bill, but this was two years after the couple had filed their return and had moved, as millions of Americans do every year. Because of that move, the IRS didn't know where they lived. Then they moved again. Notice after notice went unclaimed, including the Final Notice of Intent to Levy.

"You mean we don't actually have to receive that final notice for the IRS to have the right to levy?" asked the husband. That's right. The Service only has to send it to your "last known address."

Helpful Hint: The 1998 tax reform act does not change this result. But it does say exactly how the IRS must give notice--in person, left at your home or business, or sent by certified mail to your last known address. So if you move, file IRS Form 8822.

An extreme example? Yes, but it does happen from time to time. In most cases, people know they owe taxes. They get the notices, or at least some of them, but they stick their heads in the sand. In fact, the IRS sometimes issues so many notices that people feel intimidated by the volume of paper itself. So they stack the envelopes in the corner, hoping the paper will grow legs and walk away. They don't claim certified mail, figuring its bad news from the Internal Revenue Service and will fade like morning fog if they ignore it. No matter. The IRS freight train continues to chug inexorably toward them, gaining speed with each new notice.

IRS Levy Policy and Practice

Because the levy is so powerful, IRS policy is to use it sparingly. The Internal Revenue Manual, and the 1998 tax reform act, in fact require this restraint. So as an institution, the IRS does not want to seize your wages, your car, or your other property. What the IRS really wants is your attention and commitment to face up to your tax problem and deal with it. "Dealing" with a tax debt means liquidating assets, filing an offer in compromise, making an installment agreement, borrowing money, or crafting other solutions. So think of the levy as an abrupt wake-up call. After the IRS chases you around, the levy means "Gotcha." Having focused your attention, the Service will typically release most levies if you begin to cooperate. Surprising as this sounds, in the real world it holds true, and confirms the IRS' policy not to use the levy power unless it sees no other choice.

All is Not Lost When the IRS Levies

You also have certain rights when the IRS levies. For example, you may request expedited review if the IRS seizes personal property that you need for your business. You also have the right to request that property be sold within sixty days. Note that these "rights" do not automatically grant you the relief you seek. They are generally dependant on the discretion of the IRS. You also have the right to a preseizure review using the Collection Appeals Process or the very powerful, new pre-levy appeal procedures described below. If the IRS wants to seize your home, it now must go to court for a court order. And before the Service seizes business assets, the appropriate official must personally review the agent’s proposed action.

You also have the right to a release of any levy if the equity in the property is not enough to warrant its sale. This might occur even if the property seems to be worth little more (but is actually worth less) than the debt attached to it. For example, a home worth $100,000, with a debt of $90,000, has no equity for IRS purposes, because the IRS discounts the market value (normally by 20%) for the hypothetical forced sale condition of the property.

People who are deemed "uncollectible" can also now get a levy release as a matter of right. Many people who owe taxes can’t afford to pay anything--their income is so low it covers only their basic living expenses. So the IRS declares them "currently not collectible." In the past, some agents levied their wages anyway. Now these "uncollectibles" have a legal right to a levy release.

The IRS' internal policies, and the law, also require the release of the levy if certain conditions are met. For example, if the tax is paid or it expires, the levy must be released. If you enter an installment agreement, or if releasing the levy will facilitate tax collection, it may be released. Also, if the levy is creating an undue economic hardship, it must be released. The 1998 tax act wrote this into law. This last condition, in fact, is the one most often relied on to obtain a release of a levy.

Avoiding or Releasing the Levy

What to do when the revenue officer's threat to levy seems real, or if in fact she has levied?

Before the levy is issued, by far the most important tactic is: Communicate! Never let a notice go unanswered. Write and call the IRS every time it notifies you or every time it asks for information. Stay in touch with the revenue officer or the Automated Collection System representative. Ask that no seizure action take place. Consider getting help from a tax professional, and ask for time from the IRS if you need it.

Consider also appealing the proposed seizure, either to the Office of Taxpayer Advocate or to the revenue officer's group manager, and from there to the Office of Appeals.

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Important new right: The 1998 tax reform act created new, important rights for anyone threatened by a levy. Everyone should know these rights because they represent the first time that one, and in some cases, two, independent challenges to any levy can be mounted. In the real world, people use them every day.

Under the 1998 tax reform act, the IRS must give you 30 days notice and advise you of certain rights before it can levy. The most important of these is the right to a hearing before a neutral, independent hearing officer. That means the Office of Appeals inside the IRS. You get one notice for each tax period at issue. (One notice will often contain several periods.) The notice must tell you several things; all in clear, non-technical terms:

1. The amount of unpaid tax
2. Your right to a hearing within the 30 days
3. The IRS' proposed action (i.e., seize and sell assets)
4. The law relating to levies and sale of property
5. IRS procedures governing levies and sales
6. The appeals available to you
7. The alternatives you have that would prevent a levy, such as an installment agreement
8. The law and procedures relating to redemption of property and release of liens

That hearing is called the "Collection Due Process Hearing." People abbreviate this to "CDP." The law thus gives *you* the right to avert a levy -- by action you can take. If you file the "CDP" hearing request, the agent must stop collection and refer the case to the Office of Appeals.

The hearing must be conducted by an officer with "no prior involvement" in you case. The appeals officer will consider many issues, including:

1. Whether all law and procedures were followed
2. Spousal defenses (e.g., innocent spouse--see Guide 6)
3. Whether the levy is the "appropriate" thing to do
4. The collection alternatives, such as posting a bond, substituting other assets, an installment agreement, or an offer in compromise

This law specifically requires the appeals officer to determine whether the proposed collection action balances the need for efficient collection with your legitimate concern that collection action be no more "intrusive than necessary."

Never before had such broad administrative rights, pre-levy, been available to ordinary citizens. In fact, before Congress enacted the Collection Due Process Hearing procedures, the United States Supreme Court had ruled in numerous cases that the taxpayer has no right to avoid any collection action – no "injunction" against the collection of taxes. And, while your appeal here is pending, the IRS may not seize your property.

If you lose at the Office of Appeals, for the first time you can go to court! The United States Tax Court and the federal district courts are now empowered to review the IRS' decision. The levy is still suspended only if you are contesting the underlying merits of the tax, that is, whether you in fact owe the tax. These rights also don't apply in jeopardy assessment cases, in criminal cases, and in cases where the IRS has levied on a state to collect a state tax refund.

In the real world, many taxpayers in fact go to court. However, most lose.

Tip: The IRS in practice is extremely careful and conscientious in handling Collection Due Process cases. Courts give the agency wide latitude and will overturn the IRS decision to proceed with collection only in rare cases of abuse.

If you don't exercise these rights, now you must deal with the Revenue Officer or the Automated Collection System. If the IRS has just levied your bank account, your car, or your business property, you must obviously take immediate action. The most extreme form of action is to file an emergency bankruptcy petition. Such a petition will usually result in the release of tangible property and real property, but not cash or cash equivalents. Still, filing for bankruptcy ought to be a last resort, never done lightly or without careful consideration and consultation with an experienced bankruptcy attorney. Short of bankruptcy, you may call the revenue officer and ask for release of the levy. Of course, if the revenue officer is willing to do this at all, there will be conditions. These may include entering an installment agreement, providing updated financial information or anything else the revenue officer deems appropriate.

If the levy is creating a true hardship, you may seek a "Taxpayer Assistance Order" (see Guide 3), or simply go up the chain of command through the group manager and his or her superiors. It's all a matter of negotiation, and in such negotiations, the less hostile you are, the more businesslike and cooperative, the better things usually go.

What can the Levy Capture?

Almost nothing is beyond the reach of the levy. Bank accounts, wages, commissions, accounts receivable, stocks, bonds, the cash value of insurance policies, jewelry, even homes can be seized and sold by the IRS. The law excepts only eleven narrow categories of property from the levy power. The exceptions, discussed below, include books, tools of your trade, and some parts of salary, among other things. Everything else is fair game.

Of course, the IRS goes for the low-hanging fruit first: bank accounts, cars, stocks, bonds, and wages. Its second set of targets are items such as insurance policies and accounts receivable. Third, the agency really hits home: it can seize your retirement accounts and your home (with some restrictions).

Bank Accounts

These assets are easy marks. The Service sends a one-page form entitled "Notice of Levy" to your bank. From the instant the levy is received, by law the collected balance in your account is frozen.

Caution: The "collected balance" is not your checkbook balance but the balance you have at the bank. This means that unpaid checks may bounce once a levy hits the bank.

Then the bank waits twenty-one days, after which it sends that frozen balance to the IRS. (Of course, the bank also deducts the usual processing fees.) The 1988 Taxpayer Bill of Rights stretched the grace period from 10 to 21 days to allow you time to work things out with the IRS. But you're certainly bargaining from a position of weakness. Many revenue officers, knowing they have the money, will simply refuse to release that first bank levy.

The IRS uses names and Social Security numbers to find and identify bank accounts. A levy to the First Patriotic Red-Blooded American Bank will recite your name, Social Security number, and a description of the tax due according to the IRS. It also contains a demand to pay the account balance. The IRS also uses "third-party" information such as Forms 1099 sent to the IRS from banks, brokers, etc.

What if you have a joint account and you are not the owner, or you own only part of the funds? Examples would include a bank account in trust or a joint account where a nondelinquent taxpayer like a child or spouse puts in some of the money. If so, the IRS has no right to those funds; they don't belong to you. But usually the account does not reflect someone else's ownership. So, convincing the IRS to release this levy is roughly equivalent to pulling teeth from an alligator. If the account bears your name or Social Security number, the IRS will try to take it, all on the legal presumption that it's all yours because you have the right to withdraw it all. You then have to prove someone else owns the funds in the account in whole or in part. Normally, that's done by showing who deposited the money, but this can be difficult. In fact, such seizures of joint accounts in parent-child names prompted Congress to expand the freeze period to twenty-one days from the original ten. Moreover, under some state laws money you put into a joint account in fact becomes 50% owned by the co-tenant in the account.

Helpful Hint: This is the ideal case in which to invoke the new appeal rights to contest the levy before it is made. You'll have a full opportunity before a neutral officer, and possibly a court, to make the case that the account amount is owned by someone who does not owe taxes.

> Example: Abe was a good and dutiful father. He opened a bank account for his children and began putting money in it, all as gifts. Unfortunately, only Abe could sign on the account, and the account card did not show that the money was property of his two sons, Todd and Tim. He also got a passbook for his savings account (banks issued passbooks in those days) with his name on it, but not the children's. Abe put the passbook in an unlocked drawer in his living room. Years passed. Abe got into tax trouble; the IRS levied on the bank accounts. The bank sent the money to the IRS. Abe got notice, and nine days later went to withdraw the balance. The bank refused. A month later, the

> children went to the bank and tried again to withdraw the money. "Gone," said the bank, "sent off to the feds." So Abe and his children sued the bank. The bank won. Had there been any evidence that the money belonged to the children, the bank might have lost the case. But absent such evidence, the money belonged to Abe, and the bank was perfectly right and duty-bound to send the money to the IRS.

To add insult to injury, after the IRS applies the money to taxes, then penalties and interest, you may still end up owing a substantial sum.

Tip: The IRS will apply the money in its own best interest. You have the right to designate any voluntary payment you make, but levy proceeds are not "voluntary."

The bank can do nothing to help you. It's not the bank's problem; the bank is a mere stakeholder.

The IRS knows where you bank from many sources: your last several tax returns, a Form 1099 the bank may have filed for you, a Collection Information Statement you gave to the IRS the previous year, or simply good detective work on the agent's part in the computer system. Revenue officers will sometimes loose a flurry of levies, at random, to see what targets they hit. Often they strike gold.

In the meantime, since your bank account funds have been frozen, your checks will begin to bounce. Each bounced check results in another bank charge, which can quickly add up, as well as the damage to your reputation in the eyes of your payees. So those twenty-one days are precious time in which to negotiate with the IRS to release the levy. The price is usually an interim agreement to begin paying the taxes in installments. (See Guide 3)

Wages and Salaries

A wage levy is "continuous," meaning the IRS has to levy only once to get your wages, salaries, or commissions week after week, month after month. It differs from one-time levies, which seize only the property in the possessor's hands when the levy hits. The "continuous" IRS levy also reaches certain "specified payments" that are not wages, such as federal payments, some unemployment and workers compensation benefits. Starting in 1998, an IRS officer must specifically approve levies on these sources before the levy is made.

The wage levy is probably the IRS' most effective attention-getter. It instantly clarifies the thinking of all but a few reluctant taxpayers. Out of $100 of wages, the IRS' take is typically $70 to $90. The exact amount depends on the number of exemptions you have claimed on your W-4. The IRS has a formula for this calculation that is set out in the levy notice to your employer.

> Example: James and Jackie, husband and wife, did their best to make it in the farming business. They had a good company and did just fine for many years. But then they got into trouble and didn't pay more than $200,000 of payroll taxes. What to do? James came up with the idea of selling some property at auction, so they put up the property and told the IRS about it. Naturally, the IRS levied on the $50,000 check from the auction company. To add insult to injury, the IRS also made an assessment against Jackie (not

> James) personally for $100,000, a portion of the unpaid payroll taxes. (The agency can personally assess corporate officers who are deemed responsible for the company's failure to pay payroll taxes.) So the government then had half its money, but it wanted the other half. It couldn't levy on Jackie's wages, because she appeared to be destitute. Instead, it levied on James's pay, even though he had not been assessed for these taxes. Could it do this? Yes. The IRS took advantage of the state's community property laws, which make one spouse's community property like wages vulnerable to satisfy the other spouse's separate debt. (In addition to the powerful enforcement measures available only to the IRS, the government enjoys the legal rights available to any creditor.)

Not many people can live on the paltry sum a wage levy leaves, so you need to act instantly when that happens. In many cases, the IRS will release a wage levy after you ask. However, the agent may insist on taking one paycheck and require full financial disclosure and an installment agreement or the sale of assets. To get the release, call the toll-free number on the levy form itself and explain the situation. State the obvious: you need your wages to live on; you won't be able to pay the rent, mortgage, or feed or clothe your family if your wages are seized. Of course, your statements must be truthful, but it's almost self-evident in the case of a wage levy. Also tell the agent that you intend to pay attention now and work out your collection problem.

You have several choices. You can sell assets or borrow money (not usually a realistic option if the case has gone so far as to require a levy). You can "deal with" the tax collection problem by filing for bankruptcy, which will in fact require the IRS to release the levy as to future wages (but not as to funds seized or frozen before you file). Bankruptcy is not always a permanent solution, though in many cases it can be.

You can also ask the IRS to stop collecting completely because you can't pay anything at all. That situation is so common the IRS even has a form for it, Form 53. The agency uses Form 53, to conclude that your tax debt is "currently not collectible."

The Service shelves “currently not collectible” accounts for six months, one year, or longer. It reviews your case from time to time to see whether you are doing better. In the meantime, an agent will file at least one Notice of Federal Tax Lien, protecting the IRS' position against the claims of competing creditors and preventing the sale of your home or other property (including property you acquire after the lien is filed). This gives you some immediate relief from the levy. "Currently not collectible" status is like cancer in remission: it doesn't cure the problem, and the symptoms could reappear.

Another choice is to ask the IRS for an installment agreement, a method of paying your taxes slowly, over time.

Finally, you can suggest that you will never be able to pay your taxes in full, but you may be able to pay 10 percent, 20 percent, or some other fraction. This condition calls for filing an “Offer in Compromise,” a deal in which the Service permanently forgives some part of the taxes as long as you pay the rest. See Guide 3 for discussion of offers in compromise.

Those are your choices. Select one, or a combination, and propose it, if you're hoping for any chance of the Service releasing the levy.

Retirement Accounts

That nest egg you were incubating for retirement is definitely not exempt from IRS levy. This fact surprises many people because the law bars ordinary creditors from seizing retirement accounts, including in bankruptcy. IRS can and does seize retirement accounts. In one well-known case, the IRS levied the entire IRA of a retired judge! Seizing a retirement account is a last resort; the agency will usually exhaust almost every other source of collection. So if you can arrange an installment agreement or an offer in compromise, the IRS may leave your retirement account intact.

Tip: Remember the basic rule: the IRS can legally get only what you can get. The Service "steps into your shoes," as lawyers like to say. So if you can't legally tap your retirement account now, the IRS can't levy on it. Be sure you know the rules of your retirement plan! Use them to defend against an intended levy.

But when a retirement account is seized, there's triple trouble: (1) You lose the whole thing; (2) you could owe a penalty for estimated taxes or early withdrawal; and (3) you'll trigger the income taxes due because of that withdrawal. So while the IRS has paid all or part of your old liability with the IRA, it has also created a fresh new one for the tax year in which the seizure occurs.

Insurance Policies

The IRS can seize the cash surrender value of any whole life policies you own or any other type of policy that has cash value, such as universal life or a retirement annuity. Term life policies, which have no cash value, are of no interest to the IRS. The IRS seizes the equity in the policy by sending the levy to the insurance company. By law, the carrier is then required to send a check for the cash value, less loans, fees, or penalties.

Your Home

The IRS seizes homes, cars, and other big-ticket items by physically slapping a preprinted sticker, called a Notice of Seizure, on the property. The IRS will haul away things it can move. In fact, the IRS seizes so many cars and trucks that the local collection office often has standing arrangements with towing companies and storage lots. Physically putting that sticker on a car, home, or other property is an act that legally seizes the property for the IRS. That means it's a felony to sell, remove, or damage it.

Tip: Driving your car away with the seizure notice on it, or removing the notice, is a quick and easy way to get yourself arrested. Revenue officers watch for this, and won't hesitate to call the Criminal Investigation Division to haul you away.

Agents record all seizures in a central notebook and then schedule the properties for sale. But if the seizure takes place on private property (vs. the street, for example), the IRS needs either your consent or a court order. This rule stems from the Fourth Amendment's restriction on unreasonable searches and seizures. The IRS' warrant to enter business or personal premises is called a Writ of Entry. A taxpayer who refuses to consent to entry only delays the inevitable by a few days or weeks. The revenue officer obtains the writ by asking the U.S. Attorney's Office to go to court, usually a formality. Normally you won't even know that the agent has asked for this Writ of Entry. The U.S. attorneys can obtain it without your knowledge or consent, and you would have no legal standing to contest its issuance even if you knew it was being sought from a judge.

Community Property

Nine states are "community property" states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (which has a form of community property). Figuring out what the IRS can reach in a community property state is difficult; each of these states has its own peculiar twists and turns on the community property laws. And, since the IRS' liens and levies can reach only what you, the taxpayer, own under the law of your state, the issues can become quite muddled and complex.

Still, people who live in these states should note a few general principles about community property and how the IRS' rights might apply in those states. In general, and subject to your particular state's law," community property" is property that comes into a marriage. "Separate property" is property each spouse has before marriage, or which is acquired by gift or inheritance. Community and separate property generally retain their character, but people who commingle separate property can, in effect, make it community property. Voluntary "transmutation agreements" can also convert separate property to community property.

As a general rule, community property is liable for the debts of either spouse or both spouses. That means the IRS can sometimes levy on one spouse's income for the other spouse's tax debt. This has happened many times in many cases. If you are faced with such a threat where only one spouse owes taxes, several options are available. First, you and your spouse may keep completely separate property accounts, including separate bank accounts. Remember that this works only for property that is not "community property." As noted above, some states allow you to "transmute" community property into separate property by a simple written agreement. Where that device applies, it can often protect assets from the claims of creditors, including the IRS.

The IRS is very careful about enforcing its claims in community property states. The agents are cautioned to ask for a legal opinion on what is liable for the tax debts and what is not.

Exemptions from Levy

By law, eleven types of property are exempt from levy. But don't hold your breath; even if your property fits one of these categories, it usually won't feed the children.

1. Workers' compensation payments are exempt, including any amounts payable to dependents.

2. Wages, salary, and other income are exempt, but only a small fraction figured according to a formula. The formula is linked to the IRS' standard deduction and personal exemptions, prorated on a weekly basis. Figure only 10 percent to 30 percent of your net paycheck will remain yours.

3. Clothes and schoolbooks are exempt, but only to the extent "necessary" for you or members of your family. In practice, the IRS rarely levies on clothing or schoolbooks. (It might if you had an expensive fur coat.)

4. Books and tools of a trade, business or profession are exempt up to $3125 in value. For some low income taxpayers, this means a car, and some tools, so they can continue in business. In the real world, agents rarely like to seize these items; it kills the goose that lays the golden egg.

5. Homes. If the amount you owe is less than $5,000, the IRS can't seize your home at all. The same rule applies to any other realty you own except rental property. Also, in larger cases the IRS can't seize your home or business assets without a court order or specific approval by an IRS official.

6. Fuel, provisions, furniture, and personal effects (up to $6250 in value) in your home, arms for personal use, and livestock and poultry, are exempt. So your guns, chickens, cows, and firewood are exempt from IRS levy.

7. Unemployment benefits, including amounts for dependent care, are exempt from levy, but again, that's not much. Since disability benefits are not unemployment compensation, they can be seized.

8. Annuities or pensions payable under the Railroad Retirement Act and the Railroad Unemployment Insurance Act, special payments to Medal of Honor winners, and annuities for armed forces members are exempt. Again, the amounts are not large. Social Security benefits? Government pensions? These can be seized. It happens all the time.

9. Judgments for the support of minor children are exempt up to the amount of salary, wages, or other income necessary to comply with the court order for support. And, they are exempt only if the judgment was entered before the IRS issued the levy. You bear the burden to show how much is necessary to comply with the court order, and the Service does not have to release the money until you prove that the money will in fact be used to support the child.

10. Welfare and Job Training Partnership Act payments and books and tools necessary for the taxpayer's trade, business, or profession are also exempt.

The Automated Collection System

Most wage and nonwage levies originate in the IRS' Automated Collection System (ACS). ACS is the Service's mighty reserve army, activated after a computer at one of several regional “Service Centers” nudges you to pay, and you don't. Normally, the Service Center will send out four notices of tax due for income tax cases, or two for businesses or repeat offenders. Large-dollar cases (over $100,000 owed) also receive only two notices.

In all of these cases, the last notice is called a Notice of Intent to Levy. The IRS is required by law to give you thirty days from that notice, and the right to a Collection Due Process hearing before it issues any levy. Beware of any of these notices, particularly the last one. If it expires and you've done nothing, you can expect the Automated Collection System to spring into action and start levying on whatever levy sources it can find.

In general, most problems that occur with the IRS' collection arm result from the taxpayer's failure to heed these warnings or to cooperate in giving information to the IRS. Most levies are not "out of the blue." You get plenty of opportunity to work things out. In fact, the sooner you respond to any of these notices, the better off you usually will be.

As its name implies, the Automated Collection System collects automatically by machine-generating levies and notices of lien. ACS also has a staff of real people. They work in large rooms at the regional service centers around the country, calling taxpayers to convince them to pay, receiving your calls, working out payment plans.

The ACS people work in teams. They have a number of interrelated goals. First, they will demand full payment of the tax. At the same time, they want to interview you to determine if you can pay, and how much. This interview will also establish sources on which they can levy in the future. They will set deadlines for paying or filing returns, or submitting more financial information or forms. They will warn you that collection action will follow if you fail to meet any of these deadlines.

If your case is complex, they will research it for you. All day, ACS employees talk to taxpayers like you who call trying to get a break or make a deal on their taxes. When you call, the agent is trained to note on the computer the substance of everything you say, including your promises to file an offer in compromise, make installment payments, or take other action. They do not record the calls; they just take notes.

When you call back again, you will usually get another agent, but that agent will have the institutional memory at her fingertips. In most cases, a mere contact by the Automated Collection System is enough to wake you up about your past taxes. So, even though you have received multiple notices from the Service Center and a Notice of Intent to Levy, you still have some credibility if you respond quickly and forthrightly to the ACS representative. True enough, that representative will pump you for information, exposing your financial neck. But you really have no choice, and, in any event, an attitude of cooperation is the only way you can hope to avoid levies and possibly avoid notices of federal tax lien.

Sometimes, however, liens are unavoidable. The cutoff point is usually taxes owed of $5,000 or more. If the taxes due are under $5,000, the agent has discretion to forbear from filing. If the amount is over $5,000, the Internal Revenue Manual criteria will usually result in lien filing. Exceptions include cases where you can show that such lien filing will harm your business, or sabotage an anticipated loan, or other compelling reason. ACS will warn you that notices of lien are routinely picked up by credit bureaus.

Calling the Automated Collection System can sometimes be a terribly frustrating experience. The agents are trained to collect taxes and to be tough. People lie to them ten times between breakfast and lunch. And they've heard enough sob stories to keep Ann Landers supplied for years. When you call, remember a few rules.

1. Have all your information ready. This includes complete financial data on your assets and liabilities, income, and expenses. The agents will usually ask for all of this, plus addresses, phone numbers, and so on, even before you discuss how you're planning to deal with the back taxes. Use IRS Form 433-F for this purpose, available at irs.gov.

2. Be cordial and businesslike with the agent.

3. Always tell the truth.

4. Explain exactly the hardship the levy is causing and why you need relief from it. The agents already know the levy is painful, but you may have to explain the details.

5. Propose a realistic, sensible plan of action to resolve the delinquent taxes. To do this, prepare in advance all your monthly income and expense figures. ACS will usually take these over the phone. Use the checklist in Guide 3, or the IRS' Collection Financial Standards at irs.gov/individuals as a guide.

   <u>Helpful Hint</u>: Get Form 433-F before you call. Download it from the IRS' website: www.irs.gov, or get it from another source. Go over each line item before you call; the agent will ask about each of these anyway, and your advance preparation adds credibility.

6. Your attitude, and that of the ACS agent, are crucial. Expect no breaks if you antagonize the agent. But if you are cordial, cooperative, and meet your deadlines, you may win over the agent and distinguish yourself from others who do not. And, be sure that the tax bill you are discussing is correct. The IRS usually gets it right, but not always. Check the bill. Is it for the right tax period? Are penalties and interest properly calculated? It never hurts to be sure. Finally, if you don't like the result you get with ACS, appeal to the agent's supervisor. Then, appeal again if you must. You can also appeal to the Office of Taxpayer Advocate if you believe that the installment agreement ACS insists on is too burdensome. Guide 3 discusses this in more detail.

The ACS agents will then set deadlines depending on the result of your call, such as thirty days to submit a financial statement, or, if the amount you owe is small, ten to thirty days to submit a signed installment agreement. If you cannot meet the deadline, call before the deadline expires to get an extension or to tell the agent you cannot meet the deadline, and why.

Despite the IRS' resort to a levy, you do in fact have credibility when you call the Automated Collection System to request relief. But you lose it fast if you miss even one deadline. And remember, the IRS has most of the power; you have little.

Normally, the agent will release a levy if you face your collection problem squarely and propose an acceptable solution. You need to ensure that the release gets to your employer in time for your next paycheck; otherwise, you may lose that, too.

Selling Seized Property

The Service conducts no "sale" when it seizes your wages, tax refunds, bank accounts, cash value of insurance policies, and other cash assets. It simply takes the money and pays your tax bill. But other property, such as homes, stocks, bonds, and cars must be converted to cash. Here's how they do it.

The IRS gives formal notice (usually one to two pages) of the seizure to you (the owner of real property), or to the possessor of personal property. That notice, required by law, must recite the taxes owed and describe the property seized. The notice gives you the chance to work things out with the IRS, or, if not, to attend the sale and bid for the property. Notices of seizure and everything else having to do with property sales are strictly construed against the IRS. If the assigned agent makes a mistake and realizes it, he will usually back off and redo the process, knowing that he can't give clear title if any minor detail is wrong.

After sending or delivering the Notice of Seizure, the revenue officer makes sure that the title to the property is in the taxpayer's name. He must be sure the property is really yours and that the prior liens or mortgages are taken into account. After all, the IRS wants cash. If the mortgage or lien exceeds the value of the property, there will be no cash for the IRS, so selling it makes no sense. Selling property that has no equity for the IRS is also a violation of the IRS Manual.

Next, the revenue officer prepares a Notice of Sale on an IRS form. Normally, the agent issues this notice within thirty days after the Notice of Seizure, mailing a copy to all lienholders and to you, the taxpayer. Then he publishes the Notice of Sale in the local newspaper or posts it at the post office nearest the property. The revenue officer will also typically post the notice on or outside the property to be sold, such as on a business property or a home. The notice sets the conditions of sale, such as date and time.

The sale must occur between ten and forty days after the notice. But agents often postpone these sales. The most common reasons are that they don't think they'll get enough money from it or the taxpayer is finally working on the collection problem.

Sometimes the IRS hires an auctioneer to sell property. This happens often with cars, particularly if there are many to sell.

Beginning in 2000, the agency adopted a uniform “asset disposal system.” Congress enacted this requirement to bring some regularity to IRS auctions, where the quality of the IRS sale was not always consistent or in the taxpayer’s best interest. Now the IRS must calculate the minimum bid for property and can't sell below that minimum. It must also fully account to the taxpayer for all dollars in the sale.

The IRS conducts auctions on its own, either by "sealed bid" or public auction. In a public auction, the revenue officer stands up, calls the bidding to order, recites a statement of his authority, and opens the bidding at a minimum amount. Then, as in any auction, he tries to get the highest price and declares the property sold to the highest bidder. In a sealed bid sale, people submit sealed bids in advance. The revenue officer opens them at the appointed time and place and declares the winner.

The IRS calculates a "minimum bid" for all property it sells. The minimum bid is the least someone would have to pay to get title to the property. For example, let's say a home is worth $100,000, and the first mortgage is $40,000. An IRS formula reduces the $100,000 fair market value of the home to account for the forced sale condition of the auction. While this formula varies, a typical discount could fix the forced sale value at $68,000. The minimum bid would then be $28,000: the forced sale value of $68,000 minus the mortgage of $40,000. So a successful bidder could get a $100,000 property for $28,000, subject to the first mortgage of $40,000. What about the $32,000 of "value" that was somehow "eliminated" by the IRS' formula? The taxpayer can protest long and hard, but that value is lost. (But see "redemption" discussion below.)

The IRS can sell some property that two people own together, even if only one of the owners owes taxes. The nondelinquent owner is paid his share. That doesn't normally happen with homes, which are usually owned as "tenants by the entirety" by a husband and wife in states that recognize this form of ownership. However, in 2002 the United States Supreme Court ruled that the federal tax lien attaches to the interest of one tenant by the entirety even if the other does not owe taxes. While that decision did not explicitly say the IRS could sell the real estate where only one tenant owed taxes, the IRS probably can do this, or at least sell that one tenant's interest in the property. The law in this area is still evolving.

Redemption of Property

In theory, you can reclaim ("redeem") your property even if the IRS has sold it. If it's real property such as a home, you have 180 days to "redeem" the property after sale by paying the amount the purchaser paid, plus interest at 20 percent per year. It's a tough rule, but some taxpayers have used it. Watch out: the law says 180 days, not six months.

What about personal property? That cannot be redeemed once it has been sold.

Helpful Hints

1. Pay attention to levies and pre-levy notices. The levy exists to get your attention, and failing that, to take your property for back taxes.

2. The IRS uses the levy sparingly.

3. Quickly develop an overall plan of action to solve your tax collection problem if you are hit with a levy.

4. Tell the truth to the IRS. Agents are human beings, too. They listen and pay attention to life stories, especially after levies are issued.

5. Consider getting the help of a tax professional to handle a levy or your collection problem in general.

6. Consider using the powerful rights under the 1998 tax reform act to fight levies.

3

Federal Tax Penalties And What to Do About Them

How the IRS Looks at, Then Asserts, a Penalty…The "Pain" of Each Penalty… Fighting a Penalty on the Front Line…The Nitty-Gritty of Fighting Each Penalty… The Mechanics of Making Your Penalty Appeal

Over the past two decades, Congress has asked the IRS to preside over a virtual explosion in penalties-more than 150 and counting. Sometimes it seems there is a penalty for everything, whether you are right or wrong, whether you look left or right, up or down.

Tip: In fiscal 2012, the IRS assessed penalties 28 million times for $13 billion in value. It abated only 3 million penalties. These numbers, especially on assessment side, are huge increases from prior years. Of the 28 million penalties, 17 million were imposed for failure to pay taxes due on returns.

In this chapter, we'll explore only nine of these penalties, the most common ones people face year after year. We'll see how they arise, how you can fight them, when they can be abated, and how you can appeal if you don't get satisfaction the first time around. It might be helpful to glance at the following handy summary to get an idea of how these common penalties arise and may be handled.

Business Penalties

Business Penalties	How Much	When Does IRS Impose or Recommend it?	When Can You Appeal it?	This Penalty Can be Executed if You Show:	What Form do I Use?	Where do I Send an Appeal:
Failure to deposit payroll taxes	Up to 15%	When you make the deposit or file the quarterly return	• When you make the deposit or file the quarterly return • After payment, in claim for refund • in bankruptcy	Reasonable cause and no willful neglect; ordinary business care and prudence	• Form 2751 or letter • Form 843	• Service Center • Office of Appeals • Federal Court • Bankruptcy Court
Trust Fund Recovery	See Chapter 4					

Personal Penalties

Personal Penalties	How Much	When Does IRS Impose or Recommend it?	When Can You Appeal it?	This Penalty Can be Excused if You Show:	What Form do I Use?	Where do I Send an Appeal:
Late filing of a tax return	5% of amount due per month; 25% maximum	• When you file your return • During audit • After assessment of tax	• When you file return • When IRS bills you • During audit • After payment, in claim for refund • In bankruptcy	"Reasonable cause" and no willful neglect	• Form 2751 or letter • Form 843 • Bankruptcy	• Service Center • Office of Appeals • Bankruptcy Court • IRS Auditor • Federal Court
Late payment of a balance due	0.5% per month of amount due, escalating to 1%; 25% maximum; not imposed where late filing penalty is also imposed	• When you file your return • After IRS assesses more tax	• When you file return • When IRS bills you • After payment, in claim for refund • In bankruptcy	Reasonable cause and no willful neglect	• Form 2751 or letter • Form 843 • Bankruptcy	• Service Center • Office of Appeals • Bankruptcy Court • IRS Auditor • Federal Court
Fraudulent failure to file	15% per month; 75% maximum	• When you file your return • During audit after you file returns During audit if IRS files for you.	• When you file return • When IRS bills you • After payment, in claim for refund • In bankruptcy	No intent to evade the filing requirement	• Form 2751 or letter • Form 843 • Bankruptcy	• Service Center • Office of Appeals • Bankruptcy Court • IRS Auditor • Federal Court
Fraud	75% of amount due to fraud	• When you file your return • During audit	• When you file return • When IRS bills you • During audit • After payment, in claim for refund • In bankruptcy	No intent to evade tax; reasonable cause	• Form 2751 or letter • Form 843 • Bankruptcy	• Service Center • Office of Appeals • Bankruptcy Court • IRS Auditor • Federal Court
Estimated tax penalty	Penalty rate × amount underpaid × period of underpayment	• During audit • When you file your return	• When you file return • When IRS bills you • During audit • After payment, in claim for refund • In bankruptcy	Casualty, disaster, or unusual circumstances so that penalty is against equity and good conscience	• Form 2751 or letter • Form 843 • Bankruptcy • Form 2210, 2210F	• Service Center • Office of Appeals • Bankruptcy Court • Federal Court • IRS Auditor
Bad-check penalty	2% of the check; if check is under $750, lesser of $150 or amount of check	• When you bounce a check to IRS	• When you send the check in • After payment, in claim for refund • In bankruptcy	Reasonable cause and good-faith belief that check was good	• Form 2751 or letter • Bankruptcy	• Service Center • Office of Appeals • Bankruptcy Court • Federal Court • IRS Agent
Negligence	20% of additional tax due	• During audit	• During audit • At appeals • In claim for refund • In bankruptcy	• Good-faith and reasonable cause, or no intentional disregard of IRS rules or regulations • Adequate disclosure of nonfrivolous position	• Protest • Form 843 • Bankruptcy	• Office of Appeals • Bankruptcy Court • IRS Auditor • Federal Court
Substantial understatement of tax in your return	In general, 20% of the understatement of tax	•During audit	• During audit • At appeals • In claim for refund • In bankruptcy	• Good-faith and reasonable cause, or no intentional disregard of IRS rules or regulations • Disclosure of the nonfrivolous item on the return • Substantial authority for your position	• Protest • Form 843 • Letter • Bankruptcy	• Office of Appeals • Bankruptcy Court • IRS Auditor • Federal Court

How the IRS Looks at Penalties

Helpful Hint: Look at the Penalty Handbook at www.irs.gov/tax professionals/internal revenue manual/Part 5 - Collection Process, to learn how the IRS views penalties and relief from penalties.

As an institution, the IRS has the overall goal to impose and administer penalties fairly. Since the penalty program was revised in 1992, agents are supposed to treat similarly situated taxpayers alike, allow them an opportunity to be heard, be fair and impartial, and make the right decision. Whether that translates into real understanding at the agent's level is another matter entirely. Results vary widely around the country. The imposition of most of these penalties depends greatly on the agent's discretion or on the judgment of an appeals officer when the agent sustains the penalty.

For this reason, you cannot count on the general "feel good" objectives of the Internal Revenue Manual. To avoid or overturn these penalties, you must have facts and proof at your command, showing "reasonable cause" or similar standard. The IRS approach must be consistent, accurate, impartial, and correct, with adequate opportunity for you to be heard. In fact, if you present anything resembling reasonable cause to the agent, he is required to advise you of the reasonable cause provisions even if you don't know about them. For all of these penalties, your reasonable cause or other explanation will be examined quite closely. The IRS will ask many questions, including these (all drawn from the Internal Revenue Manual):

1. Does your reason truly address the penalty imposed?
2. Do the dates and explanations clearly correspond to the events on which the penalties are based?
3. Is this the first time the penalty has been imposed, or are you a repeater?
4. What is the length of time between the reasonable cause events and your repair of the problem?
5. If you took too long, and failed to try to correct the problem, you may lose your reasonable cause argument.
6. Could you have anticipated the events that caused your noncompliance? Were these events truly beyond your control?

Asserting or Assessing the Penalties

The IRS can assess or assert a penalty in many different ways. It depends on the type of penalty and, in part, on how you trigger the penalty. For instance, sending a late return to an IRS Service Center will automatically attract the 5 percent per month late-filing penalty if the return reflects a balance due. But you can still suffer this penalty later, even if the return reflects a refund. Let's say the IRS audits the late return and assesses more taxes (you thought you had a refund). Suddenly, your return becomes a balance due return, subject to the late-filing penalty.

Caution: About 5-10 million Americans are "nonfilers," people who have not filed one or more returns past any extension of time. For these, the IRS normally prepares a "Substitute for Return," or “SFR.” The SFR makes all assumptions against you. So, often people who thought they had paid enough in ("I don’t have to file--the government owes me.") could in for a nasty penalty surprise.

The same principle holds true for the late-payment penalty and the estimated-tax penalty.

The IRS normally asserts the negligence, substantial understatement, and fraud penalties as a result of an audit, rather than automatically at the IRS Service Center where you file your return. That's because a real, live person must look at your facts and affirmatively determine that you acted negligently, committed civil fraud, or substantially understated your taxes. The bad-check penalty is simple; the IRS asserts it anytime you bounce a tax check. The penalty for failure to deposit payroll taxes is 10 percent.

Finally, the IRS imposes the Trust Fund Recovery Penalty on corporate officers and employees who were willfully “responsible” for their company's failure to pay withholding taxes. This special penalty is a world unto itself. See Guide 2.

These Penalties are Designed to Hurt!

Late-filing penalty. The late-filing penalty is extremely high-5 percent per month (or any part of a month, even one day) for each month a return is late, up to a maximum of 25 percent. The severity of this penalty shows how serious the IRS is about having returns filed on time. Of course, the Service also wants you to pay on time, but that penalty is lower, at least for a while.

In fiscal 2012, the IRS asserted the late filing penalty 3 million times on individual returns for over $5 billion in fines, 1.6 million times on employment tax returns.

Late-payment penalty. The IRS assessed this little cousin of the late-filing penalty more than 14 million times on individual returns, 16 million times on employment tax returns.

The computer also automatically tacks on the late-payment penalty when you send a return without full payment. This penalty is 0.5 percent per month, up to 25 percent of the amount you owe. It increases to 1 percent per month after the IRS sends you a "final notice" that your payment is overdue. The IRS may not simultaneously impose the late-filing and the late-payment penalties, so if you filed more than five months late, you get a free ride on the late-payment penalty for those five months. That's the good news. The bad news is that the maximum for both penalties, put together, is 47.5 percent of the tax due. And that does not include interest, which accrues on the penalty as well as the tax – and on the interest too! (Daily compounding).

Estimated-tax penalty. The estimated tax penalty is the third penalty relating to return filing. This penalty normally arises when you have income that is not subject to withholding, such as interest or dividends, but you haven't paid enough tax on it during the year. As with other penalties, the IRS assets it automatically when you file your return. This penalty even has a worksheet you can send with your return showing the amount of the penalty. The IRS asserted this penalty more than 7 million times in fiscal 2012 for over $1 billion.

Accuracy-related penalty. The next group of penalties relate to the accuracy of your return (vs. late filing of that return or late payment of the taxes shown on the return). These penalties range from 20 percent to 75 percent, so, in theory, a taxpayer who really messes up by filing late, paying late, and filing an inaccurate return can rack up penalties from 77 percent to 132 percent of the tax due, plus interest. It doesn't often happen, but surprisingly the law allows such a result.

> Example: Speedy Sam filed his 2001 federal income tax return six years late. The tax due was $10,000. He had no reasonable cause for this delinquency so the IRS assessed the maximum late-filing penalty (25 percent) and a late-payment penalty (22.5 percent). Then Revenue Agent Ronnie Rushmore audited the return, finding that Sam committed civil fraud. (Sam had left out income from a stock sale on purpose, that is, with intent to evade the tax laws.) So another $5,000 in tax was asserted, plus a 75 percent civil fraud penalty on this item. If the whole return was fraudulent, the penalties could have totaled 132.5 percent of the tax due.

Negligence. The negligence component of the accuracy penalty can be asserted following an audit. In the real world, some revenue agents assert it as a matter of routine. The penalty is 20 percent of the additional tax due. It applies where the IRS concludes you have negligently disregarded tax rules and regulations.

Caution: Some revenue agents think that if you made a mistake they catch, you must have intentionally disregarded the rules.

Substantial understatement. Instead of the negligence penalty, the agent can assert the "substantial understatement" penalty, also 20 percent of the additional tax due. The details of imposing this penalty are complex, but as a rule of thumb, if you owe $5,000 more tax after an audit, the revenue agent can assert this penalty. If the agent asserts this penalty, he or she cannot assert negligence as well.

Tip: The negligence and substantial understatement penalties cannot be asserted if the civil fraud penalty is asserted. See below.

Civil fraud. The civil fraud penalty is imposed where the revenue agent concludes you have intentionally evaded the tax laws, but not so clearly as to rise to the level of criminal tax evasion. This is the big one, 75 percent of the amount of tax due to fraud. It is routinely asserted after any criminal conviction for evasion. What is civil fraud? It differs from criminal fraud only in that criminal fraud requires proof of fraud beyond a reasonable doubt. For civil fraud, the proof need only be "clear and convincing." According to the IRS manual, civil fraud requires that the IRS prove you materially misrepresented facts, you knew of their falsity and intended the IRS to rely on them and act as if they were the truth.

For evidence, the IRS will generally look for "badges of fraud." These might include specific items you understated, fictitious or improper deductions, or false entries or double sets of books.

Other badges are destroyed records, false or inconsistent statements, transfers of assets, consistent underreporting of taxable income over many years. Anything you say or do that looks dishonest, misleading, or evasive could be a badge of fraud. And, remember, if the agent finds enough of these badges of fraud, he or she must suspend the investigation and refer the case to the Criminal Investigation Division. Only if CID refuses the case (or after you are convicted) will it come back for civil action.

In that time, you will live in suspended animation, never knowing whether the criminal investigators will take the case and send you to jail. But even if you are "relieved" by the case remaining civil, you could suffer the 75 percent civil fraud penalty on the underreported tax.

Fraudulent failure to file. People who fail to file returns can't incur the civil fraud penalty--they haven't filed a fraudulent return in the first place. So Congress invented the "fraudulent failure to file" penalty, also up to a whopping 75 percent of the tax due.

> Example: Daniel and Diane lived in Spokane, Washington. They made a living through bookmaking. Unfortunately for them, this was illegal. The police paid them a surprise house call. Among the things discovered in the raid were wagering records such as "pay and collect" sheets, other bet sheets, cash, bookmaking books, and other gambling paraphernalia. There was also a phone bank that attracted the interest of the police, and eleven audio cassette tapes that made for interesting listening. All of this led to raids on several safe deposit boxes plus the seizure of $50,000 in currency. Daniel and Diane were of course convicted of gambling under state law. But their problems didn't stop. They had not filed federal income tax returns when the raids took place. The IRS added the fraudulent failure to file penalty and the court sustained it.

The same "badges of fraud" that signal tax evasion also point to this penalty. These include:

1. failing to file returns
2. engaging in an illegal occupation
3. concealing assets
4. failing to cooperate with the tax authorities
5. dealing in cash
6. failing to make estimated payments
7. keeping inadequate records
8. understating income

These are by far the most common penalties normally encountered. There are more than one hundred others that are rarer, or that apply to other types of taxpayers such as return preparers, banks, mortgage companies, and other reporting institutions. These are beyond the scope of this Guide.

Fighting these Penalties on the Front Lines

The tax laws and IRS procedures fortunately give you many ways to fight these penalties, at least nine in most cases. That's the good news. The bad news is that while you may have up to nine paths to choose from, they are all uphill.

The first principle in fighting a penalty is preemption. Convince the IRS not to assert the penalty in the first place. With the late-filing, late-payment and estimated-tax penalties, the most common way is to send your return to the IRS Service Center with a written request to "nonassert" these penalties due to reasonable cause. You can do the same thing by walking into a local IRS office, speaking to the taxpayer service representative, filing your returns with her, and requesting nonassertion of these penalties.

Tip: Prepare your case in advance and attach a complete statement of reasonable cause to the return. That way, you show you understand the problem and have addressed it forthrightly.

The third path is to let the IRS assess the penalties, then file your "request for abatement." You may also request nonassertion to any revenue officer on an assessed penalty (but not if your return is still in audit).

A fourth way is to assert reasonable cause (or other grounds for nonassertion) during an audit if the penalties are asserted for the first time at that stage. With negligence, substantial understatement, and fraud, the revenue agent's level is normally the place to start. You may also appeal to the revenue agent's boss, the group manager. But the chances of a reversal at this level are somewhere between "slim" and "none."

Fifth, you can wait for the Collection Division to begin collecting the assessment, and then request abatement due to reasonable cause. Sixth, you can pay the penalties and file a claim for refund, asserting reasonable cause in your claim or in a later lawsuit for refund of the penalties. Seventh, you can make an offer in compromise (see generally Guide 3) on the grounds that you don't owe the penalty because you have reasonable cause. This type of offer is known as an offer based on "doubt as to liability."

Eighth, you can file for bankruptcy. A bankruptcy can often discharge a penalty that is more than three years old, but the technicalities of this rule are complex. In fact, it is unwise ever to file bankruptcy without sound legal advice, especially if you are filing to discharge a tax penalty. Bankruptcy being strong medicine with severe side effects, you need to proceed with caution, and after full consideration. Still, bankruptcy promises to deal usefully and effectively with many penalties. Guide 3 discusses how to manage taxes and penalties in bankruptcy.

Finally, you may fight any of these penalties in court. When the IRS asserts them after an income tax or estate tax audit, you may go to United States Tax Court first, that is, without having to pay the penalty. (See Guide 7) If you prefer, you can pay the tax and penalty, then file a claim for refund. If the claim is denied or six months pass without action, you can file suit in federal district court or the United States Court of Federal Claims to contest the penalty. Guide 7 discusses these procedures in more detail. In particular, the Trust Fund Recovery Penalty (see Guide 2) may be contested, and often is, in federal court suits.

With all of these paths to choose from, how to guide your choice? Generally, it's best to fight the penalties at the earliest stage and the lowest level. This could be when you first file your return if it's a balance due return, or at the audit stage if that's where the penalty is first asserted. Generally, the later you launch your claim for abatement or nonassertion, the less likely the IRS will be to abate it. Besides, in the tax business, it’s usually better to know bad news as quickly as possible. It helps in your tax and business planning.

Appealing Denial of Penalty Abatement

All of these paths converge when you appeal. You may appeal the denial of your abatement claim after most of these stages (before going to court). The appeal goes to the Office of Appeals, the same office that considers income tax appeals following an audit. Appeals officers have wide authority to abate or compromise penalties, wherever the appeal comes from within the system. If the auditing agent asserts a penalty, or one is tacked on at the Service Center when you file a return, you will usually receive a polite letter explaining your rights to appeal. The IRS must also furnish a statement explaining how the penalty was computed. The IRS normally gives thirty days to file a “Protest.” If you do, the Revenue Agent or Taxpayer Service Representative packs up your file and ships it to the Office of Appeals. The appeals officer reviews the case, contacts you, asks for more information if you have it, and schedules either a phone call or an in-person conference to review your appeal.

Now let's say the appeals officer denies your request for abatement of the penalty. Are you out of luck? Of course not. You can still fight some penalties in court. The Tax Court has jurisdiction (in many cases) if you haven't paid the penalties. The federal district courts or United States Court of Federal Claims can hear the case if you have.

You can see that you have many chances to contest these penalties, at least three and sometimes four or five depending on how often you appeal within the court system. Moreover, there is usually no reason not to appeal except the expense of doing so. These penalties are add-ons, frightening, maddening, and onerous, especially when you were just trying to do your best.

Proving Your Case

You, not the IRS, have the burden to prove your case to abate these penalties except for fraudulent failure to file and civil fraud. To avoid the late-filing, late-payment, estimated-tax, and bad-check penalties, you must show "reasonable cause," or something conceptually similar. The casebooks and professional literature are littered with thousands of cases interpreting what these two little words mean. It all boils down to this: If you have a pretty good excuse, the mistake wasn't your fault, you tried to prevent it, and you corrected it as best you could, and could not have anticipated the cause of the penalty conduct, that's reasonable cause. Even then, you don't always win; remember that thousands of taxpayers who thought their cases were airtight went to court and lost. Even the winners wound up in court in the first place because the IRS rejected their statement of reasonable cause.

The Internal Revenue Manual spells out what the agency considers reasonable cause. All winning arguments in penalty excusal cases are variations of these.

Here are the eleven "official" reasonable causes:

1. Death, serious illness, or unavoidable absence. A death, serious illness, or unavoidable absence of you or a member of your immediate family may be reasonable cause. Of all the official excuses, this is probably the most common, measured by paper used and litigation filed.

   "Serious illness" appears to be epidemic among nonfilers, that is, people who are so late with their returns that they haven't filed at all. The Service's own studies of nonfilers have shown that a pattern of nonfiling often results from a serious physical or mental illness. It could be a bitter divorce; a business disaster; mental illness; drug, alcohol, mental, physical, or sexual abuse; or other personal tragedy lasting for years at a time. Combinations of two or more of these disasters are common. The tale of personal woe has to be serious and credible. If it is, the IRS often listens with a sympathetic ear and grants the request for abatement. Many are the cases in which a mental illness has prevented someone from filing for three, four, or five years. Often a downward slide into drug abuse or alcoholism caused an otherwise diligent taxpayer to fail in filing and payment obligations.

   Example: The "mental illness" card can, however, be played too much. Consider the story of Zachary, who hired a tax attorney and accountant to file returns, but somehow failed to file for ten years. He even received an IRS refund check but didn't cash it, and didn't sign one return his wife had prepared. He also failed to answer IRS correspondence. What was the problem? He saw a psychiatrist one month before his tax court trial. The doctor's diagnosis? A "phobia of preparing tax returns." Yes, that's right, "tax-return-phobia." Imagine the consequences if the Court had accepted this proposition. It did not.

   Example: In another case, Joseph, a professional, failed to file tax returns for five years. His reasonable cause was alcoholism. While the court was sympathetic, the facts just weren't there. In particular, he was shown to be fully capable in other aspects of his life, including service as president of a corporation for some of the years involved. (Apparently even a drunken return is better than none at all.)

   Example: If not this reason, then possibly something else outside your control might work. How about the following: "I couldn't prepare the return in time because I was having a baby." Noah and Hannah tried that one. They had an extension to file their return to August 15. But Hannah gave birth on August 14. They didn't file the return until September 20. Not good enough, said the court.

But in other cases, if you can prove mental or physical illness, you should be relieved of the penalty. For example, Sam was a partner in a professional firm when he got into tax trouble. He had omitted a large amount of income from his tax return. The IRS assessed the tax and a penalty, but the tax court rejected the penalty. It seems that Sam suffered from severe depression, anxiety, and paranoia, causing him to be hospitalized for many months. The court believed his testimony, and he was relieved of the penalty.

A regular illness also will do. In one case, John couldn't file tax returns because his arms and legs became paralyzed. He was hospitalized and diagnosed with a condition with an extremely long, unpronounceable name. He saw a number of physicians and underwent many tests, all to no avail. He tried experimental therapy, which didn't work. Essentially, he was unable to take care of himself. Nor was his wife familiar enough with return preparation to do the job. That was reasonable cause.

Also, the nature of the particular syndrome, such as alcoholism, depression, or abuse, often has roots in childhood or at least stretches back many years. The more you elaborate on how the illness got started, how it culminated in your late filing or late payment, the more likely an IRS employee will be inclined to believe you and find you have shown reasonable cause. A full statement of reasonable cause can sometimes run to ten single-spaced, typewritten pages, with a half an inch or more of medical, social, or psychiatric documentation.

To request abatement of these reasonable cause penalties due to illness, write the IRS a letter, include Form 2751, and tell the full story. Include the dates and nature of your illness or absence, show how the illness or absence prevented compliance, and note whether other things you did in life, such as running your business, also suffered as a result. It is impossible to overstate the importance of thorough documentation for this type of reasonable cause (and for others as well). The IRS treats your statement of reasonable cause very seriously; its agents also diligently guard the privacy of the information you submit. Painful as it is to recount the details, a compelling story causes the IRS to listen, hear, and, in many cases, give you the benefit of the doubt.

2. <u>Fire, casualty, natural disaster, or other disturbance</u>. Believe it or not, some people succeed in abating penalties by claiming, "There was a flood in my basement," or, "A fire burned my records." Of course, it's one thing to say, another to prove. You have to show how and why. Address whether you could have gotten your tax return or payment together by other means. Again, documentation always helps. Enclose fire, police, or insurance reports. If these are not available (or even if they are), attach any other supportive documentation. Notarized statements from disinterested third persons are often credible and helpful. Pictures also are worth thousands of words.

3. <u>Unable to obtain necessary records</u>. If your records are unavailable, you may have reasonable cause. When your records are missing, the "reasonableness" of your cause depends on whether you exercised "ordinary business care and prudence" but your records nevertheless disappeared because of circumstances beyond your control. In your request for abatement, specify the nature of the records, why they were unavailable, how

you tried to fix the situation, whether you called the Service about the missing information, and why you couldn't use estimates and still comply.

<u>Example</u>: Sal was divorced from his wife Mona. She moved out and took all records of income and expense of Sal's profession. He went to court to get the records back, but failed. He met with the IRS before the due date, told them he was at his wit's end trying to get his records, and signed an extension until July 15 to file the return. Before that deadline, he went again to the IRS and told them he still couldn't get all of his records together. So the IRS told him to do the best he could, which he did. Naturally, the IRS penalized him. But the court rejected this penalty. He had done all he could to reconstruct his records, and even asked for professional help, so his conduct should not be penalized.

4. <u>Lack of funds</u>. "I can't pay" is not usually reasonable cause, but if you couldn't pay despite your best efforts or due to circumstances beyond your control, that might be reasonable cause for late payment, NOT for late filing. For example, if you were about to pay a tax bill but someone stole or embezzled the money you had set aside, that might be reasonable cause if you had no way of preventing or foreseeing it. If undue hardship, bankruptcy, or insolvency might have resulted if you paid the taxes on time, you might have reasonable cause. An example might be a sudden, totally unexpected bill, or a sudden downturn in business. Not many people succeed with this reason, but if you have the facts, it's worth a try.

   <u>Example</u>: This happened in a case involving a company that was building ships for the Navy. The Navy and the builder had the usual fights over performance of the contract, but nothing horrible happened until the Navy stopped progress payments. Eventually, the taxpayer-contractor could pay only certain subcontractors and suppliers, and as a result failed to deposit payroll taxes. The Navy then terminated the contract, owing the company more than $165,000. "Reasonable cause," said the court. The company did the best it could, and it had a right to rely on the Navy's promise to pay. It was the government's own fault that the contractor couldn't pay its taxes.

   <u>Example</u>: An electrical and mechanical contractor ran into the same problem in another case, though not with the government. The contractor had decided to finish a number of large jobs, relying on the owner's promise to pay right after completion. Of course, the promise was empty. The contractor tried his best to pay some of the taxes, but could not pay all. If the contractor had paid the taxes, he would not have been able to finish the jobs and would have gone out of business. That was enough, said the court, to show reasonable cause for late payment. Payment would have caused "undue hardship."

5. <u>Ignorance of the law</u>. This one is especially tough. We've all heard that “ignorance of the law is no excuse,” a principle that applies doubly when it come to taxes. Still, there's a bit of wiggle room in this principle. The IRS' manual says that ignorance of the law, combined with other facts and circumstances such as limited education or lack of previous tax penalty experience, may support reasonable cause. For instance, where you confront a difficult or complex tax issue and the Service doesn't give you guidance, the IRS may concede that reasonable people might differ as to how to treat the issue. Also, if

ignorance is based on a recent tax law change unavailable to people generally, that might qualify.

6. You or a subordinate made a mistake or were forgetful. Again, not usually an excuse, but some court cases have held that a subordinate's error was excusable. An example might be when you tell your trusty assistant, "Now, Dr. Watson, I want you to take this tax return and immediately go to the post office to mail it." When Dr. Watson fails to mail the return because he forgot or stuck it in the drawer, that might be reasonable cause. Of course, if Dr. Watson had a reputation for forgetting things, you'd be out of luck.

   Example: But what if your trusted employee makes the mistake? Even that may not be reasonable cause, as one physicians' group found out. The long-employed, trusted secretary was supposed to make tax deposits and file returns, but did not. The doctors could not delegate this ministerial responsibility to someone else, then avoid responsibility for that employee's failure.

   Example: A supply company filed its tax return late and applied for an extension only after the deadline had run out. "But I relied on my attorneys, accountants, and pension adviser," said the president. Not good enough, said the court. You can't rely on your adviser to do what the law requires of you. That's not what reasonable cause means. These kinds of deadlines may not be delegated, so the penalty was proper.

7. Relied on the advice of a competent tax adviser. If your accountant or lawyer made a mistake in advising you, you shouldn't be blamed for it. Of course, you are in the awkward position of proving that an adviser *you* selected made the mistake. Also required is proof the auditor was otherwise competent, and that you gave complete information and cooperation. If your accountant says you don't have to file on October 15, that might not be reasonable cause, because everyone is held to know that October 15 is the last date. But if she said, "Your $100,000 court award is not taxable," and it really was, that might be reasonable cause because this is a gray area of the law.

   Example: One corporation tried to blame the accountant when the corporation failed to file payroll tax returns on time and failed to pay the taxes. The problem was with one customer, who delayed paying invoices for up to four months. "Not a problem," said the accountant. "You don't have to file until you have enough money to pay. In fact, if you don't file, the IRS will not close the business, and you can catch up on your payments when your customer pays." Clearly, such misplaced reliance will not be reasonable cause.

   Example: But in another case, "blaming the accountant" worked. Oliver had a high school education. Anita, his wife, quit school before finishing the tenth grade. Neither had any other formal education. Oliver had other problems: diabetes, hearing loss, and impaired eyesight. They joined forces with Oliver's brother to open other businesses. They also bought real estate. Things got complex, so they hired a CPA. Everything went fine until Oliver threw caution to the wind by investing in foreign speculative ventures. He made a killing. But the CPA said Oliver did not have to pay U.S. taxes since Oliver and Anita were paying taxes overseas. Not so, said the IRS. And the agency was right, so Oliver had to pay a hefty tax. But the tax court threw out the penalty. Why? Oliver and

Anita had limited education. They relied on a competent CPA who turned out to be wrong. But that doesn't mean they should pay the extra burden of a penalty.

8. Erroneous oral advice from IRS. Where the IRS gives you bad advice, you would expect to have reasonable cause, and indeed that is so. But, again, you must jump through hoops. You must show you gave the IRS accurate and complete information, and you exercised ordinary business care and prudence when you relied on the advice. Because this relates to oral advice, proving these elements is difficult, but even your detailed handwritten notes of your conversations with the IRS may suffice. Note in particular what office you called, to whom you spoke, and the date the IRS gave you the advice. These days IRS agents on the phone are required to provide their names and ID numbers. Make a note of them.

   Example: To appreciate how difficult the "erroneous oral advice" case is to prove, consider the case of a law firm that failed to file employment tax returns for most of two years. Naturally, this minor omission attracted the IRS' attention. Marilyn, a revenue officer, got the case, and the firm asked for her help. She helped fill out the returns, and the firm sent in payment of more than $100,000, which the law firm claimed was all that was due. Not so, said the IRS' computers. So a large penalty was assessed. Could the law firm get out of it? No. Even if the law firm relied on Marilyn, she had access only to the taxes shown on the computer. The computer was wrong because the law firm had filed an incorrect return in the past.

9. Erroneous written advice from IRS. The same idea is at work here, and your proof is a little easier. In fact, there's even a law on this one, requiring the IRS to abate any penalty attributable to its own erroneous written advice. But that advice must refer to your specific written request. Also, you must have given the IRS complete and accurate information about your situation, and you have to have relied on the advice. In the real world, the IRS is fairly liberal about granting relief here, giving the taxpayer the benefit of the doubt if the advice was written.

10. Failure to deposit due to no coupons. Employers used to deposit payroll taxes using a coupon, Form 8109. Now the IRS' electronic payment system, "EFTPS," is required in most cases. Errors or problems with the IRS' computer system can sometimes be "reasonable cause."

11. Embezzlement. Employees and officers who embezzle company money are becoming an increasingly common fact of business life. However, blaming a late-filing or late-payment penalty on embezzlers seldom works.

    Example: For almost thirty years, Hartley worked long and hard in his leather importing business. Then he suffered a heart attack. So his vice president and controller took over. And "take over" they did. They embezzled more than $150,000 and tried to hide their offense by failing to file payroll tax returns. The accountant for the company sounded general quarters. Hartley returned to find the disaster. Could his company get out of the penalty? No, said the judge. The same thing happened to another company that performed medical research and manufacturing. The chief executive officer /chairman of the board and the chief financial officer embezzled so much money that the company had to file for bankruptcy. Of course, the top echelon were indicted and convicted of embezzlement. In this case, that was enough to relieve the company of the penalty, that is, to avoid the normal rule that a company is liable for the acts of its agents. But the company still had to show that it did everything else right, including maintaining adequate internal controls that the embezzlers were able to circumvent.

12. <u>Bad-check penalty</u>. This one is tough to have abated, but there are some times when the IRS will do so. If the bank made a mistake or the IRS made a mistake in handling the check, that's probably reasonable cause. If the check was lost in the mail and you replaced it, stopping payment on the first check, the IRS should abate the bad-check penalty if it later receives your first check and tries to cash it. Also, sometimes a freeze can be placed on your bank account for other reasons, such as another creditor's judgment or the death of a signatory. The Service will usually consider these to be reasonable cause as well, but, again, you have to show you tried to prevent the bad check or did your best to make it good afterward.

13. <u>Negligence penalty</u>. When you omit an income item from your return or your deductions are disallowed, you may have acted "negligently." Negligence means you failed to make a “reasonable attempt to comply” with the revenue laws or failed to exercise ordinary and reasonable care in preparing your tax return. Negligence also includes a failure to keep adequate books and records or to substantiate items of income or deduction properly. Finally, an item on your return is attributable to negligence if it lacks a reasonable basis but falls short of outright fraud.

    These standards don't mean that every dollar a revenue agent adds to your tax bill is due to negligence. But in the real world, revenue agents often take that position. If you had not been negligent (they reason), you would not have taken a disallowed deduction, or you would have included an extra item of income. So they deem any mistake to be negligent by the fact it was made. This circular reasoning is not the law, but sometimes you may need to fight long and hard to convince them.

    Still, some actions are clearly negligent. Failing to include an income item as to which an information return (e.g., Form 1099) has been filed (example: bank interest), or taking a deduction or credit that seems too good to be true, are examples. If you are careless or reckless, or if you intentionally disregard IRS rules or regulations, that's negligence.

    To overcome the negligence penalty, you need to show that you did your best and acted reasonably and prudently in taking the deduction. Check for such things as prior audits where your position was allowed. Prove you examined your return carefully. Show you relied on the advice of an accountant or an attorney, that you reasonably interpreted IRS publications in taking the deduction, or that the law changed. Demonstrate that your position was justified, even if it turned out to be incorrect. In particular, proving an honest misunderstanding of the facts or the law may overcome the negligence penalty. <u>Example</u>: Jack liked to buy insurance. Jack's life insurance agent proposed a scheme under which Jack took out whole life policies, paid the premiums, and received the same amount from the agent as a kickback. Then he allowed the policy to lapse. The agent (not

Jack) was indicted and convicted of several crimes. Jack was taxed on the kickbacks. But was he negligent? No, said the court. The kickbacks may have been "improper," even illegal, but that didn't mean Jack negligently failed to report them. After all, Jack's returns were prepared by a professional preparer, and Jack promptly paid the tax once the IRS declared the payments taxable. Since Jack's position on the tax issue was "not frivolous," the negligence penalty didn't apply. This type of case, and hundreds like it, highlight the rules of the road to avoid the negligence penalty: Take a good-faith position, stick to it, and make full disclosure to your advisers and the IRS.

14. "Substantial understatement" penalty. Another component of the accuracy penalty is the "substantial understatement" of taxes. Even if you weren't negligent, the IRS can penalize you 20 percent if the changes to your return result in a "substantial" understatement. You avoid this aspect of the accuracy-related penalty if (1) you disclosed the item on the return or (2) you had substantial legal authority for reporting it the way you did.

Tip: “Disclosing” an item on a return normally requires a special form, Form 8275. But for some common items, merely listing them on the return in the right place is adequate disclosure. These include all Schedule A items (medical expenses, real estate interest, state taxes, charity, and miscellaneous) and other items as well. Every year, the IRS publishes a list of the items that are "adequately disclosed" just by reporting them on the return. As to every other item, consider filing Form 8275 if the item is questionable.

You may also avert the substantial understatement penalty by finding “substantial authority” for the position you took on the return. This requires researching the law, including statutes, regulations, court cases, and other tax authority. Of course, assembling this authority before taking the deduction also satisfies the negligence standard. All these grounds for penalty relief have an additional common element: do everything you can to fix the problem, catch up, or get duplicate records. You can't sit back thinking, "Oh well, I got sick (or I lost my records), I don't have to file or pay until I get around to it." Show the IRS that you scrambled in every reasonable way to avoid or fix the problem once you learned of it, or to correct it after the failure occurred.

15. Estimated-tax penalty. To earn relief from the estimated-tax penalty, you must generally show that your failure to pay the right amount of estimated tax was caused by casualty, disaster, or unusual circumstances, and that imposing the penalty would be against equity and good conscience. This is not quite the same as the reasonable cause you may use for other penalties. The Internal Revenue manual itself describes that reliance on a competent tax adviser, or erroneous advice from the IRS, would not be enough to waive the estimated tax penalty. You must show circumstances such as: your records were destroyed by fire, flood, or other natural disaster, you became seriously ill or injured, or that your estimated-tax payments were offset against past-due child support or other federal debts. There are other waivers available for newly retired or disabled individuals, but, again, these must be shown to include reasonable cause and an absence of willful neglect.

Mechanics of Making Your Abatement Request

The chart at the beginning of this chapter shows the forms to use or letters to write. Try to use these forms; IRS employees are familiar with them. The supporting documentation for your reasonable cause request need not follow any particular form. Letters, affidavits, exhibits, or statements will suffice. When you appeal from a denial, you likewise need no particular form; a letter is sufficient. Also, the IRS' denial letters often contain specific instructions on how to frame the appeal letter, where to send it, and when. Above all, don't give up. These penalties can be your profit margin or your discretionary budget. They are sometimes quite high, and interest is charged on them. Sometimes you'll have success at the second or third level where the first was a disaster. Take advantage of every chance the law and the IRS give you to contest and protest these penalties.

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Your Worst (Tax) Nightmare – Personal Liability for Corporate Payroll Taxes (The Trust Fund Recovery Penalty)

How a Small Business Gets into Big Payroll Tax Trouble…
There ought to be a Law! (There is!)…How the IRS Investigates Your Case…
Fighting Back Against This Penalty

Statistics show that most of America is small business, not big business. That entrepreneurial spirit motivates large numbers of people to start their own businesses. In whatever form, getting those ventures off the ground is often difficult. And, because the tax laws make you, the employer, responsible for withholding taxes, those withheld taxes are sometimes a tempting source of cash for business operations. Many hundreds of thousands of business people succumb to that temptation every year, using money that is not their own to pay their bills. A typical case might arise something like this.

Setting the Scene

It had been a banner year for Wonder Widgets, Inc. Sales had finally hit the $1 million mark, an all-time high. The last calendar quarter (October, November, and December) had been exceptionally good, capped by a great Christmas rush. Sure, some of Wonder Widgets' customers were a bit slow to pay, but the money always came in, enough for a great Christmas party and bonuses for Ed Wonder, the president, Ben Bighthard, the controller, and Penny Pencil, the chief bookkeeper.

Early in January, Ed Wonder called a meeting with Bighthard, Pencil, and the sales force. He did this every year. This time, he was feeling good. "How do we look for this year?" he asked. "Things look great," said Sam Sellmore, the chief sales representative. "We've just gotten three big orders from the U.S. government for thirty thousand boxes of widgets. You can buy a widget down the street for ten bucks, but we got the government to pay $900! You may have to bring on more workers or order new machines. Certainly, you'll need more steel and other parts."

"Great," said Wonder. "Our slow-paying customers will always pay, and I know that 2014 is going to be a terrific year." Bighthard jumped in. "Not so fast. You know we have a lot of bank debt to service, and there was that little IRS payroll tax problem last year. We had to pay a 10 percent penalty for late deposit of payroll taxes because we didn't get enough money in to pay anything but net payroll. Let's be careful."

"Nonsense," scoffed Wonder. "That was an exception. In fact, I'll get out in the field myself a lot more this year to help with sales and servicing of our widgets. While I'm gone, you and Penny can mind the store. Go ahead and make the federal tax deposits, but if you're short at the end of a week, don't worry. Just pay our people their net pay. They'll never feel the difference, and we'll always get the money in later."

January began with a record snowfall and the beginning of a severe recession. Wonder was in the field for most of the month. He kept in touch with Bighthard, Pencil, and Sellmore by telephone. In the third week, one big check they were expecting never came through. Another came through, but bounced. So money was short. "I told you," said Wonder, "pay our employees their net pay. We have to keep the doors open, and they simply won't work, nor should they, if we don't pay them." "What about paying Soomee Supply Company, which just shipped us a trailer load of widget parts?" said Bighthard. "They'll just have to wait," said Wonder. He told Bighthard that if the same situation happened again, he and Pencil should use their own judgment as to whether to pay Soomee or other suppliers.

January became February. February rolled into March. At the end of the quarter, the company owed $10,000 in payroll taxes. "What do we do now?" lamented Bighthard. "Don't worry," said Wonder. "Things will get better." But they did not. In April, May, and June, the company fell another $15,000 behind in payroll taxes. Now Ed Wonder was harder to reach. He called in less often. Bighthard and Pencil, following Wonder's request, began to use their own judgment, paying this bill here and not paying that bill there, just to keep the doors open. They always paid the employees their net wages, and Bighthard always filled out, signed, and filed the payroll tax returns (Form 941) on time.

But he and Pencil were worried. What if things didn't get better? What if Wonder gave up? What about the state withholding taxes? State sales taxes? In September, Bighthard had had enough. "You have to do something, Ed. I can't go on like this. I'm afraid the IRS will catch up with us, and we've got all those penalties to pay, too." "I know, I know," moaned Wonder. "But we have to keep the doors open. We have to pay our people. We have to keep making widgets. I know some of our customers are even slower paying now than they were before, but they'll catch up. I've just put another $10,000 of my own money into the company, and that should hold us for a while."

But it didn't. The company fell behind another $10,000 in September. Money was tighter than ever. The recession was biting deeply. Then came the notices. Some IRS computer had awakened to the company's $35,000 tax debt. The first notice came to Bighthard. It was polite but firm. He called Wonder. "Ed, we just got a notice from the IRS for $35,000. There's a penalty in there as well. What do we do?"

Wonder wondered and pondered. "Pay what you can," he finally said, "but if we can't pay it all, we'll just have to tough it out. I know that the money will be there. Just use the net incoming checks to pay the IRS." "But we promised that money to Soomee Supply, remember? And also to Cold Steel for more parts." "I know," said Wonder. "Just use your own judgment. You and Pencil work it out. You decide who is screaming the loudest, and pay them."

September became October, then November. November rolled into December. On December 15, the knock on the door came. It was an IRS revenue officer, Dan Dollar, there to collect the back taxes. "Did you know, Mr. Wonder," Dollar said in a firm and sincere tone, "that you can be held personally liable for the withheld taxes that you didn't pay to the government? That's what I'm here to investigate." Wonder cringed. Acid turned his stomach to silly putty. "I guess so," he sighed, "But I really wasn't making any of the payment decisions, at least not lately. I've been out in the field. Ben Bighthard and Penny Pencil were doing all of the decision making and all of the check signing. It's their fault." "Did you know that these taxes were due?" asked Dollar. "Yes, we all did," said Wonder. "We've had the same problem before, and we fixed it! Nobody meant any harm. Lots of money has come in to the company, more than enough to pay the taxes, but there always seemed to be something that was more pressing. But don't worry, we'll catch up."

"I know you will try, Mr. Wonder," said the revenue officer. "But in the meantime, I'm here to see who should be made personally liable for these back taxes. It's called the Trust Fund Recovery Penalty. Let's start with-YOU."

Does this scenario sound familiar? Something like it happens hundreds of thousands of times each year. Here's how that company payroll tax problem becomes a personal problem, and what you can do about it.

What is this "Penalty"?

The Wonder Widgets problem occurs because employers really work for Uncle Sam, collecting the IRS' taxes through the withholding system. States with income tax laws also impose wage withholding. If most employers didn't obey the withholding laws, our federal and state governments would screech to a halt. In fact, most employers comply, doing their best to get you the right forms, to withhold the right amount from your pay, and to pay that money over to the federal and state governments.

By law, employers make three kinds of payments to the IRS after each payday. The check (or electronic transfer) they send covers (1) the income tax withheld from your paycheck, (2) the Social Security and Medicare tax also withheld, and (3) the employer's matching Social Security/Medicare payment. The first two items-the withheld portions-are known as the "trust fund" part of the tax because a special statute imposes a trust on those withheld funds until the employer pays them to the IRS. The money doesn't have to be put in a separate bank account, but it's automatically deemed "in trust" from the instant your employer withholds it from your pay. In a perfect world, the money is there. But the world is far from perfect. What if your employer, like Ed Wonder of Wonder Widgets, just doesn't have the money, or decides to pocket that money? What if he deliberately fails to pay the payroll taxes to the federal and state governments for some other reason? The Wonder Widgets example (a company short of cash) is only one example of how it happens in the real world. The federal and state governments lose billions that way every year.

There Ought to be a Law!

Actually, there are several laws. (There's a law against everything except more laws.) Technically, it's a crime for an employer to fail to pay the payroll taxes. But the IRS rarely invokes that law. Instead, the IRS goes for the wrongdoer's pocketbook. It uses a special weapon thousands of times each year, the Trust Fund Recovery Penalty.

Fun Fact: It used to be called the "100 percent penalty," because the penalty equaled 100% of the taxes that were withheld but not paid over. It wasn't really a penalty, though, just a substitute for the corporation's unpaid tax.

This penalty makes the people who were responsible for the nonpayment personally liable for 100 percent of the money that was withheld but not paid over to the IRS, that is 100 percent of the unpaid income withheld and Social Security/Medicare tax. The penalty does not apply to the employer's share of Social Security/Medicare.

> Example: The payroll for a two-week pay period totaled $92,500. But the net pay to the employees was only $70,000. The other $22,500 was made up of (1) $15,000 of withheld income tax and (2) $7,500 of withheld Social Security/Medicare. (3) The corporation also owes another $7,500 of Social Security/Medicare. If the employer doesn't pay that $30,000 to the IRS, the people responsible for the nonpayment are each personally liable for the $15,000 and the withheld $7,500 (items 1 and 2), though not for the $7,500 of employer Social Security/Medicare.

Of course, the corporation is also liable, and the IRS goes after that primary payor first. But the Trust Fund Recovery Penalty makes the responsible persons "guarantee" the corporation's payment, at least in part. This penalty is a debt that can follow you for at least ten years, or the rest of your life, whichever comes first. The limited liability you personally enjoy from most corporate debts does not apply against this federal law. On top of that, you cannot discharge this penalty by filing personal bankruptcy, as you can with most personal debts. Though the debt is enforceable for a long time, many employers either don't realize this or give in anyway to the temptation not to pay the IRS. Most states have laws like the federal one, holding the responsible officers personally liable for state withholding taxes. The same laws impose personal liability for many other types of taxes, sometimes including sales tax and other taxes.

This Trust Fund Recovery Penalty can be a major tragedy for the businessperson. After all, why would any employer not pay these trust fund taxes? For most, like Ed Wonder, it's only because he doesn't have the money. Sure, in some cases the businessperson simply pockets the money and takes a permanent vacation to Tahiti. But those cases are rare. Most business owners want to stay in business and prosper, but when money gets too tight, many take a chance by paying the squeaky wheels.

Caution: The cost of paying late is always at least a federal tax deposit penalty, usually 10% of the amount not paid or deposited, plus interest.

As in the Wonder Widgets story, sometimes an employer misses one tax payment, holds his breath, and finds that the world doesn't end. Then another is missed, and another. Many never catch up. Quarter after quarter goes by; the back taxes keep building up. Their accountants, controllers, bookkeepers, lawyers, or other financial advisers warn them of what they already know, that they must pay those taxes. But the cash never seems to come in the door fast enough. There is an unexpected repair on a big machine, the air conditioning system breaks down, or an important customer goes bankrupt. A failing economy or recession can collapse interdependent businesses like dominoes, with the result that withholding taxes seem to be last on the payment list. To such employers, keeping the doors open is paramount. Since the IRS squeaks only later, though louder, many ever-optimistic businesspeople take a chance by hoping that good times are right around the corner.

What about the employees? They've paid their taxes. Despite their employers' failure to pay that money to the federal government, by law they still get credit on their tax returns.

How the IRS Handles these Cases

The IRS is like a hibernating bear in these payroll tax cases. It wakes up late, sometimes years after the first default, but it also wakes up very hungry and aggressive. Often two or three years have gone by; the employer may owe $50,000, $100,000, $200,000, or more. On top of that, penalties and interest have been assessed by the IRS' computers, so the situation often looks close to hopeless.

Tip: The IRS is becoming more efficient at catching these defaults earlier; the agency has "FTD Alerts" in place for many businesses that stop depositing payroll taxes. An FTD Alert means an agent will call quickly to check on the problem.

The longer the default goes on, the easier it is to continue and the harder it is to feel that you can ever catch up. When the IRS' computers wake up to an employer's default, the service centers first print out a series of notices. These notices have lots of information, but they boil down to this idea: "Hey, Wonder Widgets, you didn't send us your tax deposits. Do so now, or else." For every calendar quarter the employer doesn't pay in full, normally 2-4 such notices go out. The first one is polite ("It seems there may be a problem here, please check and pay."), the last, a declaration of war ("This is your final notice. Enforcement action may be taken immediately against you."). Some repeat offender businesses and large-dollar cases get only two notices. Others get phone calls, too.

When you get one of these notices, the absolute worst course is to ignore it. The computer remembers (and takes offense) that it sent you the notice, and that you didn't respond. Once the last notice is issued and thirty days pass, the IRS is legally free to start collecting by any means it can. This can include levying on bank accounts and accounts receivable, or even closing down a business where the boss is "pyramiding the payroll taxes." See Guide 2 on levies and seizures.

Helpful Hint: The IRS Restructuring and Reform Act of 1998 gives every taxpayer important rights to contest IRS levies before they are made. Basically, you have the right to appeal the intent to issue a levy to the Office of Appeals, and if the underlying liability is in doubt (as it often is in payroll tax cases), you can appeal that denial to the U.S. Tax Court or U.S. District Court. This new right may not be used solely for delay, but it can prevent the closing of a business in the right case.

Sometimes the delinquent accounts are transferred to the Automated Collection System (ACS), the IRS' second-stage collection function. Despite the name, the Automated Collection System employs real people who call you for payment and schedule payment dates or installment agreements. The "automated" part comes into play when ACS automatically files notices of tax lien and issues levies. The IRS collects a great deal of money by these computerized notices from the service centers and the Automated Collection System. But billions still fall through the cracks.

That's when the cavalry - the revenue officers of the Collection Division - charge into action. The computer doesn't give up. It prints alert notices known as TDAs, or Taxpayer Delinquent Accounts. One TDA form is printed for each reporting period, in this case, a calendar quarter (January through March, April through June, and so on). The computer, having done its best, now sends the TDA to the Collection Division and its frontline employees, revenue officers. The TDA forms for each quarter arrive at the local Collection Division office, where the case is assigned. The revenue officer's job is to go out and get the taxes. For the most part, revenue officers are well-educated, well-trained, and tough. They use a range of powers. At one end, there is friendly persuasion. At the other, they can impose and carry out a corporate "death sentence," physically closing down a business by locking the doors and changing the locks to prevent more tax defaults.

Tip: The 1998 tax act also imposed some restrictions on the revenue officer's authority to seize business assets. In particular, this intention to seize assets must now be personally approved by the highest IRS officer in the district. Another provision requires that the business assets be evaluated for their collection potential. Probably this means on an item by item basis.

The revenue officer's first step is to call or visit the employer and have a little "chat." He does not say, "Hello, I'm Revenue Officer Dan Dollar, and I'm here to help you." He is and he's not. At this first meeting, the revenue officer demands full payment immediately of all the taxes. He also explains how much is due-taxes, penalties, and interest. Does Ed Wonder immediately turn around and write out a check, saying, "Gosh, I'm glad you're here. I was just about to give you a call"? Of course not. He doesn't have the money. That's why the company defaulted, and that's why the revenue officer is there in the first place. Revenue officers know that, but they are required to make the demand anyway. Then the revenue officer and Ed Wonder discuss how the back taxes can be paid (if they can be paid). Paying over time is possible in some cases.

While dealing with past defaults, the revenue officer will insist on one absolute, nonnegotiable condition of any deal to pay the back taxes. The bleeding must stop. Wonder Widgets must start paying the current payroll taxes (that is, make federal tax deposits) right away when they are due, and must demonstrate that compliance to the revenue officer. Otherwise, the revenue officer will seize assets and/or close the business. Of course, Ed Wonder agrees. What choice does he have?

Between life and death, he'll choose life, even if it turns out to be short. Wonder then gets down to the nitty-gritty: negotiating with the revenue officer for payment of the rest of the back taxes.

The Agent Goes for Your Wallet

In the meantime, Revenue Officer Dollar also begins to investigate the people who might be personally liable for the nonpayment. He reminds Ed that he and others in the company can be held personally liable for the trust fund portion of the payroll taxes. He tells Ed that even if the corporation can pay, the IRS is required to investigate others' personal liability for the Trust Fund Recovery Penalty.

Helpful Hint: As a rule of thumb, if a corporation owes $10,000 in taxes, about $6,000 to $7,500 will be the withheld, or trust fund, portion.

At least that way, the government can hope to recover about two-thirds of the unpaid taxes if all else fails and the corporation goes under. When your personal assets are on the line because of this potential penalty, it tends to focus your attention. But the Trust Fund Recovery Penalty is not automatic or self-executing. The revenue officer can't just hand you a bill. He has to investigate thoroughly who should be assessed, then make a recommendation based on the facts and the law. That's all he can do-recommend. That recommendation has to be approved and a bill sent out. As we'll see, anyone who is considered for the penalty has an appeal right before the recommendation is made final, and the additional right to fight it afterward in court. The revenue officer's investigation usually lasts several weeks. Often it can stretch into months.

Who Is a "Responsible" Person?

The Internal Revenue Code imposes personal liability for the Trust Fund Recovery Penalty on anyone who (1) is a "responsible" person and (2) "willfully" caused the corporation not to pay the payroll taxes or "willfully" failed to ensure that the taxes were paid. You don't even have to be employed by the corporation to be liable for this penalty. Even other corporations have been held liable for this penalty where they took such an active role in the defaulting corporation's financial affairs that they became responsible for the trust fund taxes. But those cases are rare.

These days, only the true sources of financial authority inside the corporation will be investigated and held liable. In most cases, it's the officers and directors on whom the IRS first focuses. So Revenue Officer Dollar will be on the lookout for two issues as to each person he investigates: (1) "responsibility" and (2) "willfulness."

The responsible persons are those who truly controlled the finances and made the decisions on whom to pay and when. The revenue officer looks for "badges of authority." Signature authority on the checking account is usually a dead giveaway, especially if the revenue officer finds that the signatory also actually signed checks to creditors. In the Wonder Widgets case, clearly Ed Wonder had enough financial authority. What about Bighthard and Pencil? Not at first; but later, when they began to make decisions on their own and signed checks, they became “responsible.”

The revenue officer also looks at the corporate officers, shareholders, and directors. He'll find out who hired and fired employees, a sign of significant authority. Who was responsible for completing the employment tax returns (Form 941)? Who was responsible for signing these returns, for preparing payroll, for cutting the payroll checks? Who negotiated for loans at the bank?

> Example: Abel, his two sons, Baker and Charlie, and his wife, Delta, all worked together in the family business, a retail store. While the company had been formally incorporated for more than twenty years, the family ran the shop as informally as their breakfast table. Abel and his sons operated the store; Delta kept the books. In fact, she had the authority to sign checks and signed over ten thousand of them stretching over seven years. Delta was the only one who had training in financial matters, and she used that training to work with the bank, the company's accountant, and the IRS. While she called herself a bookkeeper, in fact she exercised control and made all the decisions on expenses, including paying taxes. She could have stopped the $250,000 of defaulted payroll taxes, but she didn't. So the IRS assessed her for $194,000, and made it stick in court.

> Example: Robert formed Fixtures, Inc., to install fixtures in office and commercial buildings. The next year, he hired his brother Gary as controller, treasurer, and chief financial officer. Gary's job was to supervise all accounting, prepare financial statements, keep up the books, and supervise an outside payroll service. An outside accountant also helped Robert run the business. On top of this, Robert had signature authority over the checking account. Three years later, things went downhill. Cash flow became very tight, and Gary and Robert fought often over a new computer system that was supposed to help them. Everyone met in October. The accountant recommended a delay in paying the payroll taxes for up to six weeks so the company could save $60,000. "Of course," said the CPA, "there will be interest, and, at worst, the government can make some personal assessments," but it will give the company breathing room. That breathing space turned into a gasp and a choke. The payroll taxes went unpaid, and the IRS assessed-you guessed it-Gary. Who won this case? This time, Gary won. True enough, he had the authority to sign checks, but Robert and the CPA actually decided which checks were to be made out. All financial control was in the hands of Robert and the CPA, not Gary. So despite all his apparent authority, he was found not responsible.

To find these and other badges of authority, the revenue officer hunts for and demands to see paper: corporate minutes, stock records, bank records, bank signature cards, and virtually anything else he can find that tells him who had the true authority to direct the payment of creditors. He'll look at contracts and bills, canceled checks, and receipts.

Tip: If you think you are "innocent," try to gather all of this evidence as you go along, or after the revenue officer shows up. This puts control of your tax fate in your own hands rather than depending on the president of the company, who wanted to place the blame on others.

He will interview as many people as seems appropriate, using an interview form, Form 4180, as a guide. When completed, this form tells the revenue officer virtually everything he needs to know about the financial movers and shakers inside the corporation.

You can find a current version of Form 4180 on the IRS website, irs.gov. This form provides a thorough, excellent review of all of the factors courts have looked to in imposing liability under this penalty.

The revenue officer then turns to the other issue, willfulness. He has to show that a responsible person willfully caused the corporation not to pay, or stood by while other creditors were paid ahead of the IRS. No fraud or evil intent need be proved. In the Wonder Widgets story, there was no fraud, but everyone knew the taxes were due. So all involved were "willful." The revenue officer needs to show that a responsible person knew the taxes were due at a time when that person could have paid the IRS. Simple knowledge is enough. And even if you didn't actually know, if you should have known, that's enough to make you willful.

For example, if you signed a Form 941 payroll tax return showing a balance due, as Ben Bighthard did, you know taxes are due. If you prepared or saw a financial statement for the company showing taxes due, that's enough. If there was a payroll tax problem in the past, as happened in the Wonder Widgets example, that too could be enough to put everyone on notice and make those future defaults willful.

> Example: Ed and Boris formed Buildit, a construction firm. Both were in charge, with full authority to sign checks, determine the payment of creditors, and essentially run the show. Soon after starting, Ed discovered that the company owed $5,000 in withholding taxes. The IRS had sent notices, but Boris assured him that the problem would be taken care of and would not happen again. OK, thought Ed, so far so good. Things went along fine for ten years. Then, the company became delinquent again. Eventually, it went out of business. The IRS assessed the two officers, but Ed said, "I didn't know the taxes were due. I can't be 'willful' for those periods." Not so, said the court. You knew about the earlier default, and that put you on notice that the company was in trouble. You had a duty to confirm or ensure that the future taxes were paid. One default, however small, is all it takes.
>
> Example: Omri was a terrific baker, but he lacked a certain finesse as a businessperson. He was operating his business as a proprietorship when the IRS made an assessment against him for payroll taxes. He was able to work out an installment agreement. Seeing the handwriting on the wall, he formed a company with Bill, a longtime friend who had a catering business. Bill did all the book work, including paying expenses and sending checks to the IRS. Still, Omri had his share of check-signing duties. Things began to go downhill. Omri defaulted on his installment agreement and the IRS sent a notice of levy. The power company called about unpaid bills. They also had to pay a key supplier to keep the doors open. The fledgling company downsized by laying off two employees, but, all the time, Bill assured Omri that the taxes were being paid. Omri did not investigate on his own; he relied on Bill's statements. Of course, these assurances were false. The company ended up in bankruptcy, and the IRS assessed both Omri and Bill. Omri's defense: "Bill told me all the taxes were paid. I had a right to rely on him." No, you did not, said the court. You can't watch the financial walls crumbling all around you

in every other way and assume that the taxes are also being paid. So, Omri was just as willful as Bill, and had to pay his share of the payroll taxes.

After the revenue officer gathers the evidence, he writes a report as part of a form called Recommendation for Trust Fund Recovery Penalty Assessment. True enough, it's only a recommendation; but once the agent “recommends,” it’s all over but the shouting. The revenue officer sends that form and all the supporting documentation to his boss, the group manager. If the group manager approves, as they almost always do, the revenue officer then calls the responsible persons, asking whether they will agree to the liability.

Tip: Many people so fear the IRS that they quickly give in when the revenue officer proposes to assert the penalty. This could be a major mistake. Often a bookkeeper, or even someone higher up like a corporate controller, was simply following the boss' orders. That subordinate should not be held liable, at least not for all the taxes. Just because a revenue officer says you are liable doesn't make it so.

Remember that the revenue officer, despite his power, cannot actually make you liable or give you a tax bill. All he can do is recommend. You then have rights you can exercise before any bill is issued. When you exercise those rights, sometimes the penalty is reduced or not imposed.

Now, let's say the revenue officer has called you, and after careful thought you politely say, "No, thank you" to the suggestion that you agree to a $100,000 tax bill. ("Sorry, can't contribute this year. Not in my plans.") What then?

If you have more evidence in your favor, you can send it to the revenue officer. But that's normally a useless exercise. The officer has already made up his mind. More evidence won’t convince him. Save your evidence for the appeal.

The revenue officer then writes a formal letter to you, stating he intends to recommend the assessment. Again, that is not a bill. It's only a notice that he wants to make it official, subject to your right to appeal. That formal letter, now required by law, is known as a "sixty-day letter."

<u>Note</u>: The period of limitations to assess you is now suspended for the time recited in the letter (60 days normally), plus the appeal time if you appeal.

You have sixty days to agree or disagree. If you agree or fail to respond, that ends the matter. Your tax bill will shortly issue, and you will become even better acquainted with the revenue officer as he pursues your personal assets for collection. If you disagree, you can fight the recommendation by appealing. Should you? Yes, if you truly believe you are not liable for some or all of the default and you have favorable evidence. To stop the revenue officer's recommendation from becoming a legally enforceable bill, respond to the sixty-day letter by sending a document called a "protest" whenever there is real doubt that you in fact are liable. It’s your right. During that appeal time, no interest accrues on the penalty (nor is it assessed). And, appeals can be heard quickly or not, depending on how busy your IRS district is.

Make Your Case More "Appealing"

Now let's say you want to appeal. At this point, it is essential to get help from a tax professional experienced with this penalty. Appealing a Trust Fund Recovery Penalty recommendation is complicated. The case law governing who is liable is vast and challenging. You may need only advice. You may need more guidance or reassurance that you're on the right track. Or you may need the tax professional to carry the full burden for you. But do not appeal on your own. You will almost surely lose. To fight the penalty, send the protest as a letter to the IRS office that proposed the assessment. These protests are similar in format to protests in income tax cases. In the protest, acknowledge receipt of the sixty-day letter and state that you are now protesting it.

The body of the protest has these seven parts.

1. Name and Address

2. Date and Symbol of Letter. State the date of the sixty-day letter, and the symbols of the letter, normally located in the lower-right or lower-left corner on the first page.

3. Tax Periods Involved. Here state what calendar quarters are proposed in the assessment. You can take these straight off Form 2751, an attachment to the sixty-day letter.

4. Request for Appellate Conference. If you want a conference with the office of appeals before a decision is made, say so here. It's almost always in your interest to request a conference or at least preserve your option to have one.

5. Findings to Which the Taxpayer Protests. State the errors you believe the revenue officer made. In Trust Fund Recovery Penalty cases, it is enough to say, "I was not a person responsible for the failure of Wonder Widgets, Inc., to collect, account for, and pay over the withholding and Social Security taxes for the periods stated above." You can also say, if true, that you were either not "responsible" or not "willful."

6. Statement of Facts and Argument. This is the heart of your protest. Here you present all your facts, furnish all the documents you have (providing copies), and make all credible factual and legal arguments to show that you are not responsible at all, or not responsible for all periods, or not willful.

Tip: Appeals officers know that many people prepare and file their own protests. So don't worry about how "legal" the protest sounds. Proven facts always speak loud volumes, so just state and support the facts and tie them to the legal standards as best you can.

Still, a professional adviser can greatly help. A professional knows the law and how to gather or present the facts and law in the most effective way. Also, don't worry about whether facts you state would be admissible in court. The rules of courtroom evidence don't apply to appeals cases. Often hearsay and other inadmissible evidence will be considered. Still, everything you say must be true. It's a criminal offense to lie to a federal official, under oath or not, in writing or not.

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Your concluding paragraph should ask for the result you want. That's usually called "nonassertion" of the penalty, but frame this paragraph exactly in the terms of the relief you seek.

Defenses You May Use

People have thought of dozens of defenses to put in protests and in later court cases. Let's take a look at the most important ones.

1. The "Nuremberg" defense. Maybe you can argue that you were "just following orders." From our Wonder Widgets example, Penny Pencil or Ben Bighthard would say, "President Wonder told me what checks to sign, what checks to write, and I just followed orders. Even though I could prepare and sign checks myself, the reality was that only Ed Wonder told me what to do. Every Friday he would call me into his private office. There he would go over the list of people we had to pay, and sort them out by the ones that we absolutely had to pay and others who could wait. Unfortunately, the IRS could always wait. I told him I thought it was wrong, but he ordered me around anyway. He told me he would fire me if I disobeyed him."

   That's a common defense bookkeepers and controllers use. It works in most (not all) parts of the country if it's true and you prove it. But you bear the burden of proof. Very often Wonder will say just the opposite, so try to get other people to back you up, people who have no ax to grind. And put it in writing! Under oath!

2. The "pointing finger" defense. In this defense, Ben Bighthard points the finger at Ed Wonder and says, "He did it, not me." Ben claims that Wonder was the only person authorized to sign checks, even if Ben was on the bank signature card. Ben also tries to get the backing of others by letters or affidavits. This defense also works if you can prove it. If you resigned your corporate office, or went off the company's checking accounts at the bank, show these facts by documents such as new bank signature cards or a corporate resolution demonstrating that you resigned. However, in the real world, corporations often lack such formal documentation.

3. The "it's been paid" defense. Sometimes all or part of your liability has been paid. The corporation might have paid it by designated payments.

   A "designated" or "voluntary" payment is a payment that you designate for a particular liability right on the check itself. In the case of the Trust Fund, you may use the notation, "apply to trust fund only" and the particular quarter involved. The IRS is obligated by law and by the Internal Revenue Manual to honor this designation unless the payment is not voluntary. That would occur if the payment is made under levy or in a bankruptcy case. You can also argue that payments the corporation made with the payment coupon must be applied to taxes (including the trust fund), not to penalties or interest.

   Or, some other officer might have paid some part of the liability the IRS now seeks from you. Under IRS policy, you are entitled to credit for those payments. The IRS is also required by law to let you know what efforts it has made to collect from other responsible persons. Insist on that right.

4. The "your numbers are wrong" defense. Sometimes the IRS makes a mistake in calculating the amount of trust fund taxes. Go back to the corporation's employment tax returns and do it yourself.

5. The "contribution" defense. If the IRS is coming after you for these taxes, and someone else is also liable, you may sue in federal court to have that person "contribute" his or her share. This right did not exist before 1996, when Congress added it in the 1996 Taxpayer Bill of Rights. However, this right is rarely invoked, at least measured by reported cases.

Filing Your Protest

Once you have assembled your documents and have written your protest, send it to the office that sent you the sixty-day letter. Missing the sixty-day deadline is fatal to your appeal. The IRS will quickly process the paperwork and make the assessment. If you can't meet the deadline, ask for an extension. Call the revenue officer assigned to your case as soon as you know you will need more time. Ask for thirty days at a minimum, but as long as you realistically need. Tell the revenue officer why you need more time. He'll usually deny the request. Sometimes he'll grant it grudgingly, sometimes for fewer than thirty days. It is one of the great ironies of tax practice that the IRS may grudgingly grant one extension-usually not more than one-and then wait multiples of that time period to hear your appeal. But that's the way it is.

Helpful Hint: If the revenue officer won't extend the deadline at all, file a bare-bones protest to preserve your appeal rights. You can supplement it later.

Now you are ready to assemble your protest. It should have two main parts: first, a cover letter with all the identifying information that a protest normally requires, as discussed above; second, as much supporting documentation as you can possibly assemble to show you are not liable for the penalty. While you're preparing the protest, what's the revenue officer doing? Nothing. He has to wait.

After he gets your protest, he writes a rebuttal. His instincts and training are frustrated because he is forbidden to seize assets or otherwise collect during this sixty-day period (or longer, if extended). He may want to collect, to seize bank accounts, sell your house, but he cannot. The Internal Revenue Code forbids it.

What if your corporation is in bankruptcy? There, too, official IRS policy calls for "no collection" as long as the corporation is current in its payroll taxes and proposes a plan of reorganization that will take care of these taxes. But it's not a hard-and-fast rule. In any case, if the business begins to liquidate assets, or "pyramids" its delinquencies, among other things, the revenue officer can go full speed ahead to recommend the assessment against you.

In the great majority of these proposed assessments, the responsible persons never protest. They throw up their hands and say, "You got me. I'm guilty." And in most cases, they are. But it's surprising how many times revenue officers propose the Trust Fund Recovery Penalty assessment against persons who are not liable, or who have one or more credible defenses. Even the 100 percent owner, a president and chief operating officer of a corporation may still have some defenses, usually relating to the proper amount to be assessed. But most, feeling badly about the default or assuming they are absolutely liable no matter what, give up without a fight. In other cases, even if he has a defense, he misses the sixty-day deadline. It's not possible to overstress the importance of meeting that deadline or any extension. If you do, and file a proper protest, the revenue officer will wait until the protest is resolved. You have exercised a right that the law grants you, the right to preassessment reconsideration within the IRS.

The Appeal

After you file a timely protest, you wait. And wait. And wait. In busy IRS districts, you can wait up to a year to have your protest considered. Sometime shortly after you file the protest, you may receive a polite letter from the office of appeals. The letter says simply that it has received your protest, it is assigned to Ms. Jones, appeals officer, and you will be hearing from Ms. Jones shortly. Then you wait some more. Sometimes the letter will courageously set up an actual appointment, with a date, time, and place, one to four months in the future. If so, check your calendar immediately. If you can't meet that date, write or call the appeals officer directly to set up a new appointment. Her number and address are on the letter.

Who are the Appeals Officers?

The Office of Appeals is simply an arm of the IRS to which you can appeal the recommendation of the revenue officer without having to go to court. It's the same office that considers appeals from income tax audits and other collection matters. Appeals offices are located in every IRS district.

<u>Fun Fact</u>: The IRS set up this office in 1925 to try to keep down the volume of court litigation on tax matters, and it has worked. Appeals officers settle a high percentage of income tax and employment tax cases. "Settlement" is even written into their job description.

In theory, appeals officers are neutral and detached; they consider both sides, and to try to arrive at a fair settlement. They will generally make a good-faith effort to see your side of the case and to consider all your evidence. They are trained to be more objective and detached than the revenue officer. But remember: They get a government paycheck just like the revenue officer who wants to sell your house. Appeals officers will also candidly tell you that Trust Fund Recovery Penalty cases are tough to settle. Some invoke a moral component: the taxpayer sitting across the desk from them has been accused of violating a trust, the obligation to hold employees' monies and pay them over to the government. Others confess they find it hard to settle these cases because all the accused are pointing fingers at each other, even under oath, saying, "He did it, not me." So the appeals officer sometimes throws up her hands and sustains the revenue officer's recommended assessments with the comment: "Let them fight it out in court."
In addition to your protest, the appeals officer has the revenue officer's entire case file. That includes everyone else's protests, the interview forms, the revenue officer's written

recommendations, and his rebuttal to your protest. The file also contains all of the corporate documents, bank documents, canceled checks, and other evidence. The size of that big administrative file discourages the appeals officer from settling many cases because she typically finds so many contradictory accusations and facts. That is also discouraging to you; it means the appeals officer is less likely to reach any settlement, or a good settlement from your point of view. An appeal in a Trust Fund Recovery Penalty case can therefore be very much an uphill battle. The appeals officer has seen a hundred come and go, many involving taxpayers who lie under oath to try to get a better result.

Preparing for Your Conference

Now you're in the period between the protest and the in-person conference. What can you do? The rule is: Keep moving. Look for more evidence. Find more documents and witnesses. Obtain their statements, preferably under oath, and send them to the appeals officer. She'll always take new evidence, up to the date of the conference and even after. If you made a Freedom of Information Act request for the IRS' administrative file, continue to comb through that file for holes in the revenue officer's investigation, helpful facts, or leads to other evidence that can help your case. Relentlessly track down those leads and get them on paper. For example, let's say you want to prove that you didn't sign corporate checks to pay bills until six months after you came on the job. (The president said you did.) Ask for copies of the actual checks from the bank. It is expensive, but the banks have them, often only on microfilm going back a number of years. Then use the checks to prove your point. Suppose you were the secretary/treasurer of the corporation, but the president called all the shots. The bookkeeper has moved to Kodiak, Alaska. But you find and call her. By luck, she kept a copy of the corporation's bylaws. Those bylaws say “the president is in charge of everything.” Get the bylaws and send them to the appeals officer.

The idea is to think of any piece of evidence, any fact, any document that will help prove a negative-that you were *not* a "responsible" person or that you did *not* know or should not be expected to have known that the taxes were due.

Now it's time for the conference. An appeals conference is unlike any court proceeding. The appeals officer does not don a Tyrannosaurus Rex suit for the occasion, but neither does she greet you with a bouquet of flowers. The conference usually takes place in her office. You sit across the desk and discuss to the issues. The discussion can range over the entire history of the corporation, or it may concentrate only on the delinquent periods. Your task is to use the facts in your protest to convince the appeals officer that you are not liable. Have all of your protest firmly in mind, and be prepared to rebut any contrary evidence. If you have prepared well, there should be no surprises. You'll be especially well-prepared if you made a Freedom of Information Act request for the IRS' administrative files.

Sometimes the appeals officer will have discussed the case with the other proposed responsible persons, a circumstance for which you cannot fully prepare. She'll tell you about those discussions at the conference and ask for your rebuttal. If after the conference you need more time to gather evidence, the appeals officer normally allows it. But if the conference goes well and you don't need more time, the appeals officer will begin to discuss settlement (unless she concludes that there is no “litigating hazard” to the government’s case).

As a general rule, appeals officers will rarely suggest a settlement at less than 20 percent of the full amount of the proposed liability (unless it's crystal clear that you're not liable). The 20 percent is considered a "nuisance" settlement. To go lower, they would have to justify in detail why the IRS should not fully concede the case. So, if some evidence points to your liability, your best result may be 20 percent of the amount proposed. Appeals officers also have authority to settle if all of the responsible persons get together and agree to chip in an equal amount, or if they pay the full amount, even if somebody pays more than a pro rata share.

But if everyone denies liability and points the finger elsewhere, often the appeals officer will be unable to craft a settlement and may sustain the full penalty against each responsible person. That doesn't mean the IRS collects three or four times. It will collect only once, but it can collect 100 percent from you; 50 percent each from two people; or 10 percent from one, 30 percent from another, and so forth. If you are able to settle, the appeals officer writes up the settlement for her boss and sends a copy to you for signature. You sign it, send it back, and await the resulting bill.

Is There Life after Appeals?

If you try and try but just can't settle, Western civilization does not come to an end. True enough, that's your last chance before a formal bill, called an assessment, is generated. But it's not your last chance to contest the liability. You can always go to court.

Tip: Once the assessment becomes formal, it accrues interest until paid or settled. But if you go to court, at least the IRS is prevented by law from collecting against you while the case is pending.

Still, fighting the Trust Fund Recovery Penalty in court is difficult and expensive. Attorneys in the Tax Division of the Department of Justice, the government's lawyers in these cases, have a long and consistent winning record. Most of the case law is unfavorable to taxpayers. So, before you decide to go to court, consult an attorney experienced in these cases. Despite these odds, many people choose to litigate, and a government win is by no means a foregone conclusion.

First, to establish the federal court's jurisdiction over your case, pay a portion of the assessment and file a Claim for Refund on Form 843. The idea behind a Claim for Refund is this: You pay the tax first and then sue the government in federal district court for a refund of the tax you have paid. Paying the tax does not mean you agree to it. It simply vests the federal district court with jurisdiction over the case.

Caution: If you pay a portion of the assessment and then sue for a refund, the government will almost always counterclaim for the remaining balance. So the result could be a federal court judgment against you for the unpaid balance of the assessments.

In most cases, people cannot pay the full amount of the assessment, so the law allows you to pay only a small amount for each calendar quarter that you want to place in issue. That amount is equal to the withholding and Social Security/Medicare taxes due for only one employee for each quarter at issue. It could be the lowest paid employee, the highest paid employee, or anyone in between. It can be the same employee for each quarter at issue. If you can't find out how much that amount is, guess. Paying $100 or $200 per quarter will often be enough.

Filing Your Claims for Refund

File one claim for each quarter at issue. On your check, earmark the "memo" section of your personal check for each quarter to pay that quarter. Send your Claims for Refund to the regional IRS service center by certified or registered mail, return receipt requested. The IRS will process the claim, but since the tax has already been assessed against you, a rejection is inevitable. The rejection letter is your "ticket to court." You have two years after that formal rejection to sue, or if the IRS fails to act within six months after you file the claim, you also can sue at that time.

Winning a tax refund suit in a Trust Fund Recovery Penalty case is difficult. If you are serious about suing, always consult a lawyer experienced in such cases. Yes, it is true, some taxpayers sue on their own; some even win. But that's as rare as a surplus in the federal budget. When you file suit, the Department of Justice will counterclaim for the unpaid balance of the assessment. For example, if you sue for a refund of $500 out of a $25,000 assessment, the counterclaim will be for $24,500.

The issues in court are identical to those you and the IRS considered before. The judge or a jury will adjudicate who was a responsible person and who acted willfully. Witnesses will be called, documents will be introduced into evidence, and the trial will follow the usual pattern of trials in federal district courts. Some federal courts will complete these trials quickly; others can take years. While you're waiting for your case to be tried, interest accrues on the assessment. If you win, there is no more liability. But if you lose, you have a federal court judgment that can be collected either by the IRS or by the Department of Justice.

The Ten Commandments of the Trust Fund Recovery Penalty

1. Keep out of harm's way. Don't take responsibility for paying corporate bills if the boss should really have it.

2. Make early requests under the Freedom of Information Act for the IRS' administrative file.

3. Tell the truth-to yourself, to the revenue officer, to the appeals officer.

4. Meet all deadlines, especially for the protest.

5. Respond to all IRS notices.

6. Keep looking for evidence while you await the appeals conference.

7. Don't fight the penalty alone. Seek professional advice from a tax practitioner experienced in handling Trust Fund Recovery Penalty cases.

8. Be careful what you say to the revenue officer. Anything you say can and will be used against you.

9. Do not fear the revenue officer. Be respectful but not defensive.

10. Stand on your rights. You have them; use them.

5

Other Big IRS Headaches

The IRS' "Nuke": the Jeopardy Assessment…Fighting Back…The Non-filer's Nightmare… Saving the Non-Filer from Self-destruction…Sending People to Jail--the IRS Way… Fighting the Criminal Tax Investigation

This chapter addresses three of the biggest IRS headaches people can face:

1. jeopardy assessments,
2. nonfiler investigations, and
3. criminal investigations.

Get "Nuked" by a "Jeopardy" Assessment

One of the most frequent complaints people make about the IRS is how grindingly slow it is to act. Don't tell that to anyone who has looked down the barrel of a "jeopardy" or "termination" assessment of tax. Jeopardy and termination assessments are like nuclear weapons delivered by a stealth bomber. The damage is devastating, and you rarely see it coming. True enough, the IRS doesn't use these weapons very often, mostly reserving them for criminal cases or cases of illegal or unreported income. Still, the Service resorts to jeopardy and termination assessments hundreds of times each year, and won't hesitate to use these powerful weapons in any case where it feels collection is at great risk. Even normal folks must sometimes look over their shoulder when they owe back taxes and try to plan the sale of their assets.

What is a "Jeopardy" Assessment?

A jeopardy or termination assessment is simply an assessment made very quickly because the IRS has officially determined that collection of the tax is "in jeopardy." Termination assessments are so called because the IRS "terminates" your current tax year immediately, makes the assessment, and proceeds to collect it. Jeopardy assessments are for past years where the taxes have not yet been assessed.

In a normal, nonjeopardy case, the Service cannot begin to collect until it has taken these steps:

1. audited your tax return

2. proposed a tax bill

3. allowed your appeal rights

4. allowed you to go to court, and,

5. after the resolution any court case, assessed the tax and issued a bill.

That assessment process takes months or years. In a jeopardy case, all the in-between steps are eliminated. It takes only hours. Even after the agency assesses you, court rights are preserved, but, in the meantime, the IRS has seized everything in sight.

> Example: Horace was in the marijuana production business. One day, the local police raided his digs and found fifty pounds of the stuff, $18,000 in currency, and drug paraphernalia. One police officer was courteous enough to call the IRS during the search at Horace's house (law enforcement authorities often cooperate by tipping each other off). The IRS agent headed out to watch the search in progress. Then he checked to see if Horace had filed tax returns (he had not), found another house he owned, and located other cash transactions. He also checked with experts, learning that the wholesale value of the marijuana was between $250 and $400 per pound. Finally, the agent found that Horace had bought an Audi. That was enough for the IRS, which jeopardy-assessed $52,000 against Horace. He challenged it in court, but the court sustained the assessment in full.

Legally, the agency can make a jeopardy assessment if it officially declares that (1) you are about to leave the United States; (2) you are hiding your assets, transferring them, or otherwise putting them beyond the reach of the government; or (3) your financial solvency is in peril. As you might expect, drug busts often generate jeopardy assessments. So do gambling raids where gambling is illegal. Noncitizens who appear ready to flee the country can be the subject of jeopardy assessments, and it would not be surprising if the government jeopardy-assessed people who planned to give up their citizenship to avoid taxes.

The Service determines you are about to flee the country by looking for a number of signs: your citizenship, whether you have a passport, ownership of foreign bank accounts, and previous criminal convictions indicating that you might leave. It also checks whether you are liquidating assets, whether some other jurisdiction has warrants out for you, and even whether you have bought airline tickets. The Service knows you are concealing assets when you transfer ownership, use aliases, destroy or conceal records, or use a lot of cash.

In a jeopardy case that arises from a drug bust, police officers usually find cash and drugs. The experts estimate the purchase value of the drugs, add that to the cash, and advise the IRS. IRS special agents check for filed tax returns. If there are none (Not many drug dealers file true returns, or any returns.), the agents make a termination or jeopardy assessment by telephone, swoop down, seize the cash, and apply it to the assessed taxes. In short order, the government has $100,000. Theoretically, the suspects could contest the assessment in tax court or federal district court, but the IRS counts on them to be otherwise occupied.

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> Example: Karl and his sister lived in a small house in Denver. The police became interested in this location, and watched it, watched it, watched it. One sunny morning, Karl left the house. A short time later, the police raided the place. They found pounds of cocaine and more than $500,000 in cash. Documents found at the house bore Karl's name and referred to many sales of cocaine, with some transactions valued at more than $2 million. But Karl was not a U.S. citizen, only a resident alien who had been to the United States three other times. The police also had a confidential informant who told them where else to look. That search turned up a safe deposit box with more cash. The IRS terminated Karl's tax year and assessed $1.6 million based on the street value of the cocaine. Karl ran to federal court for relief, but the court found that it was reasonable to assume he would quickly leave the country unless the assessment were made. The assessment stood.

Jeopardy assessments can be made against plain folks as well. Let's say you anticipate a huge tax bill and you begin to put property in the names of your children, friends, or relatives, or you transfer property overseas. Nothing prevents the IRS from determining jeopardy exists, and it might well be justified in doing so.

> Example: Archibald, a surgeon practicing in a major city for many years, had a wife, five children, and a dog. From time to time, he made trips to a European country to visit his elderly, infirm mother and to pay tribute to his deceased father. There was only one little problem. The IRS thought he evaded paying taxes on millions in medical fees over three years, and that he used company money for personal expenses, hiding them as "business expenses" on his return. Also, while the IRS was investigating him, he sold all the real estate he owned and hid the nearly $1 million in sales proceeds. Now, you might ask, what tipped off the IRS? Apparently, it had something to do with the agent's obtaining copies of canceled checks, endorsements, notes on the checks, irregular second endorsements, and bank deposits, as well as the real estate liquidations. These problems, plus the trips abroad and the disappearance of funds, all showed that the making of these assessments was reasonable.

Caution: If Archibald had managed to get all his assets out of reach and appeared about to depart the United States, the IRS could resort to a writ *ne exeat republica*, a writ of civil arrest, issued by a federal court, that could have held him until his taxes were paid or a sufficient bond posted.

Fighting a Jeopardy or Termination Assessment

You can rarely see a jeopardy assessment coming, so it's hard to fight one before it explodes. But afterward, you have some limited rights. Within five days after the IRS makes the assessment, it sends an "information statement" outlining its reasons. Within thirty days, you can ask for the IRS to review the assessment, usually a useless act. Within sixteen days after the request, you can sue the government in federal district court to review the jeopardy assessment. The court has jurisdiction to determine whether (1) the making of the assessment is reasonable and (2) the assessed amounts are appropriate. Almost every case results in a victory for the government, so they are rarely seen these days. Here is an example of this type of case.

> Example: Curtis led a double life. Publicly, he was a low-profile citizen. Privately, he had a small "business on the side," conducted in a secret room behind a fiberboard wall covered by tennis rackets, snow shovels, and tools. The room remained secret until the local police somehow learned of it and arrested Curtis for gambling, specifically, running a bookmaking operation. He pleaded guilty to a state-level charge. The IRS then woke up. Based on Curtis's secret journals, betting slips, and other evidence, the IRS said that he had been in business for more than two years and took in $10,000 in bets every week. The average for one sixteen-day period the IRS examined was $5,100 per day. The agents multiplied that figure by 365 (no vacations for Curtis?), and the resulting figure by 4.5 percent, as Curtis's reasonable profit margin, coming up with unreported income on which the taxes, penalties, and interest totaled $150,000. Curtis challenged all of this in court, and was able to get a reduction because the IRS had selected his "busy season," fall football time, on which to extrapolate the assessment. Still, the court sustained most of the assessment.

Where the government's jeopardy assessment springs from such a drug or gambling raid, little if anything will undo the government's action. But if the government has jumped the gun and unfairly jeopardy-assessed anyone else, there are remedies even besides the court suit described above. You can always file Form 911, requesting a Taxpayer Assistance Order. Guide 3 describes how to do this. You can also go up the chain of command, all the way to the Area Director of Internal Revenue or the Territory Manager for your district. That official must personally review the circumstances to approve any jeopardy assessment in advance, so he has already said no to you once. But maybe the agent got the facts wrong or there are mitigating circumstances. It does not hurt to place these phone calls and write letters, unless doing so would incriminate you.

Helpful Hint: This type of action always assumes truthful statements to the government. Any false statement to a government official, oral, written, or by demonstrative conduct, is punishable as perjury.

Finally, there are more leisurely remedies, such as the normal tax court suit filed to contest the government's assessment. The jeopardy and termination assessment provisions remain among the most powerful of IRS collection weapons. You can rarely anticipate them, and more rarely still can you fight them. But you can contest them after they are made. If the IRS has truly erred and you can prove it, you may be able to recover your money and property.

The Nonfiler's Nightmare

Jeopardy assessments are sometimes used in connection with "nonfiler" assessments. Every year about three million Americans do not file federal and state income tax returns, or they add another year to non-filing. Nonfilers come in all shapes and sizes: they are blue collar and white collar workers, doctors and plumbers, even lawyers and accountants. The only apparent common factor is that most nonfilers are men, but even that "rule" has many exceptions. According to an IRS study, the average delinquency period was three years, but nonfiler cases of up to twenty years and more occur.

Why the IRS wants YOU (the Nonfiler)

While there are many apocryphal tales of nonfilers who “never get caught,” most nonfilers do not escape from the IRS forever, or for long. In this computerized age, it is easy for the IRS to scour W-2 forms, credit card records, Social Security listings, and even plain old telephone directories or the Internet to find anyone who has not filed a tax return.

Tip: The IRS opened about 2 million delinquent return investigations in fiscal 2012. They assessed over $18 billion in new taxes and collected over $1 billion.

No one can hide forever. In these days when everyone's vital statistics seem to be on the Internet, the IRS particularly has many ways to find you. The Form W-2 from your employer tells the IRS who you are and where you work. Form 1099 tells them who paid you money, where your mortgage is placed, and whether you received barter income. It says where and how much you received in dividends or interest, whether you received a state tax refund, and many other things. Each of these reporting devices can be tracked back to find you. Even if you don't file a tax return for one year, the IRS will look at the last one you did file to try to find you.

But they don't give up if these sources run dry. Do you have credit cards? These may often be canvassed by Social Security number. The IRS simply asks the credit card agency, "Give me the name and address of anyone with a Social Security number 000-00-0000." The IRS can also try to locate you through other agencies: the military, the Social Security Administration, the Immigration and Customs Enforcement Service. In fact, there are at least three varieties of telephone and geographic directories it can use. One is the familiar "white pages." Another is a "criss-cross directory," indexed by street. There are others. The Service can also use information from credit reporting agencies and consumer reporting agencies, all of which track their clients and customers by name and sometimes by Social Security number. For these reasons, anyone who had not filed a tax return is sitting on a ticking time bomb.

Why People Don’t File

The reasons for non-filing range from the absurd to the heartbreaking. Nonfilers clearly have a capacity for denial, taking quick and easy refuge in self-deluding excuses. Some say that filing can wait because they are due a tax refund ("The government owes *me* money."); more than enough was withheld from paychecks, or was paid in estimated payments, to cover the taxes. True or not, this can’t be known with any confidence until a tax return is prepared. And, the filing requirement depends on gross income, not net taxes due.

The IRS’ “Surprise” for the Nonfiler

On top of that, the IRS often surprises the nonfiler who thought the government owed a refund. The agency has the legal authority to file a tax return, or a “substitute for return,” if you don't file one. On that "substitute for return," the IRS makes every possible assumption to increase your taxes. Even if you are married, the IRS assigns you "married filing separately" status, the worst possible assumption in terms of the tax rates. The IRS assumes you have no children. At most it gives you one exemption--yourself. Mortgage interest, large deductible medical expenses, real estate and state income taxes, all normally deductible, will be ignored.

The result is a Substitute for Return on which the W-2 withholding comes nowhere near the amount necessary to cover the taxes-as calculated by the IRS. To compound the problem, many nonfilers are paid as independent contractors, or have other "Form 1099" income on which nothing was withheld. Either way, the tax bill is shockingly large, topped off by a 25 percent (maximum) late-filing penalty, a late-payment penalty, and interest. This, after the nonfiler believed he was entitled to a refund.

<u>Helpful Hint</u>: If you wait too long, your "refund" may be barred by the statute of limitations. Thousands of people kiss goodbye millions of dollars each year in just this way. The normal period of limitations on claiming a refund or credit is three years from the due date of the return or two years from the date of payment, whichever is later.

Non-filers can always ask the IRS to reconsider the Substitute for Return, but that takes time and effort. In the meantime, the IRS will spring into action to collect the taxes. Agents may file notices of federal tax lien, levy on your bank accounts, sell your assets, or garnish your wages. You could even lose your job if the IRS contacts your employer and the boss sees your problem as a terminable offense.

Filing for bankruptcy in the hope of discharging the taxes can sometimes work if you meet certain tests. (One of these is a two-year wait following filing, so bankruptcy can not solve the problem for at least that time.) But under current law, you cannot discharge income taxes that the IRS bills you on a Substitute for Return. Another excuse people give is: "I didn't have the money to pay." On April 15, that's often quite true, but not an excuse not to *file*.

Years ago, if you filed but didn't pay, the IRS was somewhat slow to act. Even now, the sky does not fall immediately, but instead the IRS issues a series of notices requesting payment of the tax, interest, and penalties shown on the return or substitute for return. The tone of these notices gets progressively more urgent and eventually the IRS collectors move into action.

A delinquent taxpayer has many ways to avoid enforced collection, even if he owes money on April 15. But the worst choice is not to file. Among other things, you will automatically be subject to the late-filing penalty (5 percent per month on the unpaid balance, up to 25 percent) for every month or part of a month a return is late. That penalty is easy to avoid-simply file on time-but hard to abate. Filing a balance-due return does mean the late-payment penalty will be imposed, but this penalty is a modest 0.5 percent to 1 percent per month. True enough, the day of reckoning for the balance due is advanced somewhat if you file on time, but that's preferable to the heavier late-filing penalty.

A third excuse is: "I'm getting my records together." Variations are: "I never got my W-2," or "I'm waiting for a Form 1099," or "I have all my records, I just haven't organized them, or "The dog ate them." If records truly are missing, you can always file for an extension; the latest one is to October 15 of the filing year. But these are your records; the law says you have a duty to keep them in sufficient shape so you can file on time. It defies common sense to risk a 25 percent late-filing penalty when you can opt for the 1 percent late-payment penalty.

Helpful Hint: One inelegant but workable solution is the "shoebox" approach. Throw all your financial papers into a shoebox (or something like it). Bring that to your return preparer.

These are only some of the excuses. Dozens of others have been used, limited only by the nonfiler's imagination.

Reasons That Work

The law does give credence to good excuses for late filing, that is, "reasonable cause." You are not relieved of the legal duty to file and pay the tax and interest. It just means that there was a good enough reason to excuse some of the penalties. Guide 2 lists the most common, "IRS approved," reasonable causes.

In the real world, it's rare to encounter most of them. The one that comes up often is the "serious illness" of the taxpayer or a member of his immediate family. The IRS understands and accepts the plight of some ill nonfilers. Its own studies found that many people don't file because some terrible, traumatic event or series of events so debilitated them that it caused the nonfiling. Chronicles of these events are sometimes heart-rending, but they are the stuff of real life, and the IRS understands them if you document them properly and in detail.

> Examples: A nonfiler suffered through a terrible youthful marriage, a bitter separation, mental and physical abuse. The other spouse also extorted money over a period of years because of the nonfiler's infidelity. All of this culminated in a bitter divorce. This nonfiler had reasonable cause to abate the late-filing and late-payment penalties.
>
> Another successful case might be the nonfiler who became addicted to drugs or alcohol, sliding into ever deeper states of dependence and depression leading almost to suicide, before turning her life around through a support group such as Alcoholics Anonymous.
>
> A third example might be the struggling salesperson, the sole support of his mother and father. The parents came down with simultaneous cases of terminal, inoperable cancer, and died within one year of each other. Another is a business disaster: the nonfiler had put heart, soul, and all of his money into a venture, to the neglect of family and friends, only to have the entire business collapse in a period of several months.

In each case, the IRS ruled there was "reasonable cause" for late filing. The "illness" reason for nonfiling often traces roots to childhood, with events from early life showing illness or personality traits that, combined with more recent causes, resulted in the nonfiling. When events like these overwhelm you, even the IRS seems to understand why filing a tax return becomes of secondary importance.

Getting Back into the System

Twenty years ago, the IRS launched a nationwide campaign to entice nonfilers back into the ranks of the taxpaying and return-filing public. Spearheading that effort was a nationwide task force of two thousand revenue agents and tax auditors who looked for the nonfilers and tried to bring them back into the system. The IRS mandated each of its local districts to begin the program, and publicized the program in speeches and news releases.

The IRS' own studies and its internal manual of procedures name these callings as most likely to harbor nonfilers and produce the most tax:

1. manufacturing apparel
2. trucking and warehousing
3. wholesale groceries and related products
4. legal services
5. wholesale dry goods and apparel
6. manufacturing and machinery (excluding electrical)
7. mining and quarrying
8. general construction
9. retail automotive dealers
10. laundry and dry cleaning
11. automobile repair

The agency's computers augment the effort through machine-matching of information reports such as forms W-2 and 1099 to filed returns. If the computer checks a W-2 or 1099 against your account and finds no return on file, it generates a notice and several follow-up notices if you don't respond to the first. These notices mean you have been discovered. Usually a total failure to respond means your case will be referred to an agent on the task force. The agent or another IRS representative will call, write, or visit-and begin the process of getting you to file willingly, or not.

When the IRS representative catches up with you, he or she will make a judgment as to whether your case should be referred for criminal investigation and possible prosecution. Statistically, few cases become criminal, but you never know if yours will be the unlucky one. To make a criminal case for nonfiling the agent typically looks for "badges of fraud," that is, illegal sources of income, the hiding of assets, a complete refusal to cooperate, transfers of property, and the like. High-dollar cases and taxpayers who deal in cash, are prime targets for criminal investigation. But everyone, whether prosecuted or not, will then enter the nonfiler system. The assigned revenue officer also will look for a pattern of delinquency over several years, the taxpayer's education level, and other factors.

Tip: Non-filers delude themselves into thinking they won't go to jail even if prosecuted. Wrong! These days, you will definitely get some "hard time."

The revenue officer also considers the amount you owe in deciding whether to refer your case for criminal investigation.

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The nonfiler program offers clear benefits if you come forward voluntarily. By official policy, the IRS will not recommend criminal prosecution of a nonfiler who comes forward on his own and without prior prompting. Of course, full payment of any tax due will stop the running of interest and penalties. The agency is also more open to working with voluntary confessors on agreements to pay any tax due in installments. It may even forgive some of the tax, penalties, or interest under the offer in compromise program discussed in Guide 3.

Most nonfilers don't end up owing a hopeless amount, even for very old tax years. In fact, among all tax delinquents (including those who filed on time but simply owe money), most qualify to pay their taxes in installments over a reasonable time, usually six to thirty-six months.

Unofficially, this is all part of the look that the IRS wants the public to accept: firm, no-nonsense, businesslike attempts to get taxpayers back into the system. The IRS' businesslike attitude toward overdue accounts means it will take steps within the law to make it easier for you to pay, file returns, and pay taxes now and in the future. In short: compliance, not compulsion.

Also, for voluntary confessors, the IRS has said it might look more favorably on "reasonable cause" requests for penalty abatements. In the real world, that pronouncement has proved illusory. But if you have to be dragged, kicking and screaming, into compliance, the IRS will skeptically eye any excuses you may offer. If you have already received a phone call, a letter, or other notice from the IRS, it's not too late to comply voluntarily. But you must respond immediately to be considered a "voluntary" filer.

The Downside of Not Filing

When the IRS catches you, you'll either go to jail, pay big penalties, or both. In most cases, the agency doesn't really want a conviction, only a filed and paid return. So it will content itself with making a Substitute for Return and collecting the resulting tax. The IRS rarely throws the book at someone for nonfiling, but the agency is quite satisfied with several big penalties. The agent will, of course, still try to get you to file. He may also issue a summons to you, requiring your appearance and the production of your business and personal books and records. Failure to obey the summons can result in civil or criminal contempt charges, with the usual and customary jail sentences. Finally, the agent can file an actual return for you and sign it himself, though in most cases, the Substitute for Return is used.

The strongest IRS weapon, criminal prosecution, is the biggest fear of many repeat nonfilers. Nonfiling is a federal misdemeanor (not a felony) punishable by up to one year in prison and/or a fine of up to $25,000 plus prosecution costs, for each year that you willfully failed to file. All states that impose income taxes have analogous criminal penalties. Sometimes, if a nonfiler persists for a number of years, the IRS will prosecute the case as "attempted tax evasion," a felony carrying a maximum fine of $100,000, five years in prison, or both (plus prosecution costs), for each year involved.

Even a willful failure to pay any tax is, in theory, a criminal offense, though that's rarely prosecuted. The IRS' approach to prosecution is both carrot and stick. Around April 15 of many years, the agency often announces a list of "chosen" individuals who have been or will be indicted for failure to file. In all, the Service prosecutes about one thousand nonfiling cases each year and initiates about 5 thousand total investigations. Of these, the “success” rate (that is, people who go to jail) is over 80%!

That's small compared to the estimated 5 million to 10 million nonfilers nationwide. So the IRS prefers to prosecute only the most flagrant cases. Adding to the IRS’ weapons, in 1989 Congress enacted the "fraudulent failure to file" penalty, equal to 15 percent of the tax due per month, up to a maximum of 75 percent. This penalty applies in cases where there are indications of fraud or attempted evasion, but not quite enough to merit criminal prosecution.

Steps You can Take

On April 15, nonfilers mired in records and paralyzed in nonfiling can help themselves. The IRS has not yet caught you, but every day the newspaper features another story about the IRS, the filing deadline, the filing season, or something else to remind you of your secret. So, you make up your mind to catch up. How to start? Beyond question, the first step is: Get help. You can't do it yourself. (You’ve already proved that.) You may need anything from a gentle nudge to a major transfusion of courage, but you need something. The mild encouragement of a spouse or friend, a few wise words from a tax professional, or assistance from a tax attorney or even from the IRS itself may be enough. But you've procrastinated too long-someone else needs to know about your problem, and ride herd on you until you get the job done.

Non-filers with new found determination think they can do it alone. But do not try this "experiment" at home. Just gather all your records and shove them at the preparer. Don’t try to sort them. If it has a number on it, take it to the preparer.

<u>A five-part filing program like this may ease the way</u>:

1. Prompt and full disclosure to a lawyer or other tax professional

2. Preparation of the returns quickly and accurately-by a lawyer, accountant, enrolled agent, or other authorized professional tax return preparer

3. A plan to pay or settle any taxes the returns show are due

4. If necessary, a full and powerful statement of reasonable cause for nonfiling

5. Luck (but sometimes you can make your own)

Many nonfilers need a team composed of a return preparer (such as an accountant or enrolled agent) and an attorney. The preparer's task is to prepare the returns. If necessary, the attorney can review them from a legal perspective and present them effectively to the IRS. A useful rule of thumb is: If three or more years are involved, first see a lawyer experienced in tax matters.

Three or more years of nonfiling increases the chances of criminal prosecution, so you may need criminal defense work or legal advice on the civil penalties in addition to accounting help.

The attorney-client privilege shields most discussions you have with an attorney (though not all). Under the 1998 tax act, even some nonlawyers have a tax advice privilege, but that narrow shield does not apply in criminal cases. Absent a privilege, the IRS can force these nonlawyer professionals to reveal anything you say to them, and you may be sure what you say can and will be used against you. Therefore, route all discussions through an attorney at least until it's clear that the likelihood of prosecution is small and a client privilege unnecessary. But beware: Even if you go first to an attorney, not all communications will be privileged. Your lawyer can advise you on this point.

Your lawyer will also explain in detail the civil and criminal penalties and discuss the likelihood of criminal prosecution (small if the returns are filed quickly and before the IRS catches you). However, civil penalties for late filing and late payment are certain to be imposed if you owe taxes. Sometimes the IRS will suspect fraud and assess additional tax penalties unless you can prove reasonable cause for the nonfiling.

Once this disclosure process is under way, keep it on track, a task often harder than it sounds. The nonfiler excels at procrastinating; initial good intentions usually fade. Once the nonfiler is into the tax return process, almost invariably he becomes complacent and reassured-the very syndrome that caused the nonfiling in the first place. Delay ensues and sometimes never ends.

After you evaluate the danger of criminal prosecution, the next step is to prepare and file the returns. Those returns must be accurate the first time and totally defensible if they are audited. But they must also be prepared quickly, especially where your lawyer advises prosecution is likely if the IRS catches you before you file. The preparer should lean toward conservatism, taking all lawful, provable deductions but avoiding those for which there is inadequate proof. Above all else, every penny of gross income must be reported.

<u>Helpful Hint</u>: Finding all your earnings from the dim, dark past is hard. Two great ways:

1. Have your preparer request "third-party payor" reports from the IRS;

2. Add up your bank deposits for each year, then subtract transfers. Throw in the cash you got but never deposited. This should match your gross income.

The attorney or preparer will often check behind the client by performing one or more indirect analyses of the correctness of the return and the gross income reported. Even as you prepare the returns, develop a plan to pay or compromise any back taxes; the IRS will demand payment a short few weeks or months after the returns are filed. If there is no balance due, this is not a problem. But often, and unexpectedly, there is a tax due. Addressing the collection problem up front helps persuade the IRS that you are sincere and committed. That perception, in turn, may limit civil penalties and ease the pain of payment.

Tip: Also, remember state returns, which normally follow and parallel the federal returns. The state tax liability can also be large, so include it in your thinking and planning.

The nonfiler for three or more years should also discuss the reasons the returns were not filed. In many cases, exploring those reasons in depth unearths traumatic events that caused the nonfiling. If the penalties are large enough, it may be cost-effective to prepare a detailed affidavit explaining the reasons, with any supporting documentation and statements you can find. So, make a judgment about how far to go and how much effort and money to spend on a showing of reasonable cause.

What's "Reasonable" Cause for Not Filing?

Officially the IRS will accept eight reasons for filing a late return. These are:

1. The post office delayed your return;
2. You filed the return in the wrong IRS office;
3. You relied on erroneous information given to you by an IRS officer or employee;
4. The taxpayer died or was seriously ill, or there was death or serious illness in the immediate family;
5. The taxpayer was unavoidably absent;
6. The taxpayer's business or business records were destroyed by fire or other casualty;
7. The IRS didn't supply the right forms in enough time to file; and
8. You tried to get help or information to prepare your return from the IRS, but its representative didn't meet with you.

Of these reasons, the first two, postal delays and filing in the wrong office, are self-explanatory, but you must prove the postal delay. It's easier to prove filing in the wrong IRS office because that office sends the return back to you. (Keep the envelopes!) If the IRS gave you the wrong tax information and you relied on it, that's reasonable cause. Even the IRS makes mistakes. Millions of people call in for advice every year (usually between January 2 and April 15).

But the excuse, "I relied on the IRS," is very narrow. The IRS has to have given you advice that you "reasonably" relied on. So if the advice is totally off base, you won't have reasonable cause even if you relied on that advice. Also, the information on which the advice was based must have been accurate and adequate. And the burden to prove all of this is on you!

The fourth reason-death or serious illness-is one the IRS and practitioners see often. As noted above, it can be mental or physical illness, addiction to drugs, mental trauma caused by life events such as a business disaster, divorce, or separation. Serious illness has to be proved, credibly and completely. It must also cover the periods of nonfiling.

Unavoidable absence is also narrow. Very few absences are deemed "unavoidable" for this purpose. Records destroyed? Be prepared to prove date, time, and place, furnish police, fire, or insurance reports, and tell what efforts you made to get copies or recreate them.

When all is said and done and you are back in the tax-filing and tax-paying system, you may find to your relief that you owe no back taxes. You and the IRS simply have a newfound relationship, and life goes on. But if you owe money, you then have to deal with the Collection Division. It's not as bad as it sounds, even though the IRS has many weapons at its command and you have limited defenses. In the last ten years, the IRS, without in any way getting soft on collection, has made paying taxes less painful by many different programs and techniques. These include forgiving some taxes altogether if the IRS concludes you will never be able to pay them.

The "Tax Police" – Criminal Investigation Division

The third big headache is that greatly-feared animal, the criminal investigation.

What feeling do you get when you receive a letter with the return address, "Internal Revenue Service"? Many law-abiding citizens with healthy superegos think, "Oh my God, I'm going to jail." The fact is, though you need not fear the IRS' Criminal Investigation Division (CID) unless you have committed a tax crime, the fear factor in tax crimes is pervasive. After all, tax fraud, not bootlegging or murder, sent Al Capone to jail. And it is tax fraud that gnaws at otherwise honest people when they "shave" a little on their returns. Given the infrequency of tax prosecutions, the Criminal Investigation Division of the IRS generates fear far out of proportion to its actual impact.

Fun Fact: In part this is due to the high profile of some cases and to the odds: anyone investigated by CID statistically has an 80% or greater chance of actually going to jail. In fiscal 2012, CID opened over 5,000 cases. Of those, 3,700 were referred for prosecution; there were 2,600 conviction.

There is extraordinarily wide variation in who is prosecuted, and how many. Some areas of the country are more prone to tax evasion cases than others. The agents may be more or less aggressive in certain areas of the country. The U.S. Attorneys who prosecute these cases may be more interested in one area of the country, or one area of the law, than another. While it may be desirable to have the criminal tax laws applied uniformly throughout the country, the fact remains that there is wide variation in prosecuting tax crimes.

Each IRS district around the country has at least one CID "group." A group consists of "special agents." Their job is to investigate suspected criminal violations of the tax laws and related offenses, such as assault on a revenue officer or seizure by the taxpayer of levied property.

Most criminal cases involve the charge of tax evasion, that is, failing to report all income or overstating deductions with specific intent to evade the tax laws. CID also investigates a fair number of nonfiler cases, about one thousand a year, an occasional failure to pay case, and a variety of other tax crimes. Altogether, CID has authority to investigate about thirty tax and nontax crimes.

How CID Starts a Case

Most criminal tax cases arise from routine audits, that is, tax audits of an individual, corporation, partnership, or exempt organization. Sometime during the audit, the revenue agent spots something that does not pass her "smell test." It could be a big bank deposit that somehow doesn't square with the tax return, the absence of an expected deposit, an overstated deduction, a business deduction that is grossly wrong, or the use of many or fictitious corporations. It could be a cash hoard or anything else that seems to be unaccounted for and untaxed.

When the revenue agent spots this, she does not immediately throw the cuffs on. She asks for an explanation. If the explanation does not ring true, she has what is known as an "unexplained indication of fraud." At this point, she pulls out Form 2797 (Referral for Potential Fraud Case), a one-page information report to CID. The form asks CID if it is interested in the case. The agent suspends her audit until CID responds. Special agents do not accept every case; they accept the most promising ones or the ones that have the most potential for publicity. After all, headlines are part of their job of enforcement and compliance.

Survival Tip: Whenever you learn – or even suspect – that you may be in CID's gun sights, STOP EVERYTHING! Immediately call a tax lawyer familiar with CID cases and GET HELP!

The winds of case selection blow hot and cold; they also change direction frequently. In the 1970s and 1980s, tax shelters and drug and gambling cases filled CID's plate. The 1990s and 2000s saw a shift to money laundering, cash businesses, and traditional tax evasion cases. In 2009, CID became involved in active case selection of "offshore account" cases, that is, those involving "secret" bank accounts in foreign countries.

Every new IRS commissioner seems to bring a different policy slant to CID case selection. Generally though, CID goes for either the most publicity-worthy cases or the ones that will yield the most money or promise the greatest deterrent effect. If the special agent and her group manager agree, they open, or "jacket," the case, and the agent begins the investigation. Often these cases are investigated jointly with the revenue agent, who acts as the special agent's assistant and works the numbers in detail. That cooperation is critical because the special agent must accumulate evidence beyond a reasonable doubt that a substantial tax was actually evaded. The revenue agent often has more expertise than the special agent in the accounting aspects of this task.

The second big source of cases is information reports. For example, someone may file a Currency Transaction Report showing more than $10,000 in cash deposited into a bank account. Another source is the confidential informant or tipster. An example could be a fired employee who knew the boss was skimming cash. Other tipsters could be an unhappy wife, husband, or partner, or anyone who has a gripe against an evading taxpayer. CID also often receives information from other law enforcement agencies, such as the Drug Enforcement Agency, the Bureau of Alcohol, Tobacco, Firearms and Explosives, the FBI, and local law enforcement agencies. CID will listen to anyone, anytime, and it can pay rewards-up to 15 percent of the taxes recovered.

Investigating the Case

Both agents then begin to investigate your case. Before you ever know they are around, they have looked high and low for information about you, the "subject." The first phase is background. They check everywhere-public records, lien searches, military history, postal covers (a request to the post office to record who sends you mail, and when), national computer banks, newspapers, electronic data sources. They check the Internet and the Web if those seem a likely source of information. The special agent's manual gives them more sources of leads than they could possibly use, but they look at every one they can. The IRS does not engage in court-authorized wiretapping, except for the occasional use of pen registers, which record the numbers of all outgoing calls. These will ordinarily be used only in gambling and other organized crime cases. Very infrequently, CID will resort to search and seizure warrants. Often, however, agents will "piggyback" on other law enforcement warrants if you are the subject of some other agency's attention.

The second phase may well be confidential interviews. They may talk to customers, suppliers, friends, neighbors, and acquaintances. The agents find out all they can about you. They examine your reputation for honesty and look for other problems you may have, such as money, marital, or other personal problems.

In the third phase, they appear at your front door, badge and credentials in hand, demanding an interview. This is almost always a surprise if they've done their job well to that point. It's astounding how many targets will, at that point, invite the agents in, close the door, and confess their tax crimes in a four-hour interview. If the agents successfully do that, in most instances their case is made and the rest is paperwork. It's all over but the sentencing. If not, they have to prove their case out of other evidence.

Survival Tip: If the agents come to your door, stop what you're doing and get legal help immediately. Tell the agents you want to consult a lawyer. Never, ever, try to explain your way out of this problem. Even if you are as innocent as a newborn lamb, something very serious has occurred to cause a Treasury law enforcement agent to appear at your door, and there is no safe way for you to deal with it without immediate, competent legal counsel.

In this third phase, the agents also launch searches for records where the fact they are searching becomes known to the subject. This would include compulsory summonses to the taxpayer, his business, banks, brokers, accountants, and any other third parties the agents think might have knowledge of the taxpayer's finances or tax transactions. The fourth stage (sometimes the third) is to formulate a method of proof-how to reconstruct your true tax picture to show where and how you cheated. The final stage is the recommendation for prosecution or nonprosecution. The agents assemble all the data, mark their exhibits, create huge, thoroughly indexed binders of documents, referenced and cross-referenced. These exhibits and the witnesses who will identify them are their case. They forward the case through the group manager. Eventually, it winds up in the hands of the U.S. Attorney's Office for prosecution. There, a case may be further developed by a grand jury investigation.

How CID Proves a Case

To prove you cheated with criminal intent, the special agent typically selects one of three principal "methods of proof." The first is the "specific item method," a so-called direct method of proof. As the name of this method implies, the agents have found one or more specific items you have omitted from a return or specific deductions you have overstated (the "smoking gun"). They could find these from bank accounts, canceled checks, or business deductions for personal expenses or from deductions that are wildly overstated. Special agents love specific item cases because they are easy to make. The agents can assume that the rest of your return is right and still get a conviction.

> Example: George was a general practitioner of medicine in Maine. He was a fine doctor but accounted for his fees in a somewhat unconventional way. Many of his patients paid in cash, so each day his receptionist prepared a list of cash and checks and put them on a deposit slip. Then the doctor personally went to the bank to make a deposit. Of course, a little of this might have slipped into a safe at home, until it accumulated to a tidy sum. Then he put that money in a separate bank account. The IRS added all of his bank accounts, subtracted out gifts, transfers, and loans, and compared the resulting figure to the doctor's income-as he reported on his tax return. Not enough, according to the IRS. The doctor was convicted. Although he tried to overturn the conviction by showing that he had previously taxed cash on hand at the start of the year (which the IRS disputed), the court sustained the conviction.

Two other principal methods are called "indirect" methods, where the agents prove, indirectly, that you evaded your taxes. One is the "bank deposits method." In this method, the agents add all your bank deposits for each year and subtract transfers from one account to another. The difference is presumed by law to be taxable. If you have net $200,000 of bank deposits but you reported only $100,000 on your tax return, you've got some explaining to do. In case after case, the courts have sustained that method of proof as valid and constitutional.

The second indirect method is called the "net worth and expenditures method." This one is harder to document, but agents have used it effectively for years. In this method, the agents establish your net worth at the beginning of one year and then prove the level to which it grew at the end of one or more additional years. The increases in net worth, plus your other spending, must have come from somewhere. If they arose because you received loans, bequests, or gifts, no problem. But if you cannot account for these large increases in net worth and expenditures as nontaxable, the law presumes them to be unreported taxable income. Many a conviction has been obtained by this method.

> Example: William and Katherine immigrated to the United States. Believers in free enterprise, they engaged in the freest possible enterprise by conducting the oldest

possible profession, big time. According to their tax returns, however, things were not very profitable. They reported only $11,500 in each of three years. But according to the IRS, that was slightly below their real income. Why could the IRS think this? It might have had to do with the couple's purchase of a $420,000 home with $135,000 down, plus their depositing more than $250,000 in cash into fourteen separate bank accounts. Based on these and other facts, the IRS concluded that the couple's net worth was largely unaccounted for, so it must be unreported income. "Right," said the jury and the judge. The cash deposits, their false statements and evasiveness with their hired accountant, and the lack of any other explanation showed that William and Katherine had intentionally violated the tax laws.

Defending Against the Investigation

Is there anything you can do to defend against these investigations? Your options are limited, but you can take a few steps. First and foremost, never let the special agents interview you. This first defense is simply the assertion of your constitutional privilege against self-incrimination. (However, it is not a defense, in a failure to file case, to plead the Fifth Amendment privilege against self-incrimination.) When they come to the door, you should politely but firmly state, "I do not wish to be interviewed, and I would like to consult my lawyer." Special agents understand this and will rarely press the point. Then immediately drop what you are doing and call your lawyer. In any criminal investigation, particularly a tax investigation, you will need a criminal defense lawyer well-versed in tax matters. Then follow your lawyer's advice!

Tip: Another mistake people make is to begin transferring assets. This not only shows a guilty mind, but also probably will do no good. After all, the IRS has full authority to make jeopardy assessments and seize property, even when it's transferred to someone else's name. And it probably constitutes a new, separate crime. Moreover, good special agents watch for this very thing; it helps prove the element of criminal intent.

A second defense is the "voluntary disclosure" defense. This applies in almost every case of nonfilers. An evader can also sometimes escape prosecution with this defense. It consists of filing original or amended returns and fully paying the taxes, penalties, and interest before the special agents make their first contact. The Justice Department's policy of nonprosecution in such cases is usually honored.

A third possibility is a grant of immunity. This is rarer, but on occasion taxpayers have negotiated for a grant of "use immunity." This means the Department of Justice will not prosecute you as to documents and information you voluntarily disclose.

Fourth, you may try to attack the agent's method of proof. For example, if the agent finds an extra $50,000 of unexplained bank deposits, explain them by showing that they were a gift, loan, or inheritance (if that is true). Several other defenses may be available, defenses not reserved to tax cases alone. For example, showing that you relied on a lawyer's or accountant's advice to report a deduction or omit an income item might be a defense. But "advice of counsel" must be proved, and you must show that you disclosed all the underlying facts to your professional adviser. This defense is a variation of the "good faith" defense, in which you argue that for one reason or another, you did not violate a "known" legal duty.

Mental incapacity is also a defense, but that too must be clearly proved. Still, occasionally this defense is successful. As in any criminal investigation, your maneuvering room is usually limited. After all, CID accepts only the investigations it feels have solid conviction potential. If you are to stop this investigation, it's usually at the agent's level or not at all. Even when the agents fail to make a criminal case, they often recommend the civil fraud penalty-75 percent of the understated tax. The lesson is simple: A criminal investigation can have no happy ending except the rare one of no prosecution or an acquittal.

Summary of Tips

1. Anticipate jeopardy assessments, but if you can't, fight them either in court or within the IRS.
2. The IRS is serious about tracking down nonfilers; nonfilers usually can't hide forever.
3. Nonfilers should immediately consult tax professionals – attorneys and return preparers – to get back into the system.
4. Most nonfiling situations can be successfully resolved, but it takes motivation and hard work.
5. If you suspect the IRS is about to open a criminal case, stop everything and talk to a lawyer.
6. Don't try to hide your assets; that only makes things worse.

About the Author

Robert Nath is nationally recognized as an authority on tax matters. He holds degrees from Yale, the University of Pennsylvania, and Georgetown University. After clerking for a federal judge, Mr. Nath litigated tax cases for 8 years with the Tax Division, U.S. Department of Justice. Since 1984, he has been in private practice advising taxpayers, accountants, and attorneys on tax procedure and controversy matters, as well as representing them before the IRS and in court in tax collection, audit and tax litigation matters.

Mr. Nath is the author of numerous publications, including:

- "The Unofficial Guide to Dealing with the IRS" (Macmillan),
- "Personal & Business Tax Traps Guide,"
- "Getting Information from the IRS Guide,"
- "How the IRS Operates Guide,"
- "IRS Collection Weapons Guide,"
- "Surviving an IRS Audit Guide,"
- "Make a Deal with the IRS Guide,"
- "Taking the IRS to Court Guide."

Mr. Nath's views have been noted in New York Times, the Washington Post, The Wall Street Journal, the Los Angeles Times, Business Week, Money, Kiplinger's Personal Finance and other national business periodicals on tax procedure topics, appeared on radio and television programs, edited professional journals and his articles have appeared in law reviews and other legal periodicals.

Mr. Nath is a former Green Beret (Major) in the United States Army Reserve.

Robert G. Nath, Tax Attorney
Concentrating in IRS and State Tax Controversy Matters

Robert G. Nath, PLLC,
1775 Wiehle Avenue, Suite 400,
Reston, VA 20190

http://www.Rnathlaw.com