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What to do When Tackling Tax Troubles

When a tax problem arises, it's not uncommon to become overwhelmed by it. No doubt, much of the anxiety stems from whether the problem can be solved and how to do it. Over the past few years, a proliferation of advertisements from self-professed "tax experts" have flooded the airwaves, promising great results for individuals facing tax troubles.

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Viewpoint

As most people know, when the flashy ads sound too good to be true, they usually are. What is not revealed in these sound-bite splashes is that most of these so-called experts take a very narrow "one-size-fits-all" approach to dealing with tax problems. While it is true that *sometimes* it is possible to settle a tax debt for a fraction of what is owed, very often this option is not available because of the taxpayer's circumstances. Often, many options need to be evaluated before a decision is made on how best to handle a tax problem. An experienced tax professional will approach the situation very differently than the 1-800 marketing mills.

As a general rule, a tax problem needs to be evaluated in two distinct phases. Phase I deals with *how much* is owed. Phase II deals with *how to pay* the amount owed. Most of the time you know whether you are in Phase I or Phase II of the process. For example, if you receive an IRS audit notice, you are clearly in the early stages of phase I. If you receive a collection notice after filing a tax return without full payment of what you agree is due, you are in Phase II. But what if you never filed a tax return reporting a balance due and now the IRS has levied a bank account? Where are you in the process? What are your options?

While there are often "typical" situations when tax problems arise, solutions work best when tailor-made for the specific taxpayer in question. Evaluating where the taxpayer is in the process helps determine available options. The "one-size-fits-all" approach may result in a resolution, but it may not be the best solution.

Phase I considerations: What do I owe?

Most income-tax obligations arise through filing a tax return that reports a balance owed. This situation is typically referred to as a "self-assessment," since the taxpayer is volunteering, under penalties of perjury, what he acknowledges to be his obligation. Even after a self-assessment is made, the amount owed can still be changed by the taxpayer or the IRS. The taxpayer can seek a change by filing an amended return. The IRS does so through an audit. As a general rule, any such change must occur within three years of when the return was filed.

In the case of an audit, if the taxpayer does not agree with the proposed audit adjustments, he/she has both administrative and judicial appeal rights. The vast majority of administrative appeals are resolved without having to go to court. The audit and appeal process can take months, sometimes years. But, as long as this process is ongoing, the taxpayer is still dealing with Phase I issues. It's only after the taxpayer has foregone or exhausted all these options to determine whether and how much is owed, does the tax problem move to Phase II of the process.

As long as a taxpayer is in Phase I, the IRS usually cannot take collection activity (Phase II). But that's not always the case. For example, if no tax return is ever filed, the IRS can determine a person's tax liability based upon information that's been reported by third parties (for example: W-2s and Forms 1099).

When a tax liability arises from this process, it is said to come from a "substitute for return." If the IRS goes through the substitute-for-return process, an amount due has now been determined (Phase I), so collection activity (Phase II) will start. When the IRS prepares a return for a taxpayer, usually the amount it determines to be owed is significantly higher than what would have been owed had the taxpayer filed the return herself. Under these circumstances, it is usually beneficial to prepare the actual return for the year in question so the correct tax debt can be determined (Phase I).

Another instance when Phase II collection activity may occur before Phase I ends is when the IRS imposes penalties for the late filing of a return or the late payment of the tax owed. There may be no question that the underlying tax obligation is due, but the circumstances that caused the late filing or late payment may serve as a basis to have penalties abated. Penalty-abatement requests need to be submitted in writing and the written request must demonstrate reasonable cause. Considerable guidance exists on what is a reasonable cause, and things like serious medical issues or catastrophic events usually qualify.

Each of these Phase I examples — the substitute for return and penalty-abatement request — muddy the Phase I and Phase II distinction. In these situations, Phase I issues to be addressed, but IRS collection activity may also be well underway. Therefore, Phase II issues are also in play.

Any time the IRS asserts a liability that does not arise from the tax return filed by the taxpayer, the possibility of there being a "Phase I issue" should be considered. After it has been determined that Phase I is over, it is time to address

Phase II.

Phase II considerations: What (and how) to pay?

When taxpayers are in Phase II of a tax problem, they are dealing with the collection efforts of what is generally regarded as the most powerful creditor in the country. In most cases, the IRS has 10 years to collect unpaid taxes and the laws enable the agency to have considerable advantages when doing so. Having said that, the IRS can be expected to follow the rules quite carefully, thus making the agency one of the most predictable creditors with which to deal.

In Phase II, three different outcomes can generally be pursued: no payment, partial payment, or full payment. Aside from the obvious distinction between these options, other considerations also exist. While of course the "no payment" outcome may seem appealing, this requires a determination that the taxpayer is presently unable to make payments — in IRS parlance, the account is marked "currently not collectible" — and it may not necessarily be a lasting solution. A "currently not collectible" determination is based upon detailed financial disclosure that demonstrates the taxpayer presently has neither liquid assets with equity, nor income in excess of necessary living expenses available. Because the tax debt is not canceled under these circumstances, should the taxpayer's financial situation change before the 10-year collection period expires, the IRS may resume collection activity. For this reason, the no-payment option does not necessarily offer closure.

The full-payment option typically involves negotiating the timing for payment, and significantly, ensuring that more aggressive collection activity, such as the filing of tax liens and issuance of tax levies, does not occur while payment is made. As a general rule, the sooner the payment is made, the easier it is to keep the IRS collection activity on hold. A promise of full payment within 60 or 90 days is usually enough to prevent such activity. The promise to pay over four or five years will almost certainly result in the filing of a tax lien. Factors such as the total amount owed, a history of noncompliance, and the type of assets all come into play when structuring payment plans.

The partial-payment option — the offer-in-compromise program — is the option that is getting the most publicity these days. There is nothing new about this option as the IRS has been entertaining offers in compromise for some time. The IRS did significantly overhaul the offer program about 20 years ago and it continues to make changes in some of the program rules. This has made the offer option very appealing if a taxpayer's circumstances are right.

Most offers are submitted on the basis that full payment can never be made during the 10-year collection window due to current and anticipated future financial circumstances. Detailed financial disclosure is required in this process. Many rules cover the valuation of assets, calculation of income, and the allowance of expenses that determine a taxpayer's ability to pay.

There is no formula for an offer in compromise. That is to say, there is no minimum percentage of the balance owed that you must offer. If the amount owed is $50,000 and the ability to pay is determined to be $1,000, then the IRS will accept $1,000 in full satisfaction. On the other hand, if the ability to pay is determined to be $50,100, then no amount less than full payment will be considered.

Often when evaluating these Phase II options, one should consider possibly filing for bankruptcy protection. Most income-tax obligations that are more than three-years old may be discharged in a bankruptcy action. The age of an income-tax obligation is determined by the assessment date for the debt. Usually, this is the date on which the tax return is filed for the year in question, but many exceptions and modifications to these rules exist. Certain types of tax obligations, such as payroll-tax related penalties and state sales-tax obligations, are generally not dischargeable in bankruptcy. If an individual has debts other than tax liabilities, the bankruptcy option may be the solution for many problems. A professional focused only on taxes may overlook the value of this option.

Taxpayers need to consider both distinct phases of the tax process to ensure achieving the best outcome possible. Calling upon the experience and guidance of a seasoned tax professional is often the best place to start. ■

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