DEALING WITH THE IRS

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More individuals deal with the IRS than any other federal government agency. The IRS processes more than 100 million individual income tax returns every year. It also collects billions of dollars in taxes. For many people, the first thing that comes to mind when thinking about the IRS is a tax audit, but individuals interact with the IRS in many other ways.

This booklet explores some of the ways that individuals deal with the IRS, including examinations, installment agreements, offers-in-compromise, liens and levies, refunds, and penalties.

> Comment. Federal law gives you many rights and protections as a taxpayer. IRS employees must explain and respect your rights throughout your contact with the agency. If you believe the IRS has failed to respect your rights, a tax professional can help.

EXAMINATIONS

Your return may be selected for examination (aka, audit) by the IRS for many reasons. In some cases, the IRS uses computer scoring to select returns for examination. A computer program assigns a numeric score to returns after they have been processed. Certain scores may trigger an examination. A return may also be selected for examination from information that the IRS receives from third parties, such as from employers that file Forms W-2 and information returns in the Form 1099 series. The IRS also selects returns for examination when it receives information about potential noncompliance with the tax laws or inaccurate filing from individuals and other sources.

The IRS handles many examinations entirely by mail (these are called correspondence audits). In fiscal year (FY) 2012, more than 75 percent of individual examinations were correspondence audits. You will receive a notice from the IRS describing why it believes you have underpaid your taxes. You can usually respond by mail. In other cases, the IRS examination may be face-to-face. In-person examinations are much less common than correspondence examinations.

Many examinations result in no additional tax liability. The IRS refers to these as "no-change" examinations.

During an IRS examination, you can act on your own behalf or have another individual, such as an enrolled agent, a CPA, a registered return preparer, or an attorney, represent you. The IRS examiner will describe the proposed changes to your return. If you agree, the IRS will ask you to sign an agreement form and pay any additional tax you owe, along with interest. If you do not agree with the proposed changes, the IRS examiner will explain your appeal rights.

Comment. One common question is why it often takes the IRS so long to contact a taxpayer after a return is filed. The IRS receives more than 140 million individual tax returns each year. The IRS must match return information with information received from employers, banks, businesses and other payors.

NOTICE CP 2000

One of the most common communications from the IRS is the "Notice CP 2000." Notice CP 2000 shows proposed changes to your income tax return. This proposal is based on a comparison of the income, payments, credits and deductions reported on your tax return with information regarding these items reported to the IRS by employers, banks, businesses, and other payers. The CP 2000 also reflects any corrections the IRS made to your original return when the agency processed it.

A CP 2000 is not a bill. The IRS is asking that you verify the income, credits and deductions reported on your return because the amounts are different from the information the IRS received from other sources. You have several choices. You can agree with the proposed changes, partially agree or disagree.

In many cases, you do not need to file an amended return after receiving a CP 2000. If you agree with the IRS's proposed adjustment, the agency will want you to pay the difference immediately. This includes interest. If you cannot pay the full amount, you may qualify for an installment agreement, which allows you to pay the amount due in installments over time.

Caution. The IRS expects your answer to Notice CP 2000 by the reply date shown on the notice. If you do not reply by that date, the IRS will assume that you agree with its proposed adjustments. The IRS's next step would be to issue you an official "Notice of deficiency." You may ask the IRS for more time to research your records.

SOFT NOTICES

The IRS has been testing what are known as "soft notices" (officially called a Notice CP 2057). A soft notice is not a traditional notice that says you owe the IRS money. Rather, it is a warning that you may not be reporting all of your income to the IRS. The IRS recommends that individuals who receive a soft notice review their returns and file an amended return if necessary.

INSTALLMENT AGREEMENTS

An installment agreement with the IRS allows you to pay your tax debts in monthly installments. If your tax debt does not exceed a certain threshold, the IRS generally agrees to an installment agreement. However, there are some exceptions; for example, if you did not file a return. You can request an installment agreement by contacting the IRS by telephone or submitting Form 9465, Installment Agreement Request. The IRS will review your request for an installment payment plan and notify you in writing if it accepts it.

If your request to pay in installments is granted:

- You may pay a user fee;
- Interest is charged on any tax not paid by its due date; and
- You will be charged a late payment penalty unless you can show reasonable cause for not paying the tax by the due date.

A one-time $120 user fee generally will be charged when you enter into an installment agreement ($52 for direct debit installment agreements). A reduced user fee of $43 applies to lower-income taxpayers. If you pay the full amount within 120 days, you may avoid the user fee.

The Internal Revenue Service's Fresh Start initiative makes it easier for individual and small business taxpayers to pay back taxes and avoid tax liens. The IRS Notice of Federal Tax Lien filing threshold is increased from $5,000 to $10,000. Taxpayers may request a lien withdrawal after the tax lien has been released and can also request a lien withdrawal after entering into a direct debit installment agreement.

> ***Comment.*** Generally, a lien that is released is continued to be reflected in a taxpayer's credit report. When a lien is withdrawn, it is often removed from a taxpayer's credit report.

Taxpayers generally can use an online payment agreement (OPA) on the IRS web site. To qualify, a taxpayer needs a balance due statement from the IRS, a social security number or an individual taxpayer identification number, and a personal identification number which can be created online.

Three payment options are available:

1. Payment in full within 10 days;
2. Payment in full within 120 days; or
3. A monthly payment plan (installment agreement) for taxpayers who cannot pay in full.

> ***Planning Note.*** Taxes can be paid by check or credit card. If you pay by credit card, the payment is processed by a third-party vendor. Any convenience fees you pay to vendor may be deductible if you itemize your deductions. There are no fees to have funds withdrawn electronically from your bank account by the IRS.

OFFERS IN COMPROMISE

An offer in compromise essentially allows you to pay less than what you owe. Consequently, the IRS is not too keen about entering into offers. Unlike some installment agreements, the IRS has complete discretion whether to enter into a compromise. It will consider an offer in compromise if it is based on one or more of the following grounds:

- Doubt as to the taxpayer's liability for the tax;
- Doubt as to the collectability of the tax; or
- Effective tax administration.

Special rules apply to lower-income individuals. The IRS cannot reject an offer from a lower-income individual solely because of the amount of the offer. The offer must be evaluated to determine whether it meets any of the grounds on which an offer may be accepted.

> Caution. The IRS will not consider an offer in compromise unless you have filed all required tax returns.

Individuals must use Form 656, Offer in Compromise, to submit an offer. Additionally, the IRS requires a nonrefundable partial payment of 20 percent of the amount offered or the first proposed installment, depending on the type of offer submitted. There is also a user fee, which the IRS applies to tax

debt. There are additional requirements for offers based on inability to pay.

Payments under an offer in compromise may be made in:

- A lump-sum (five or fewer installments);
- A short-term periodic payment offer, in which the amount offered will be paid in installments within 24 months from the date the IRS receives the offer; or
- A deferred periodic payment offer, in which the amount offered, will be paid in installments over the remaining statutory period for collecting the tax.

While an offer is pending, the IRS cannot collect your debt by levy. Moreover, the IRS is prevented from levying until 30 days after your offer is rejected. However, the IRS can levy sooner if, among other things, it determines that the offer was submitted solely to delay collection.

The IRS Fresh Start Initiative has made some taxpayer-friendly changes to offers but the IRS still prefers that taxpayers enter into an installment agreement whenever possible.

Planning Note. An offer is not rejected until the IRS issues a written notice to the taxpayer, advising of the rejection, the reasons for rejection and the right to an appeal. You can appeal a rejection to the IRS Office of Appeals.

Caution. Defaulting on an offer has serious consequences. The IRS can, among other things, immediately move to collect the entire unpaid balance.

ASSESSMENT

The IRS must make an assessment before it can collect any tax deficiency. The IRS generally cannot make an assessment until it has complied with deficiency procedures. This means that the IRS must first issue the taxpayer a notice of deficiency.

A notice of deficiency describes the basis for and identifies the amount of the tax due, interest, and penalties. The notice also informs you of your right to contact the Taxpayer Advocate Service.

The IRS's notice of deficiency is presumed to be correct. This places a great burden on taxpayers; they must show that the IRS is incorrect. Once the IRS issues a deficiency notice, you have 90 days to file a petition in the U.S. Tax Court. If you do not file a petition, the IRS will assess the taxes.

Sometimes, the IRS can make an assessment without first following the deficiency procedures. These include:

- Taxes shown on the return (these amounts are considered to be already assessed);
- Deficiencies attributable to mathematical or clerical errors on a return;
- A tentative refund that exceeds the correct amount; and
- Certain excise taxes.

Generally, the IRS must make an assessment within three years after your return has been filed. If the IRS does not assess the tax within the three-year period, it may not later attempt to collect the tax either through a court proceeding or by levy. The three-year period starts running the day after your return is filed. Also, the three-year period for assessment does not start over if you file an amended return is filed.

Comment. Returns that are filed early are treated as filed on the due date of the return. For example, Andrew files his 2013 Form 1040 on February 24, 2014. The IRS will treat his Form 1040 as filed on the due date of the return (April 15, 2014).

Exceptions. There are exceptions to the three-year assessment rule. There is no statute of limitations on assessment if you fail to file a return. The IRS may assess and collect the tax at any time. There are also special rules for certain taxpayers, such as foreign persons and individuals serving in the U.S. military in a combat zone. The IRS can also immediately assess a deficiency if the assessment and collection of tax would be jeopardized by delay or otherwise.

The IRS also has additional time in certain situations. The normal three-year period of limitations on assessment is extended to six years if more than 20 percent of the taxpayer's gross income is omitted from the return. The IRS and a taxpayer can also agree to voluntarily extend the assessment period.

COLLECTIONS

The IRS may collect taxes by:

- Obtaining a tax lien;
- Levying on your property;
- Offsetting your overpayment (refund) of tax against your unpaid tax liability; or
- Bringing a collection suit.

The IRS generally has 10 years from the time an assessment is made to collect the taxes. There are some exceptions, however. For example, the collection period is suspended when a taxpayer is in bankruptcy, when a taxpayer requests a collection due process hearing and when a taxpayer applies for a Taxpayer Assistance Order (TAO) from the Taxpayer Advocate Service.

Comment. The IRS cannot contact you anytime day and night about your taxes. Generally, the IRS can only contact you after 8 a.m. and before 9 p.m. The IRS cannot harass you in collecting any unpaid tax. The prohibited conduct includes the threat or use of violence, the use of profane language and making repetitive or otherwise harassing phone calls.

IRS Appeals Division

The IRS Appeals Division handles appeals from taxpayers who are dissatisfied with the results of an examination. In most cases, before issuing a notice of deficiency, the IRS sends a preliminary notice advising the taxpayer of his or her right to appeal (this is called a "30-day letter"). A taxpayer may start an appeal within 30 days after receiving notice from the IRS of the right to appeal. The 30-day letter must identify the amount

of the tax, interest and penalties included in the notice. It must also describe why the IRS believes these amounts are due.

When you request an appeal, your case is assigned to an IRS Appeals officer for review and scheduling of the conference. Conferences are generally held at IRS offices. A conference may be held at another site when it is convenient to do so. If necessary, more than one conference may be held, but the IRS tries to keep the number of conferences to a minimum.

■ ***Planning Note.*** You need to carefully prepare for the conference with the help of a tax professional. The Appeals officer tries to negotiate a settlement on behalf of the IRS.

Some cases are settled in Appeals through concessions by both the taxpayer and the government. Some settlements are reached by compromising on an issue that, if decided, would be entirely favorable to the client or the government.

If the taxpayer and Appeals cannot agree on a settlement, mediation may be available. This procedure attempts to resolve issues without going to court. However, mediation may not be available in certain cases; for example, if the issue is a frivolous issue or the taxpayer did not act in good faith during settlement negotiations.

LIENS AND LEVIES

A lien is a claim against your property to secure payment of a federal tax. All of your property and rights to property are subject to the federal tax lien. The IRS must release the lien within 30 days after the tax liability is satisfied or the taxpayer posts a bond for payment of the taxes. A taxpayer may appeal to the IRS for the release of a lien.

Comment. The filing of a tax lien may hurt your credit score. Therefore, it is essential to work to resolve your tax liability as soon as possible, before a lien filing becomes necessary.

A levy is another way the IRS can collect taxes. A levy is the most powerful way that the IRS can collect taxes. Levying means that the IRS confiscates your property and sells it. The IRS uses the proceeds to satisfy your tax debts.

The IRS can levy on many types of property, including cars, boats, real estate, and rental payments. The IRS can also levy on property that is yours but held by someone else, including your wages and bank accounts.

A levy may not be made unless there has been an assessment of tax, notice and demand for payment, and notice of intent to levy. Generally, a levy may not be made until at least 30 days after the notice of intent to levy is delivered

or mailed. A person whose property is going to be levied upon is entitled to a hearing before the levy is made. The IRS must provide notice of that right before issuing the levy.

Exemptions from levy. Some of the property exempt from levy includes clothing, fuel, provisions, furniture, personal effects, books, and tools necessary for your trade or business, unemployment benefits, a portion of wages and salary, and military disability benefits. Dollar limits apply to some of these exemptions. Your principal residence is exempt from levy unless a court approves.

COLLECTION DUE PROCESS

Generally, the IRS cannot levy on your property unless it notifies you in writing of your right to a collection due process (CDP) hearing before the levy is made. The IRS must hold a CDP hearing if you request one within 30 days.

If the 30-day period has passed, taxpayers may request an "equivalent hearing." This is similar to a CDP hearing but there is no right to judicial review.

CDP hearings are held by the IRS Appeals Division. The hearing is conducted by an impartial IRS agent with no prior involvement in your case. You can challenge the appropriateness of the IRS

collection actions and offer collection alternatives. However, a CDP hearing generally cannot address the assessment underlying the deficiency.

After the hearing, the IRS Appeals Division notifies you of its decision. You have 30 days to file a court petition if you disagree with the IRS.

■ ***Planning Note.*** A CDP hearing is not like a formal court hearing. In certain cases, it can be done by telephone rather than in person.

CLOSING AGREEMENT

A closing agreement is a final settlement of a tax issue between you and the IRS. The IRS is often reluctant to enter into closing agreements because they are final. The matters covered by the agreement may not be reopened except upon a showing of fraud, malfeasance, or misrepresentation of a material fact.

Generally, the IRS prefers instead to settle cases by less formal means.

Because a closing agreement is final, it must be carefully drafted. It is essential that closing agreements set forth the basic facts in clear, straightforward language. Closing agreements should only be drafted by tax professionals.

REFUNDS

Taxpayers are entitled to a refund or credit for taxes overpaid. However, the IRS will not automatically refund your overpayment. Instead, you must file a claim for refund. Typically, a refund claim is made on your annual federal income tax return. If an overpayment is discovered after you have filed your return, you must file an amended return.

Refund claims must be filed within either:

- Three years after the return to which the overpayment relates was filed; or
- Two years after the tax was paid, whichever period expires later.

> Comment. If you did not file a return, any refund claim must be filed within two years after the time the tax was paid.

Sometimes, the IRS will extend the time for filing for a refund. For example, the IRS often gives victims of natural disasters additional time to file for refunds. Individuals serving in the U.S. Armed Forces in a combat zone also have more time to file for a refund.

> Caution. Your tax refund may be less than you expect if you owe a debt to a federal agency or unpaid child support. The government will apply your refund to that debt. Any portion of the remaining overpayment is refunded to you.

AMENDED RETURNS

If you need to make a change to a return that has been filed with the IRS, you can file an amended return. Individuals use Form 1040X, Amended U.S. Individual Income Tax Return. Form 1040X must be filed on paper. You cannot file Form 1040X electronically.

Individuals file amended returns for many reasons. You may have incorrectly reported your filing status, income, deductions, or credits. Sometimes, an amended return will increase your tax liability. In other cases, an amended return could generate a larger refund.

> Comment. You do not have to amend a return because of a math error on your original return. The IRS will correct math errors and advise you of its recalculations.

PENALTIES

The IRS can impose two types of penalties: civil or criminal. There are penalties for many types of taxpayer misbehavior, such as failure to pay taxes when due and the late filing of tax returns. Since

many of the failures that give rise to civil penalties can also give rise to criminal penalties, a single violation can often result in both a criminal penalty and a civil penalty.

If a return is not timely filed or if tax is not timely paid, a penalty is imposed unless you show that the delay resulted from a reasonable cause rather than willful neglect. For failure to file a timely return, the penalty is five percent of the net amount of tax due for each month or partial month of the delinquency, up to a maximum of 25 percent. The failure-to-pay penalty is generally one-half of one percent of the amount of the unpaid tax for each month of the delinquency, up to a maximum of 25 percent for 50 months.

Comment. If you are liable for both penalties, the failure-to-file penalty is generally reduced by the amount of the failure-to-pay penalty.

The IRS can also impose what are called "accuracy-related" penalties. An accuracy related penalty may be imposed if your underpayment is because of negligence or disregard of the tax rules or if there is a substantial understatement of income tax.

The amount of the accuracy-related penalty is generally 20 percent of the portion of the underpayment resulting from the misconduct. The accuracy-related penalty may be imposed only if a

return is filed. If the return is filed late, both the accuracy-related penalty and the penalty for failure to timely file may be imposed.

Comment. The IRS may not impose an accuracy-related penalty if you can show that there was a reasonable cause for the underpayment and you acted in good faith.

The IRS can also impose penalties on individuals who assert "frivolous positions." A frivolous position is one that has no foundation in the tax law. Frivolous positions include claims that wages are not income, the IRS is unconstitutional and only employees of the federal government are required to pay federal taxes.

Sometimes, the IRS will agree to remove a penalty. The IRS has great discretion whether or not to remove a penalty. Taxpayers have to show, among other things, that they acted in good faith. In certain cases, the IRS will waive a penalty.

Many of the failures discussed above in terms of civil penalties can also give rise to

criminal penalties. There are a variety of both felony and misdemeanor tax crimes, including attempted tax evasion, failure to file a return or pay tax, filing a false return, and aiding and abetting the filing of a false return. The government must prove each element of a tax crime beyond a reasonable doubt. The statute of limitations for prosecution is generally three years but is longer for some offenses.

TAXPAYER ASSISTANCE SERVICE

The IRS's Taxpayer Assistance Service (TAS) is a special office devoted to helping taxpayers resolve disputes with the IRS. Congress has given TAS authority to assist taxpayers experiencing, or about to experience, a significant hardship. TAS can issue a Taxpayer Assistance Order (TAO), either ordering the IRS to take an action or to cease an action, or ordering the IRS to review a decision already or about to be made. For example, TAS may direct the IRS to release a levy on a taxpayer's property.

IRS LETTERS

The IRS uses many types of letters to communicate with taxpayers. All of the letters are known by their number. Here's a brief rundown of some of the more common letters.

Letter 525 – General 30 Day Letter

This letter accompanies a report giving you a computation of the proposed adjustments to your tax return. It informs you of the courses of action to take if you do not agree with the proposed adjustments. The letter explains that if you agree with the adjustment, you sign and return the agreement form. If you do not agree, you can submit a request for appeal/protest to the office/individual that sent you the letter. You need to file your protest within 30 days from the date of this letter in order to appeal the proposed adjustments with the Office of Appeals.

Letter 531 – Notice of Deficiency

This letter is notice of the IRS's determination that you owe additional tax or other amounts for the tax year(s) identified in the letter. The letter explains how to dispute the adjustments in the notice of deficiency if you do not agree. To dispute the adjustments without payment, you file a petition with the Tax Court within 90 days from the notice date.

Letter 3391 – 30-Day Nonfiler Letter

This letter advises you that the IRS believes you are liable for filing tax returns for the periods identified in the letter. It includes a report giving you a computation of the proposed adjustments to your tax return and explains the adjustments. The letter explains that if you agree with the adjustments, you sign and return the agreement form. If you do not agree, you can submit a request

for appeal/protest to the office/individual that sent you the letter. The letter or referenced publications explain how to file a protest. You need to file your protest within 30 days from the date of this letter in order to appeal the proposed adjustments with the Office of Appeals.

Letter 11 – Final Notice of Intent to Levy and Notice of Your Right to a Hearing

This letter is to notify you of your unpaid taxes and that the IRS intends to levy to collect the amount owed. The letter and referenced publications explain how to request an appeal if you do not agree. You need to file a Form 12153, Request for A Collection Due Process Hearing and send it to the address shown on your levy notice within 30 days from the date of the letter to appeal the proposed action with the IRS Office of Appeals.

Letter 3172 – Notice of Federal Tax Lien Filing and Your Rights to a Hearing

This letter is to notify you that the IRS filed a notice of tax lien for the unpaid taxes. If you do not agree you can request appeals consideration within 30 days from the date of the letter. The letter and publications explain how to request a hearing from Appeals. You need to file a Form 12153, Request for A Collection Due Process Hearing and send it to the address shown on your lien notice within 30 days from the date of the letter in order to appeal the action with the IRS Office of Appeals.

CP 523 – IMF Installment Agreement Default Notice

CP 523 notifies you that the IRS intends to terminate your installment agreement in 30 days. You have the right to request an appeal if you do not agree.

SCAMS

Everyone knows what the initials "IRS" stand for and this name recognition makes the IRS-brand one of the most commonly used by scam artists. Criminals, often posing as IRS employees, attempt to steal an individual's personal and financial information.

Phishing is one tactic used by criminals on the Internet to trick you into revealing personal or financial information. The scam artists use the information to steal your identity, access bank accounts, run up credit card charges or apply for loans in your name.

One of the most common phishing scams involves emails that claim to be from the IRS, but are actually emails from scam artists pretending to be the IRS. The IRS never initiates unsolicited e-mail contact with taxpayers about their tax issues.

The IRS has special safeguards in place to help victims of identity theft. If you suspect your identity has been stolen, it is important to let the IRS know as soon as possible.

There are many other tax scams. Many promise big refunds. If something sounds too good to be true, it probably is. If you have any questions about a refund or tax position, contact a tax professional.

CONCLUSION

Dealing with the IRS, as we have seen, is often a lengthy and complicated process. Many routine items can be disposed of quickly. However, more complex problems often take significant time to resolve. A tax professional can give you invaluable help. If you have any questions about how to deal with the IRS about your tax issue, don't hesitate to contact our office.