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King's Free Report: 15 Ways to Beat Delinquent Taxes



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by

Morgan D. King

Attorney & Counselor at Law
Member of the California Bar

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- ❖ Get rid of tax penalties
- ❖ Let someone else do the talking for you
- ❖ Protect your spouse
- ❖ Settle with the IRS and FTB to fit your budget
- ❖ Get rid of back taxes in bankruptcy
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The Law Offices of Morgan D. King

**Consulting tax professionals
&
Representing taxpayers
With Delinquent Tax Liabilities**

**In The Tri-valley California area
And across the nation**

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PREFACE

This abbreviated guide is intended for delinquent taxpayers and tax professionals seeking information about how to get fast shelter from the tax collector, protect the taxpayer from the terror of aggressive tax collection, and craft a feasible solution that can grant such individuals a true fresh start. The guide presumes the taxpayer is sincere, is not attempting to commit tax fraud or tax evasion, and is not a tax “protester.”

The intent of this document is to provide taxpayers as well as tax professionals a short and quick checklist of the major legal avenues available to tax-burdened individuals.

We encourage readers’ constructive criticism because it helps us to improve the product. So, please don’t hesitate to e-mail your questions, complaints, or suggestions to us at Editor@TaxJustice.com.

Morgan D. King
June 10 2008

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15 WAYS TO BEAT DELINQUENT TAXES

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1.1 GENERALLY

The problem: Taxpayer has been, or is about to be subject to IRS collection for delinquent taxes, interest and/or penalties. Delinquent simply means the taxing agency believes the taxpayer owes taxes for a previous tax period and has failed to pay them. Or, the taxpayer knows or believes he owes un-assessed taxes.

Typically the taxpayer calls an attorney or other tax professional in a panic; he or she has just received a notice of tax levy, or an intimidating call from an IRS or FTB collections officer. So, it may be a situation demanding immediate action to protect the taxpayer, an “intervention” to halt collection activity.

Ideally, though, a professional called upon to intervene to stop a levy or business lockup will have some ideas for a more permanent solution. Merely stalling collection provides welcome relief and ends that tight knot feeling in the pit of the taxpayer's stomach, but it is an illusory remedy unless there is an ultimate solution that satisfies the taxpayer, as well as the tax collector.

This booklet represents a quick lookup of possible remedies that may halt a levy, at the same time offering a legal remedy for an ultimate solution. When confronted with the problem of delinquent taxes the taxpayer has several options. Briefly, the taxpayer's options include:

1. Pay the taxes in a lump sum
2. Wait out the statute of limitations
3. Challenge the liability
4. Do an installment plan
5. Do an offer-in-compromise
6. Seek non-collectible status
7. Seek innocent-spouse status
8. Request a due-process hearing
9. Demand collection appeals
10. Discharge the taxes in bankruptcy
11. Pay and sue for refund
12. Transmutation agreements

If the problem also includes current or pending tax collection activity, such as levy, lien, seizure or sale, the taxpayer may have to explore methods of urgent collection intervention, some of which apply below.

A brief discussion of each legal remedy, and how it may benefit the taxpayer, follows. The topics discussed briefly could be used as a checklist of discussion points with the tax professional.

1.2 PAY OFF THE LIABILITY IN A - LUMP SUM

Paying the liability in full is, of course, an obvious option. However, it is equally obvious that had the taxpayer the sufficient means to pay the tax he or she probably would have done so, and would not be exploring other remedies or visiting the office of a tax professional for help.

The most frequent reason a taxpayer cannot pay the liability is *not enough money*. In fact, many taxpayers would dearly love to pay the tax, and they often have the money to do so, but they

don't have enough money to pay the interest and penalties that have accrued over a period of time.

A few lucky ones admit they owe the taxes and can get the money in a more-or-less *lump sum*. They may borrow it, liquidate assets to raise cash, or perhaps have obtained the benefit of a windfall enabling them to pay the tax.

The more typical situation, however, is the taxpayer who either disputes the assessment, or can't pay it. For those taxpayers, the first option, paying the tax, is typically not a feasible option.

KEY BENEFITS: Paying the liability off in a lump sum or in only a few closely-spaced payments in most cases is the optimal solution; it ends tax levies and other collection actions, releases liens, and stops accrual of interest and penalties.

1.3 THE STATUTE OF LIMITATIONS¹

26 U.S.C. § 6502
26 U.S.C. § 6503
IRM § 5.1.19

- a. Assessment - Three years from date return is filed
- b. Collection - Ten years from date of assessment
- c. Lien – Ten years from date of assessment

In most cases the IRS does not have an unlimited amount of time to assess or collect a tax. In a nutshell, the IRS must assess a tax within three years of the taxpayer filing a tax return, and must collect it within ten years after the assessment. These periods of time may be tolled, or extended, by certain events.²

The statute of limitations for the enforceability of a tax lien is the same as for the collection of the tax itself, i.e., ten years from date of assessment.

¹ 26 U.S.C. § 6502.

² In some cases the IRS goes to the trouble of reducing the assessment to a civil judgment in U.S. District Court, which greatly extends the period for collection.

Like ordinary income tax claims, the statute of limitations for assessment of a payroll withholding tax claim is three years (IRC § 6671) and the three-year period commences with the date of filing of the return, or from the succeeding date the return is due, whichever is later, pursuant to IRC § 6501(b)(2).

The statute of limitations to assess the individual responsible for corporate payroll withholding is three years from filing of the applicable quarterly return.³ This period may be tolled by certain events. The assessment procedure is the same as that for income taxes. IRC § 6671. The statute of limitations for collection of payroll tax is 10 years from assessment, pursuant to IRC § 6502.

KEY BENEFITS: The expiration of the Government's right to collect or lien against the taxpayer has obvious benefits. The taxpayer, quite simply, gets off "scot free."⁴

1.4 CHALLENGE THE LIABILITY

Some taxpayers haven't paid the liability because they believe they should not be liable for the tax. For example, a taxpayer who has not filed a tax return may have been assessed a bigger tax than he or she would have had the return been filed. Perhaps the taxpayer is unable to file the return because the records have been lost or destroyed. Or, the taxpayer may believe he or she was not a "responsible person" for a corporation's payroll taxes, or a spouse was an "innocent spouse" and should not be required to pay the taxes incurred due to the other spouse's incompetence or dishonesty. Thus those taxpayers object to the assessment, and seek to challenge it somehow.

a. Responsible person liability

In evaluating whether or not you may have a defense to liability for the business payroll taxes it might be prudent to go down the list of

³ *Jones v. U.S.* 60 F.3d 584 (9th Cir. 1995); *Lauckner v. U.S.* 68 F.3d 69 (3rd Cir. 1995); *Stallard v. U.S.* 806 F. Supp. 152 (5th Cir. 1992).

⁴ A "scot" is a payment or a charge, also an assessment or tax. To get off "scot free" means one gets off without paying anything; no assessment, fine or tax.

questions that the IRS forms ask. Among the questions posed on the Interview Form⁵ are –

Did the taxpayer –

- Hire/fire employees?
- Manage employees?
- Direct (authorize) payment of bills?
- Deal with major suppliers and customers?
- Negotiate large corporate purchases, contracts, loans?
- Open / close corporate bank accounts?
- Sign / countersign corporate checks?
- Guarantee / co-sign corporate bank loans?
- Make / authorize bank deposits?
- Authorize payroll checks?
- Prepare federal payroll tax returns?
- When and how did taxpayer first become aware of the delinquent taxes?
- What action did he or she take to see that the tax liabilities were paid?
- Were discussions or meetings held by stockholders, officers or other interested parties regarding the nonpayment of the taxes? Describe.
- Are minutes of the meetings available?
- If financial statements were prepared for the corporation, by whom were they prepared?
- Did the corporation employ an outside accountant? If so, whom?
- Who reviewed the payroll tax returns or tax payments?
- Who handled contacts with the IRS?
- Who made the decision whether or not to pay the payroll taxes?
- Did any person or organization provide funds to pay net corporate payrolls?

b. Audit appeal

Out of the clear blue the taxpayer receives a notice of deficiency or a notice of proposed assessment. This document notifies the taxpayer that the tax collector intends to sock him/her for a big additional tax he/she didn't know was owed. Or, perhaps the taxpayer was expecting it, but doesn't think it's fair or correct.

These notices provide so many days to file an appeal or object to the proposed tax. If the

⁵ IRS Form 4180.

taxpayer misses the deadline for filing the appeal or objection, the only way he/she can get out of the problem is to pay it, reduce it with an offer-in-compromise, or erase it in a bankruptcy.

KEY BENEFITS: The benefit to successfully pursuing an audit appeal is defeating the proposed assessment. However, it only works if the taxpayer actually has solid factual or legal grounds with which to argue.

1.5 DO AN INSTALLMENT PLAN

26 U.S.C. § 6159
IRM § 5.14.1

Installment Agreements⁶ are arrangements whereby the Internal Revenue Service allows taxpayers to pay liabilities over time. If the liability cannot be full paid within the statutory collection period⁷, the IRS has latitude to accept a partial payment installment arrangement [PPIA]. If necessary, the taxpayer is allowed an installment arrangement that can extend up to the conclusion of the statutory collection period. At the conclusion of the statutory collection period, any uncollected balance is adjusted to zero.

During the course of payments, penalty and interest continue to accrue. No levies may be served while an installment agreement is in effect. The taxpayer may have a variable number of years to pay the liability. The official installment agreement is IRS Form 433-D, but in practice the agreements are often done by letter or verbal agreement.

Variations of installment agreements include the “guaranteed” 3-year plan and “Streamlined Installment Agreement” 5-year plan.

TIP: Under 26 I.R.C. § 6159(5)(c)(1) the IRS is required to accept installment payment agreements when the underlying tax liability is less than \$10,000.⁸

When an account cannot be paid in full, a taxpayer may propose an installment agreement by completing Form 9465, Installment

⁶ IRC § 6159

⁷ See ¶ 1.3, above.

⁸ USA Financial Services, Inc. v. U.S.I.R.S. § 459 F.Supp.2d 440, 451 fn4 (E.D.Va. 2006)

Agreement Request. After reviewing the account, the service center will either accept or reject the taxpayer's proposal or, if necessary, request additional information. If accepted, an acknowledgment letter is sent stating the terms of the IA and the date the first payment is due.

The full IRS procedure and policy on installment agreements may be found at the IRM, Installment Agreement Handbook.⁹ The IRC reference to installment agreements is IRC § 6159. IRS procedure for defaulted installment agreements. The IRS checklist for Compliance and Customer Service Managers. Guaranteed installment agreements and completing Form 433-D. Request for installment agreement, IRS Form 9465.

KEY BENEFITS: Once an installment agreement is entered into, the IRS is barred from collection activity¹⁰. No levy may be made on taxpayer accounts:

- while requests for installment agreements are pending;
- while installment agreements are in effect;
- for 30 days after requests for agreements are rejected;
- for 30 days after agreements are terminated; and
- while an appeal of a default, termination or rejection is pending or unresolved.

1.6 OFFER-IN-COMPROMISE

26 USC § 7122
26 CFR § 301.7122
IRM § 5.8.1
IRM § 5.19.7.3
IRM § 8.23.1

In a nutshell, an offer in compromise is a taxpayer's offer made to compromise and settle a delinquent tax liability. The amount the IRS is willing to accept in settlement is the cash equivalent of what the IRS could collect by levy or other seizure of the taxpayer's income and assets, over a certain period of time. The IRS refers to this as the *taxpayer's realizable collection potential*. The offer of settlement may be made on the ground that the taxpayer does not have the financial ability to pay the full

⁹ IRM § 5.14.1 Securing Installment Agreements

¹⁰ IRM § 5.14.1.6

liability, or there is doubt about the taxpayer's legal liability to pay the claim, or where under the circumstances it would be unfair to force the taxpayer to pay the claim.

Recent amendments¹¹ to the key IRS Code section authorizing compromises have imposed some new requirements to the offer process.

New law, IRC §7122: The new law contains the following requirements for submission of an OIC:

- The taxpayer must pay 20% of the OIC at the time a lump-sum OIC application is submitted to the IRS for approval. The term "lump-sum OIC" means any offer of payments made in five or fewer installments.
- The taxpayer must pay the first proposed installment at the time a periodic payment OIC application is submitted to the IRS for approval.
- The taxpayer must continue to make the proposed installments of a periodic payment OIC during the time period the OIC is being evaluated by the IRS for approval. Any failure to make an installment during this period may be considered a withdrawal of the OIC.
- The application of any payment made under the above rules with respect to the tax liability may be specified by the taxpayer.
- The tax liability which is the subject of the OIC is reduced by any user fee imposed with respect to the OIC.
- The IRS may issue regulations waiving the required payment rules above in a manner consistent with the practices established under Section 7122(d)(3).
- Any OIC which does not meet these new requirements may be returned to the taxpayer as unprocessable.
- Any OIC submitted will be deemed to be accepted by the IRS if the OIC is not rejected by the IRS within 24 months after the date the OIC was submitted.

These new rules are effective for OICs submitted on and after July 16, 2006.

KEY BENEFITS: An offer in Compromise

¹¹ Internal Revenue Bulletin: 2006-31 July 31, 2006

deemed processable by the IRS halts levy and other tax collection seizures during the time the offer is under consideration.¹²

Where this remedy applies, it is a good way to get the taxpayer a fresh-start; the IRS accepts a presumably small amount of money and forgets the rest. In some cases it can be said this remedy literally settles a huge tax debt for "pennies on the dollar," although settlements that good are rare.

A caveat is that the taxpayer is on a kind of "probation" for 5 years following the acceptance of the offer, during which the taxpayer must file all tax returns timely and pay the taxes due. Default may result in retraction of the agreement and demand for full payment.

1.7 CURRENTLY NOT COLLECTIBLE

IRM § 5.16
IRS Policy Statement P-5-15

The tax IRS Manual provides that where levy or other collection activity will result in an actual hardship to the taxpayer or his or her family, the IRS is supposed to back off and forestall collection.¹³

The IRS may designate the taxpayer's account as "Currently not collectible," designated as Collection Status Code 530. This is sometimes referred to as the account being "53'd." This means the IRS is convinced that collection against the taxpayer is not possible without creating an undue hardship, or is simply not collectible at all, and so all collection efforts are stopped until there is a change of circumstances allowing collection to resume.

KEY BENEFITS: Collection activity stops¹⁴. However, if the taxpayer's financial circumstances improve in the future, the IRS may demand payment, and interest will have continued accruing while the hold-off on levy was in effect.

¹² 26 U.S.C. § 6331(k)

¹³ IRM § 5.16.1.1

¹⁴ IRC § 6343(e); IRM § 5.16.1.2.9.7

1.8 INNOCENT SPOUSE

IRM 5.19.1.3.2.3
 IRM § 4.11.34
 IRM § 25.15.1.6
 IRM § 25.18.3
 26 U.S.C. § 6013, 6015
 26 CFR § 1.6015-1

In some cases, a spouse (or former spouse) will be relieved of the tax, interest, and penalties on a joint tax return.

There are three types of relief from joint and individual liability for spouses who filed joint returns:¹⁵

1. Innocent Spouse Relief for additional tax taxpayer owes because taxpayer’s spouse or former spouse failed to report income or claimed improper deductions or credits.

2. Relief by Separation of Liability provides for the allocation of additional tax owed between taxpayer and spouse or former spouse because an item was not reported properly on a joint return. The additional tax allocated to taxpayer is generally the amount taxpayer is responsible for.

3. Equitable Relief may apply when taxpayer does not qualify for innocent spouse relief or separation of liability relief for something not reported properly on a joint return. Taxpayer may also qualify for equitable relief if the correct amount of tax was reported on the joint return but the tax remains unpaid.¹⁶

The IRS describes the innocent-spouse defense as follows¹⁷:

“Many married taxpayers choose to file a joint tax return because of certain benefits this filing status allows. Both taxpayers are jointly and individually responsible for the tax and any interest or penalty due on the joint return even if they later divorce. This is true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns. One spouse may be held responsible for all the tax due even if all the income was earned by the other

spouse.”

“Taxpayer must meet all of the following conditions to qualify for innocent spouse relief:¹⁸

- Taxpayer filed a joint return which has an understatement of tax due to erroneous items (defined later) of his/her spouse (or former spouse).
- Taxpayer established that at the time he/she signed the joint return he/she did not know, and had no reason to know, that there was an understatement of tax.
- Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for the understatement of tax.

A request for innocent spouse relief will not be granted if the IRS proves that the taxpayer and his/her spouse (or former spouse) transferred property to one another as part of a fraudulent scheme. A fraudulent scheme includes a scheme to defraud the IRS or another third party, such as a creditor, ex-spouse, or business partner.

KEY BENEFITS: Requesting innocent spouse status halts levies and other collection activity while the request is pending.¹⁹ A successful prosecution of this defense relieves the “innocent” spouse of all or a portion of the liability.

1.9 COLLECTION DUE PROCESS

IRM § 8.22.1
 26 U.S.C. § 6320 (liens)
 26 U.S.C § 6330 (levy)

A taxpayer may request a “collection due process” hearing.²⁰ This opportunity arises in a window of 30 days from the date of a final notice of levy, or notice of lien.

¹⁵ IRM § 6015; 26 CFR 1.66-4.

¹⁶ Tax Topic 205 - *Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*

¹⁷ IRS Publication 971. IRS Form 8857 Rev. June 2007.

¹⁸ Tax Topic 205 - *Innocent Spouse Relief*

¹⁹ 26 CFR § 1.6015-7(c); IRC § 6015(e)(1)(B)

²⁰ IRM § 8.22.1

The request must identify proposed alternatives to, or the reasons for disagreeing with, the lien filing or the levy action. Alternatives or reasons for disagreeing may include:

- Collection alternatives such as installment agreement or offer in compromise.
- Subordination or discharge of lien.
- Withdrawal of Notice of Federal Tax Lien.
- Appropriate spousal defenses.
- The existence or amount of the tax, but only if taxpayer did not receive a notice of deficiency or did not otherwise have an opportunity to dispute the tax liability.

The taxpayer may not raise an issue that was raised and considered at a prior administrative or judicial hearing, if the taxpayer participated meaningfully in the prior hearing or proceeding.

Where payroll taxes are involved, once a “due process” hearing has been held in connection with existing liabilities, future due process hearings are limited to subsequent delinquencies.

Unless the IRS has reason to believe that collection of the tax is in jeopardy, levy action is not permitted for the subject tax and periods during the 30 days after the levy notice and during the timely-requested CDP hearing. Normally, there will be no levy action during the period the taxpayer has to request a hearing from a lien notice and during the CDP hearing. If the taxpayer’s request for a CDP hearing is timely, the 10-year period²¹ the IRS has to collect the taxes will be suspended until the date the determination becomes final or the taxpayer withdraws the request for a hearing in writing.

IMRS²² 06-000168 – Collection Due Process Issue: Practitioners are concerned over the response time following a request for a Collection Due Process (CDP) hearing. Taxpayers must notify the IRS of their intent to appeal within 30 days of a levy or lien notice. However, even after 90 days, practitioners are told that their request is in the system but has not yet been assigned to a local office. They are particularly concerned about the accrual of interest. **Status:** Practitioners were advised that Appeals has established two campus Appeals units to work CDP cases. Taxpayers

²¹ 26 U.S.C. § 6502, § 6503.

²² IRS *Issue Management Resolution System*

will be notified that their request has been received within 30 days of receipt. An Appeals officer is then assigned and will contact the taxpayer within 30 days (from the date assigned) to schedule the hearing. In order to stop or reduce interest on part or all of the proposed balance due, taxpayers can make payments toward the tax or post a cash bond.

KEY BENEFITS: A timely request for a due process hearing halts levies and other collection activity while the hearing is pending.²³ The due process hearing provides the taxpayer with an opportunity to arrange collection of tax liabilities in less drastic ways than levy or other seizure.

Among other things, an offer in compromise may be made within the Collection Due Process hearing procedure.²⁴

Unlike the ordinary collection appeals process (see below) a taxpayer may seek judicial review of a determination made at a CDP hearing.²⁵

1.10 COLLECTION APPEALS (CAP)

IRM § 8.24.1

IRM § 8.1.1

If the taxpayer has received all the pre-levy notices but allowed the deadlines for requesting a due process hearing to expire, he or she can appeal under the Collection Appeals Program (CAP), or request an “equivalency” hearing. Unlike the CDP hearing, however, the taxpayer cannot seek judicial review if he/she disagrees with Appeals’ decision.²⁶

Collection activities may be appealed through CAP at any time.

The IRS explains CAP:

The CAP procedure is available under more circumstances than Collection Due Process

²³ IRM § 8.22.2.2.3.6; 26 U.S.C. § 6330(a)(1).

²⁴ SBSE-05-1007-033. Expiration: October 9, 2008. SBSE: Small Business / Self-Employed Division

²⁵ IRS Bulletin No. 2006-46 November 13, 2006; 26 U.S.C. § 6330(d).

²⁶ IRM 5.1.9, Collection Appeal Rights; IRM 8.24.1.2. and IRM 8.22 for additional information on CAP and equivalent hearings.

(CDP).²⁷

Unlike CDP, the taxpayer may not challenge in CAP the existence or amount of the tax liability. And, the taxpayer cannot proceed to court if he/she doesn't agree with Appeals' decision in his/her CAP case.

Collection actions that may be appealed under CAP are:

Notice of Federal Tax Lien.

Taxpayer may appeal the proposed filing of a Notice of Federal Tax Lien (NFTL) or the actual filing of an NFTL. The taxpayer is entitled to a CDP hearing after the first filing of an NFTL.

Hearing Available under Collection Due Process

The taxpayer may also appeal denied requests to withdraw an NFTL, and denied discharges, subordinations, and non-attachments of a lien.

Notice of Levy

The taxpayer may appeal before or after the IRS places a levy on wages, bank account or other property. The taxpayer may also have additional Collection Due Process appeal rights. He/she may also appeal the denial by the IRS of a request to have levied property returned.

Seizure of Property

The taxpayer may appeal before or after the IRS makes a seizure.

Rejection or Termination of Installment Agreement.

The taxpayer may appeal when the IRS rejects a request for an installment agreement. The taxpayer may also appeal when the IRS proposes to terminate or terminates the taxpayer's installment agreement. The taxpayer does not have to submit the appeal request in writing.

KEY BENEFITS: An appeal or "equivalency" hearing is available in situations where the taxpayer has missed the 30-day deadline to request a "due process" hearing. By policy,

²⁷ From IRS Publication 1660 (Rev. 03-2007); IRM § 8.24.1 Collection Appeals Programs.

collection action is suspended while the case is in Appeals for lien, levy and seizure CAP appeals.²⁸ The Collection function may continue enforcement action, however, if it believes withholding the action would put collection of the tax liability at risk.

1.11 DISCHARGE IN BANKRUPTCY

11 U.S.C. § 523(a)(1)
11 U.S.C. § 1328(a)
IRM § 5.9.1

Another remedy for delinquent taxes is bankruptcy. Bankruptcy is frequently found to be an excellent way to erase the liability entirely, or substantially reduce it, or a combination of reduce and pay the balance over time pursuant to a bankruptcy-court approved payment plan. Under the bankruptcy statutes²⁹ the IRS typically has little say in what happens in the bankruptcy. Unless the IRS can prove that the taxpayer filed a fraudulent tax return or otherwise engaged in tax evasion, the treatment of the tax liabilities in bankruptcy is entirely out of their hands.

Although the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005³⁰ ("BAPCPA") curtailed a taxpayer's ability to reduce tax liabilities through bankruptcy, the bankruptcy reform provisions only apply to certain situations. The taxpayer's ability to discharge eligible taxes in chapter 7, for example, are unchanged³¹.

KEY BENEFITS: Filing a petition in the bankruptcy court operates to immediately halt all debt and tax collection activity due to the effect of the automatic stay.³² To the extent that the tax liabilities are dischargeable, the liability is erased

²⁸ IRM § 8.24.1.2.9

²⁹ Principally found in Title 11 United States Codes.

³⁰ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").

³¹ Chapter 7 is a "straight bankruptcy" that discharges certain debts, and may liquidate some of the debtor's property. Chapter 7 does not include a payment plan. An alternative, Chapter 13, provides a payment plan of up to 5 years to pay any non-dischargeable debts.

³² 11 U.S.C. § 362.

(discharged) by operation of the U.S. Bankruptcy Code.³³

1.12 PAY AND SUE FOR REFUND

26 U.S.C. § 7422
IRM § 35.1.1
IRM § 5.17.5

Where the taxpayer has been assessed, levied, or given notice of intent to assess a tax he or she believes is not owed in the amount claimed, or owed at all, he/she has the right to appeal the proposed assessment or intent to levy administratively through the IRS. In the event the taxpayer loses the administrative appeal, he/she has two basic options for judicial review; sue in Tax Court without paying in advance the claimed liability, or pay the claimed liability and sue for refund in District Court.

“You do not usually need to pay the amount in dispute while your case is pending before the Tax Court. If the Tax Court ultimately concludes, however, that you owe some amount of tax, or if you settle or agree to an amount of tax liability, the law provides generally that interest runs on unpaid tax from the date it was originally due until paid in full. Interest also runs on some penalties. Although you do not need to pay the amount in dispute while your case is pending in the Tax Court, you may do so if you want to stop the interest on the unpaid tax from accruing.”³⁴

The rules regarding prepayment of tax and penalties differ in U.S. District Courts and the U.S. Court of Federal Claims.³⁵

1.13 JUDICIAL REVIEW

26 U.S.C. § 6330(d)(1)
5 U.S.C. § 706
IRM § 36.1.1

Generally, the District Court and the Court of Federal Claims hear tax cases only after the taxpayer has paid the tax and filed a claim for a credit or refund. A taxpayer can file a claim with the IRS for a credit or refund if he/she thinks that the tax he/she paid is incorrect or excessive. If the claim is totally or partially disallowed by the IRS, the taxpayer should receive a notice of

claim disallowance. If the IRS does not act on the claim within 6 months from the date the taxpayer filed it, the taxpayer can then file suit for a refund.

The taxpayer generally must file suit for a credit or refund no later than 2 years after the IRS informs him or her that the claim has been rejected. However, the taxpayer can file suit if it has been 6 months since he or she filed a claim and the IRS has not yet delivered a decision.

The taxpayer can file suit for a credit or refund in United States District Court or in the United States Court of Federal Claims. However, the taxpayer cannot appeal to the United States Court of Federal Claims if his/her claim is for credit or refund of a penalty that relates to promoting an abusive tax shelter or to aiding and abetting the understatement of tax liability on someone else's return.

For information on District Court review of Appeals determinations with respect to lien notices and proposed levies, see Publication 1660.

1.14 MARITAL TRANSMUTATION

Cal. Family Code § 850 et seq.

In situations where one spouse incurred the liability for the tax prior to marriage to his/her current spouse, but the IRS is now going after the current non-liable spouse's paycheck based on community property laws, one way to protect the non-liable spouse is to draft a marital property transmutation agreement.

A marital property transmutation agreement is one in which the spouses transfer, convey and confirm to the other spouse their respective community property so that the spouse's respective share of the community property becomes each spouse's separate property.

If valid, a transmutation agreement can be used, for example, to confirm the non-liable spouse's income as his or her separate property; the IRS cannot levy or seize the separate property of a non-liable spouse for the purpose of satisfying the liability owed by the liable spouse.

The extent to which a transmutation agreement may be valid, and the requisite steps in creating a valid agreement, are based on state law.

³³ 11 U.S.C. § 727, § 523.

³⁴ *Flores v. United States*, 357 U.S. 63 (1958).

³⁵ www.ustaxcourt.gov “Taxpayer information.”

Since state law determines who owns what property and rights to property, the U.S. Government cannot interfere in an agreement that is valid under the respective state laws and that makes the community property the separate property of the respective spouses.

Federal law determines how property is taxed, but state law determines whether, and to what extent, a taxpayer has "property" or "rights to property" subject to taxation.³⁶

Accordingly, federal tax is assessed and collected based upon a taxpayer's state created rights and interest in property.³⁷

Community property states have created laws allowing spouses to contract out of the application of normal community property laws. The states have different rules concerning when this may occur and how notice of these agreements is given to affected third parties, such as creditors. These rules vary greatly between the community property states.

Caution must be used in considering drafting a transmutation agreement for a married couple where the purpose is to protect the non-liable spouse from collection for liabilities owed by the other spouse; the California Court of Appeal has ruled in at least one case that where the purpose is clearly to frustrate collection of taxes, the agreement is a fraudulent transfer and of no effect.³⁸

KEY BENEFITS: If valid under state law, by converting the non-liable spouse's share of the property to his/her separate property, a marital property transmutation agreement protects a non-liable spouse's share of the community property (e.g., paycheck, bank account, car) from levy or seizure to satisfy the tax debt of the liable spouse.

1.15 PENALTY ABATEMENT

IRM § 20.1.1.3 (02-22-2008) Relief From Penalties

The tax code gives a taxpayer the right to

³⁶ IRM § 25.18.1.1; *Aquilino v. United States*, 363 U.S. 509 (1960); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

³⁷ IRM § 25.18.1.2.24

³⁸ *State Board of Equalization v. Woo*, 98 Cal.Rpte.2d 206 (1st Dist. 2000).

request cancellation of any IRS penalty. Every one of the more than 140 penalty provisions of the code contains what is called a *good faith* exception. It means that if the taxpayer acted in good faith and based upon a reasonable cause for his or her actions and not out of a deliberate attempt to cheat, deceive or mislead the IRS, the penalty does not apply. The procedure for seeking cancellation of penalties is remarkably simple. It does not even require a special form.

To make a request for cancellation of penalties, simply respond in writing to the IRS service center that issued the notice.

KEY BENEFITS: The benefits of penalty abatement are fairly obvious. If a penalty is voided, the interest that accrued on the penalty is, as well, thus extinguishing what could be a substantial liability.

