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Catching up on your taxes once the COVID-19 pandemic finally ends - by Michael Duffy

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Michael Duffy

The reality is once the COVID-19 pandemic finally ends, many individuals and businesses will not have enough capital to pay all their bills. This is especially the case with respect to folks that have fallen behind on their taxes.

Not filing your income tax returns can result in the imposition of costly penalties. Even more penalties may be assessed if an unpaid balance is not paid on time. Coupled with these financial costs is the fact that the IRS and the Massachusetts Department of Revenue (DOR) have expansive collection powers. Owing back taxes can result in liens being filed, bank accounts being levied, wages being garnished, driver's licenses and other professional credentials being cancelled. If you don't come to the table and deal with the government, they can and will take your livelihood from you.

On the other hand, the United States does not send people to jail for not being able to pay their bills. This principle applies even to tax bills. Consequently, the IRS and DOR collection playbooks are grounded by the reality that you can't get blood from a stone. The government will even settle a tax debt for less than the amount owed if the conditions are right.

Below is an outline of key elements of the tax collection process and some guidelines on how to approach resolving back taxes. These guidelines apply whether this is the first year you don't think you'll be able to pay, or the debt is old and you are looking for the resolve to get back on track.

Filing and Payment Deadlines Have Been Extended

If you are calculating that you have tax liability for a given year and you don't think you'll be able to pay, it is usually advisable to file your tax returns by the due date anyway. The IRS penalty for filing a late income tax return is usually 5% of the amount due per month for each month the return is late. So, if you file four months late and owe \$20,000, this results in an automatic \$4,000 in additional tax penalties. However, if you file on time, but pay late, the penalty is only 0.5% per month of the amount due. In this case, filing on time and paying four months late results in a penalty of only \$400. Simply put, there is usually no good reason to increase the amount of penalties assessed by filing late.

For individuals and businesses concerned that they won't be able to pay their 2019 taxes, you have surely already heard there is some good news. The IRS and Department of Treasury have extended the filing deadlines for 2019 individual, trust and estate, and corporate income tax returns from April 15 to July 15. The deadline to pay taxes reported on these types of returns has also been extended to July 15, as has the deadline for reporting and paying quarterly estimated tax payments due in the 2020 tax year. The extension of these deadlines gives folks more time to figure out their actual tax liability and get the necessary funds together.

For taxpayers already behind on their taxes, the IRS announced in late March that it is pausing most collection activities until after July 15, 2020. Accordingly, the IRS will not be imposing any automated liens or levies at this time, nor will the IRS be taking any action concerning liens or levies already in

place. For folks currently paying the IRS under an installment plan, all payments due under the agreement from April 1 through July 15, 2020 are suspended.

Collections Won't Start If You Work Something Out

Both the IRS and DOR have broad powers to collect taxes. Usually the first action taken against a taxpayer who owes back taxes is that liens will be filed. The liens let other creditors know the taxpayer owes back taxes and potentially gives the IRS the right to foreclose on property. It is rare for the IRS to initiate foreclosure proceedings, however. Typically, getting hit with tax liens causes a 120-point drop in the taxpayer's credit score. The IRS and DOR will then consider more serious collections actions if the taxpayer does not come forward and attempt to work out a resolution. These actions can include co-opting employers to garnish the taxpayer's wages or directing third parties, who owe funds to the taxpayer, to pay these funds to the government instead.

Probably the most invasive action that the IRS and the DOR can take is a general levy of the taxpayer's bank accounts. The government does this by sending a request to the taxpayer's bank and forcibly withdrawing funds from the account to apply towards the tax debt. This is almost certainly one of the most traumatic things that can happen to a taxpayer who now may be facing the prospect of bounced rent checks or other cascading defaults as a result of the withdrawals.

Even though the government has extremely powerful collection tools, it will agree to not use its most coercive methods against taxpayers who voluntarily come forward and negotiate an installment plan or settlement offer. Furthermore, if a taxpayer comes forward and demonstrates a current inability to pay anything toward their back taxes, the government has the power to put the taxpayer into a "currently not collectible" status that will buy them time to get liquid. The caveat to these types of arrangements is that the government doesn't put itself last in terms of what expenses come before the tax debt. For taxpayers with out-of-control spending, their idea of a reasonable payment offer may differ dramatically from the government's definition.

Collections Can't Last Forever

One of the main sources of leverage taxpayers have in collections is the fact that the government's power to collect taxes usually⁽¹⁾ does not last forever. We frequently meet with clients who are shocked to learn that the IRS typically has only ten years to collect back taxes. After this ten-year period is over, the debt is unenforceable and uncollectible. If the IRS has taken the step of putting liens on the taxpayer's property – which is usually standard operating procedure when \$10,000 or more is owed – the liens become unenforceable once the ten-year collection period ends. The fact that the IRS can't collect taxes forever means the government is incentivized in certain circumstances to bargain down the total amount of tax due and settle with the taxpayer for less than what is owed.

The collections rules in Massachusetts are less taxpayer-favorable. As is the case with federal tax debt, tax debt in the Commonwealth may only be collected against a person during a ten-year, post-assessment collection period. If, however, during the ten-year period the Massachusetts DOR also files a lien on the taxpayer's property, the lien can be enforced past the expiration of the normal collections period. For this reason, the Massachusetts DOR has less incentive to compromise taxes

owed by taxpayers who also have significant property holdings. The Massachusetts DOR will also normally ask that taxpayers agree to extend the ten-year collections period when they enter into an installment agreement. In contrast, the IRS rarely asks taxpayers to extend the ten-year collections period.

You Can Settle Old Tax Debt for Less Than the Full Amount

If you've ever been up at 3:00 am watching TV, you may have stumbled upon an infomercial starring somebody claiming to be a "tax guru" who can help you settle with the IRS for "ten cents on the dollar (or even less!)." Although it is important to point out a number of these self-proclaimed gurus have ended up in jail over the years, the underlying pitch is actually true: the IRS can settle with taxpayers for an amount that is less than is legally owed.

First, if a taxpayer is on an installment plan, the plan payment amount is already based on the taxpayer's ability to pay rather than the amount of outstanding debt. The IRS can and will take partial payment installment plan offers from taxpayers in cases where the ten-year collections period will expire before all the tax is paid. When a taxpayer makes an offer for a partial payment installment plan, the offer will usually be evaluated with greater scrutiny relative to an installment offer that will result in full payment of the total outstanding taxes. But, all else being equal, the IRS would prefer to get something from a voluntarily complying taxpayer rather than play hardball.

The IRS also has the authority to fully settle a tax debt before the expiration of the ten-year period for either a lump sum or a shortened payment plan. This settlement process is called an "Offer in Compromise," and can be an extremely good deal for taxpayers under the right circumstances. Making an Offer in Compromise requires the taxpayer to disclose his or her available equity and future earnings power and propose a settlement amount. If a lump sum offer is made, a nonrefundable down payment must also be submitted with the initial offer proposal. The IRS then reviews the numbers and uses a complex formula to determine whether the offer meets its internal guidelines relative to the taxpayer's ability to pay. If the taxpayer's offer meets these guidelines, the IRS is inclined to settle the full amount due for the amount offered.

The Offer in Compromise "gurus" tend to get into trouble when they make promises to taxpayers before really diving into the particularities of each case. For example, many folks owing back taxes aren't even eligible for an Offer in Compromise because they have unsustainable spending habits, have unrealistic expectations as to what is considered "fair," or are still out of compliance. On the other hand, a qualified professional will not prepare and submit an Offer in Compromise unless he or she knows it meets the IRS guidelines and has a high probability of being accepted.

Lastly, for some taxpayers that owe back taxes to the IRS or Massachusetts DOR, bankruptcy may be a viable option. Some back taxes can be discharged in bankruptcy, although the process for determining if this is possible is very complicated. We always recommend a full bankruptcy analysis be done by a bankruptcy attorney, although we can advise clients as to whether their tax debts are eligible.

Where Do We Come In?

Our tax practice has experience with all available workout options. We advise clients on the best approach they should take to minimize penalties and interest in the event they will not be able to pay in full when their tax returns are prepared. We can then assist clients with cleaning up old liabilities by getting favorable installment arrangements in place, evaluating bankruptcy potential and, if appropriate, making an Offer in Compromise. Where we excel is right-sizing the work we propose by evaluating a client's facts before we commit to a particular course of action.

Although these are troubling times, a trusted advisor can still help clients make the right choices to minimize the damage and plan for success. If you would like to know more about our tax practice, or would like to have us evaluate your available workout options, please reach out to us.

Michael Duffy is a tax attorney at Fletcher Tilton, Worcester, Mass.

(1) We say "usually" here because in certain circumstances the collection period may extend beyond ten years. For example, this can occur if there are criminal tax charges, or if government action is taken against the taxpayer in court. Other actions the taxpayer takes to delay collections, such as requesting an Offer in Compromise, will extend the ten-year period as well.

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