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IRS Collection Function:

A Basic Overview

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Editor's Note: This is the second installment of a two-part series on IRS Examination and Collection.

In the first installment of this article, I discussed the IRS Examination function and the method by which the IRS examines tax returns. This is the second installment to that article, which discusses the IRS Collection function. The chief mission of the IRS Collection Division is twofold: (1) the collection of federal taxes reported or assessed but not paid, and (2) securing tax returns that have not been filed by taxpayers. The Internal Revenue Code equips the IRS with a rather formidable arsenal of collection devices stronger than those available to private creditors. The 1998 IRS Restructuring and Reform Act, however, resulted in monumental changes to the method by with the IRS collects unpaid tax liabilities by inserting into the Internal Revenue Code broader protections for taxpayers and third parties who are adversely affected by IRS collection actions.

Before the IRS may begin to collect an unpaid tax liability, the IRS must have assessed the tax liability. An assessment is nothing more than the recording of the tax debt on the books of the IRS. Generally, there are two types of assessments: an automatic assessment and a deficiency assessment. When a taxpayer files a return setting forth an amount of tax owed, the IRS may automatically assess the tax shown on the return without having to comply with additional procedures. Conversely, a deficiency assessment typically occurs when the IRS examines a return (discussed in the first installment of this article) and seeks to collect additional tax not reported on the return. Since the IRS is seeking to hold the taxpayer liable for additional tax, the taxpayer is afforded an opportunity to challenge the deficiency assessment through the IRS Appeals Office or federal court. As a general rule, the Internal Revenue Code requires the IRS to assess a tax within 3 years after the taxpayer filed the return. However, there are numerous exceptions and circumstances that suspend or extend the 3 year statute of limitations. For instance, there is no time limit on accessing a tax liability if (1) the taxpayer filed a false or fraudulent return, (2) the taxpayer willfully attempted to evade tax, or (3) no tax return has been filed by the taxpayer. If the taxpayer makes a substantial omission of gross income on the return, then the IRS may assess additional tax within 6 years after the taxpayer filed the return.

Once the tax has been properly assessed, the IRS typically has 10 years from the date of the assessment to collect the tax. Once a tax has been properly assessed but remains unpaid, an automatic tax lien originates in favor of the government upon all the taxpayer's property and rights to property. The general tax lien remains in effect until the tax liability (including all penalties and interest) is satisfied or becomes unenforceable due to the statute of limitations. The IRS typically does not provide the taxpayer with a notice of the federal tax lien immediately after it arises; however, it will be filed at some point during the collection process in order to protect the government's interest in the taxpayer's property. The filing of the lien is the principal means by which the IRS protects its position relative to the rights of competing creditors. The federal tax line is not self-executing and does not directly compel payment; therefore, it must be enforced through judicial or administrative measures.

Before the IRS can begin enforced collection activity against a taxpayer, the Code requires the IRS to provide certain statutory notices to the taxpayer. Once an assessment of tax is made by the IRS, the Code requires that, no later than 60 days following the assessment, the IRS must give notice of the assessment and a demand for payment to the taxpayer. This initial notice is entitled Notice of Tax Due and Demand for Payment. Once the tax has been assessed, the demand for payment has been given, and the taxpayer has not taken steps to satisfy the liability, the IRS may proceed with enforced judicial or administrative collection actions.

The Code authorizes the IRS to administratively levy (seize and sell) the taxpayer's property to satisfy an outstanding tax liability. Just like any other creditor, the IRS may also institute a lawsuit against the taxpayer to recover the debt or enforce its lien upon the taxpayer's property. Judicial attempts to collect an outstanding tax liability pose a concern where the statute of limitations on collection is close to expiring or where it appears inconvenient to levy upon a taxpayer's property (i.e., due to disputed title or multiple claims to the same property).

The taxpayer's first contact with the IRS Collection function typically comes in the form of computer generated notices sent by the Service Center where the return was filed or, in the case of an audit, where the Revenue Agent filed the examination report. The Service Center generally sends a series of four (4) computer generated notices to the taxpayer. Each notice contains incrementally harsher language than the preceding notice advising taxpayers in no uncertain terms that the IRS intends to flex its muscles to collect the unpaid tax. The last of four notices (Notice CP 504) is the Notice of Intent to Levy. If the Service Center is unsuccessful in obtaining full payment of the tax liability, the taxpayer's file may ultimately reach a Revenue Officer in the IRS office closest to the taxpayer's residence or place of business. The Revenue Officer will contact the taxpayer and being the process of gathering information on the taxpayer's assets. Before the IRS may actually levy upon the taxpayer's property, however, the Code requires the IRS to provide the taxpayer with 30 days' notice. If the case cannot be resolved, the Revenue Officer usually issues a Letter 1058 (Final Notice of Intent to Levy and Notice of Your Right to a Hearing) notifying the taxpayer that the IRS is prepared to levy on the taxpayer's assets. The letter will afford the taxpayer a 30-day period within which to file a request for a Collection Due Process (CDP) hearing with the IRS Appeals Office. Once the Letter 1058 is sent to the taxpayer, the IRS can levy upon the taxpayer's assets after the 30-day period expires if no collection appeal is filed by the taxpayer. Enforced collection action by levy commonly takes the form of a levy upon the taxpayer's bank account or a garnishment of the taxpayer's wages. The Code, however, exempts certain property from levy, such as wearing apparel, school books, and tools used in a trade or business. The IRS must receive judicial approval prior to levying upon a taxpayer's primary residence.

As mentioned above, the taxpayer may request a CDP hearing before the IRS Appeals Office during the 30-day period provided in Letter 1058. A taxpayer who timely invokes the CDP hearing procedures will be entitled to both administrative and judicial review of the collections activity of the IRS. If the taxpayer files a request for a CDP hearing, the IRS ordinarily is prohibited from proceeding with a levy upon the taxpayer's property while the case is being reviewed by the IRS Appeals Office. At the CDP hearing, the taxpayer typically is limited to presenting collection alternatives to the proposed levy. The IRS Appeals Office will only consider the correctness of the underlying tax liability during the CDP hearing in rare circumstances. Collection alternatives can take the form of an Installment Agreement and Offers in Compromise. While Installment Agreements and Offers of Compromise often are raised in the context of a CDP hearing, these collection alternatives can be presented to the IRS at any state of the collection process.

Under a standard Installment Agreement, the taxpayer agrees to pay the tax liability in full over time, similar to a loan with a bank. Interest and penalties continue to accrue on deferred amounts during the term of the Installment Agreement. For tax liability's less than $10,000, the Code now affords a guaranteed Installment Agreement. For tax liabilities less than $25,000, the IRS offers a streamlined Installment Agreement.

An Offer in Compromise – the more complex of the collection alternatives – essentially allows the taxpayer to offer to settle the tax liability for an amount that is typically less than the full amount owed. The most frequent basis for submitting an Offer in Compromise is doubt as to collectability, wherein the taxpayer demonstrates that he will never be able to pay the liability in full. Essentially, the taxpayer offers the present value of his ability to pay in hopes that the IRS will accept the offer and cancel the remainder of the liability.

Proposing these collection alternatives typically requires the taxpayer to complete a financial statement referred to as a Collection Information Statement (CIS). The information in the CIS serves as the starting point for discussions regarding the taxpayer's ability to pay the outstanding tax liability, and it must be signed by the taxpayer under penalty of perjury. Individuals and businesses are required to file a separate CIS, denoted as a Form 433-A for individuals and a Form 433-B for Businesses. In January 2008, the IRS expanded the Forms 433 to require additional information from taxpayers. For each category of information requested in the CIS, the taxpayer is asked to supply supporting documentation. In more complex collection cases, the CIS and supporting documentation can easily compete in size with an urban telephone directory.

Taxpayers who have ignored notices from the IRS and allowed the levy to go into effect may find it difficult to get the IRS to release the levy. While there are circumstances in which the IRS is required to release a levy, it is less costly and less worrisome to take proactive steps to avoid the levy altogether. Thus, the time for action on the part of the taxpayer begins with the receipt of the first collection notice from the IRS.

Delinquent Returns and Criminal Issues

There are numerous provisions in the Code and other federal statutes that provide criminal sanctions for what essentially amount to tax crimes. The cornerstone of the American tax system is voluntary compliance. Any tax system is only as good as its ability to collect taxes. The chief objective of the IRS Criminal Investigation Division (CID) is to deter taxpayers from violating the tax laws by prosecuting select offenders. Many criminal investigations result from routine audits during which the Revenue Agent discovers some information that triggers a suspicion of tax fraud. Thus, it is fair to say that every civil examination or audit had the potential to develop into a criminal investigation. CID also develops its own cases, often acting upon tips from citizens, ex-spouses, ex-employees, newspaper articles, or state taxing authorities.

The simple act of not filing a tax return can itself constitute a criminal violation under the Code. A taxpayer may have started down the path of not filing tax returns and suddenly finds himself in the position of having to reenter the system, whether by choice or because he has been contacted by the IRS

Collection Division or CID. Moreover, the IRS requires that a taxpayer be current with all tax filings prior to entering into an Installment Agreement or Offer in Compromise. A delinquent taxpayer typically receives correspondence from the IRS notifying the taxpayer that no return has been filed for certain tax years. In these notices, the IRS requires the taxpayer to file the return by a specific date. If the taxpayer fails to respond, the Internal Revenue Code authorizes the IRS to file a substitute return for the taxpayer. A substitute for return will not include any expenses or other items of credit the taxpayer may be entitled to for the tax year at issue.

In prior years, the IRS maintained a formal voluntary disclosure program through which nonfilers could reenter the system without threat of criminal prosecution. The IRS subsequently abolished the program on a formal level; however, it does maintain an informal voluntary disclosure program under both the civil and criminal systems. Regardless of the reasons for the failure to file a return, the taxpayer and his representative must engage in a candid discussion of the potential criminal ramifications that stem from that decision. Dealing with a delinquent tax filer often requires the tax attorney to enlist the services of an accountant to work with the attorney to bring the taxpayer into compliance. A delinquent taxpayer desiring to become compliant with the tax laws would be well advised to first speak with a qualified tax attorney to discuss potential criminal issues and to preserve the right against self-incrimination.

Conclusion

Many taxpayers who begin receiving initial collection notices from the IRS often reason that they will be able to resolve the liability by speaking with the IRS directly. When the IRS is attempting to collect an unpaid tax liability, however, the tax attorney serves as an important check on the collection power of the IRS. The tax attorney ensures that the taxpayer's substantive and procedural rights under the Internal Revenue Code are respected by the IRS while assisting the taxpayer with addressing the outstanding tax liability. As with the examination of a return, each phase of the collection process offers a greater opportunity to the taxpayer than the one that follows.

Where the taxpayer needs or desires to file a delinquent returns, the tax attorney must examine the reasons for the failure to file and discuss with the taxpayer possible criminal issues that may arise. In order to preserve the taxpayer's right against self-incrimination, the accountant faced with a noncompliant taxpayer should first refer the client to a tax attorney before discussing the case in detail with the taxpayer. With any delinquent filer, the tax attorney must enlist the services of a qualified accountant to work with the attorney to bring the taxpayer current with the IRS. Due to the potential criminal issues surrounding these taxpayers, the relationship between the attorney, accountant, and taxpayer must be carefully examined to limit the taxpayer's civil and criminal exposure.