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Confidential Report

Penalties and Interest: What are your options?

How Unfiled Tax Returns Hinder Your Chances of Settlement With The IRS

Do you think you're doing yourself justice by living underground and not filing your past year's tax returns? Think again! You may be doing yourself more harm than good. This report explains why you're better off staying current and in compliance with tax tiling requirements and the consequences one faces if one doesn't timely file their income tax returns.

LATE FILING PENALTY

Let's say you want to file but know you owe the IRS and for various reasons cannot pay the tax due when you file your returns. By not filing timely, you automatically subject yourself to the late filing penalty, IRC 6651(a)(1), unless you have reasonable cause for filing late. The late filing penalty is 5 percent of the amount of the tax required to be shown on the return for each month or fraction thereof that the failure continues, not to exceed 25 percent. By filing late, you've just added to the taxes you know you already owe.

INTEREST ON PENALTIES

In general, interest on penalties will only be imposed if the penalty or addition to the tax is not paid within 10 days after the notice and demand, and then only for the period from the date of the notice and demand to the date of payment. Most people who procrastinate and file late usually can't pay their taxes and penalties within 10 days of the notice and demand to do so. Now in addition to the taxes owed and late filing penalty, you are assessed interest on penalties. This is in addition to regular interest on the balance of taxes due. Fortunately, the IRS doesn't charge excessive rates of interest.

PAYMENT OPTIONS

What are one's payment options when they can't pay their taxes after filing them? Requesting and obtaining an installment plan is one. An Offer In Compromise is another. Another is discharging the taxes through bankruptcy.

INSTALLMENT PLAN

In order to obtain an installment plan all of one's tax returns must be filed. So if you receive a wage levy at work and want to obtain an installment plan in lieu of the IRS grabbing up to 25 percent of your take home pay, you must have all of your past year's taxes filed. If not, the IRS won't deal with you because you lack – "Good Faith" and are not in "compliance."

OFFER IN COMPROMISE

An Offer In Compromise (OIC) is an Offer to pay the IRS, in settlement of tax liabilities, less than 100% on the dollar but as much as they otherwise would expect to collect. The recent IRS Restructuring and Reform Act of 1998 includes provisions making the IRS more receptive to and even encouraging Offers In Compromise (OIC) in settlement of tax liabilities. However, all tax years must be filed or the IRS won't consider an OIC. By not filing past years' tax returns you may be missing a great opportunity to settle with the IRS, depending on your current financial position, for substantially less than the total taxes, interest, and penalties you owe them. People think the best time to make an Offer is when they're financially sound. Actually, the best time to make an Offer is when they're financially distressed because the IRS usually accepts OIC's when they otherwise could not expect to collect the full amount owed. One caveat, if the IRS accepts your OIC, you must remain current for five years by filing on time and paying timely, otherwise the IRS can revoke your OIC.

DISCHARGING TAXES THROUGH BANKRUPTCY

In general, you can discharge personal income taxes through bankruptcy if all of the following rules are met:

1. The Three Year Rule — the tax return due date, including extensions, must be more than three years old before the bankruptcy petition date.
2. The Two Year Rule — no discharge will be allowed if a tax return, including extensions, was not filed or a delinquent tax return was filed within two years of the date of the bankruptcy petition.
3. The 240 Day Rule — any tax must be assessed more than 240 days before the bankruptcy petition date.

If a Chapter 7 is filed and the three rules above are met for each tax year, one can discharge individual income taxes completely. The rules vary for a Chapter 13. In certain circumstances a taxpayer may completely discharge his/her taxes for a given tax year even though no return was filed for that year. For the most part, in order to completely discharge individual income taxes through bankruptcy, tax returns need to be filed.

DON'T MAKE THIS MISTAKE

I had a client engage me to prepare seven years back tax returns. Four of the seven years he was due refunds totaling \$ 10,000, he lost those refunds because he filed the returns too late. Yes, there is a statute of limitations on collecting tax refunds. Generally, if no return was filed, the claim for refund must be filed within two years from the time the tax was paid.

CRIMINAL IMPLICATIONS

Criminal penalties may be incurred when a taxpayer: willfully fails to file a tax return, fails to keep records, fails to supply required information, or fails to pay any tax or estimated tax. You don't want to risk the IRS construing your not filing as being willful. The cost of hiring a criminal tax attorney is expensive and the mental anguish of undergoing a criminal investigation can be devastating.

THE BOTTOM LINE

The bottom line is this, if you have unfiled tax returns, stop procrastinating, you may be hurting yourself and ruining your chances of getting an installment agreement, obtaining a refund, getting an Offer In Compromise or having your taxes discharged through bankruptcy. Why live in hiding? It's not pleasant to live without a bank account. If you can't locate income records, you can hire a tax professional, give them a Power of Attorney, and they can request your income records from the IRS under The Freedom of Information Act. There's no better time to get your unfiled tax returns filed and get current. Once you start the process, you'll feel better. Once your returns are filed, your chances of settling your tax liabilities will be enhanced.

Call my office today at 760-948-2899 to set up an appointment for a Free Consultation.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Scott M. Penn', with a long horizontal flourish extending to the right.

Scott M. Penn, CPA, CTRS
Fellow of the National Tax Practice Institute