

What if a Taxpayer Can't Pay Their Tax Liability?

At one time or another, many taxpayers face the harsh reality of being unable to pay their income tax liability on April 15th. If this happens, what options are there?

First and foremost, do not let the inability to pay 100% of the tax liability prevent the preparing and filing of the tax return on time. Even if the entire amount of tax due cannot be paid when filing the return, include as large a partial payment as possible, and consider borrowing the funds to make the balance of the payment. As discussed below, even filing without full payment can save substantial amounts in filing penalties. More importantly, procedures exist for payment extension and installment payment arrangements that will keep the IRS from instituting a collection action (lien, property seizure, etc.) for the amount of the unpaid tax.

Penalties for Failing to File and Pay. If a taxpayer fails to file their tax return on time, and has not sought an extension of time to file, the “failure to file” penalty accrues at the rate of 5% per month or part of a month (to a maximum of 25%) of the amount of tax shown due on the return. If the taxpayer fails to pay the income tax liability on time, and the IRS has not granted an extension of time to pay, the “failure to pay” penalty accrues at the rate of 1/2% per month or part of a month (to a maximum of 25%) on the amount actually shown as due on the tax return. If both penalties apply, the failure to file penalty drops to 4.5% per month (or part thereof) so the total combined penalty remains at 5%. The maximum combined penalty for the first five months is 25%. Thereafter the failure to pay penalty continues to accrue at 1/2% per month for up to 45 more months (an additional 22.5%). Thus, the combined penalties can reach a total of 47.5% over time. Both of these penalties are in addition to interest the IRS charges for paying taxes late. If quarterly estimated tax payments are also missed during the year, an additional penalty is tacked on for the period running from each payment’s due date until the tax return due date, normally April 15th (or earlier, if the payment is made before the due date).

Extensions of Time to Pay Tax. Rather than file on April 15th, many taxpayers obtain an automatic extension of time to file their tax return, allowing them to delay filing until October 15th. It is important to remember, however, that an extension of time to file a tax return does not constitute an extension of time to pay the tax bill. An extension of time to pay is available by showing that paying the entire tax liability would cause “undue hardship;” however, this extension is not automatically given. In order to establish undue hardship, it is not enough to show that it is merely inconvenient to pay the tax when due. For example, if

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a market exists, the IRS does not view selling property at market price to pay a tax liability as resulting in undue hardship. However, if the property would have to be sold at a “sacrifice” price, the undue hardship exception may apply. If the IRS grants the taxpayer’s request for an extension of time to pay, this will avoid the failure to pay penalty but the IRS will still charge interest on the unpaid tax.

Where Does the Tax Payment Come From? If obtaining an extension of time to pay tax is not possible, consider borrowing money to pay the tax liability. Loans from relatives or friends are often the simplest method to pay the bill, or at least a portion thereof. One advantage of such a loan is that the interest rate will probably be low, but also consider that loans over \$10,000 at below market rates of interest may trigger additional income tax consequences. If loans from individuals are not available, seek a loan from a bank or other commercial source; however, interest on a commercial loan to pay income taxes is nondeductible personal interest. In contrast, borrowing against the equity of a home and using the proceeds to pay a tax liability, allows the interest payments to be deductible even though the loan proceeds are not used in connection with the house. As a final source of payment, consider paying a tax liability by credit card (ideally, one with a low interest rate).

Finally, if a taxpayer simply cannot make a tax payment on time, request an installment agreement with the IRS. An installment agreement request is made by filing the designated IRS Form or by applying for a payment agreement online. The IRS charges a fee for installment agreements, which is deducted from the first payment after approval of the request. However, if the entire balance of the tax due can be paid within 120 days, the IRS will not charge a fee for the installment agreement. Even if the IRS grants a request to pay in installments, it will still charge interest on any tax not paid by its due date. The late payment penalty, however, will be assessed at half the usual rate as long as the return is filed on time. The IRS cannot reject an installment agreement request if the tax liability is \$10,000 or less and certain other criteria are met.

Too many taxpayers hide their heads in the sand when they run into financial difficulties and, as a result, fail to file their tax returns. Tax liabilities do not go away if left unaddressed. It is very important to file a properly prepared return on time even if the full amount of the tax due cannot be paid at the time of filing. Include as large a partial payment as possible with the return and borrow the remainder, or start working with the IRS for a hardship extension or installment agreement as soon as possible. Ignoring unpaid taxes will result in

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escalating penalties, plus the risk of having liens assessed against assets and income. Down the road, the collection process will also include seizure and sale of property. In many cases, taxpayers can avoid these tax nightmares by taking advantage of payment arrangements offered by the IRS.

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