What If You Can’t Pay Your Tax Liabilities?

What will happen and what should you do in the event that you cannot pay your taxes on time?

First and most importantly, don't let your inability to pay your tax liability in full keep you from filing your tax return properly and on time. It is also important to remember that an extension of time to file your tax return doesn't also extend the time to pay your tax bill. Even if you can't make full payment of your liabilities, timely filing your return and making the largest partial payment you can afford will save you substantial amounts in interest and penalties. Additionally, there are procedures for requesting payment extensions and installment payment arrangements which will keep the IRS from instituting its collection process (liens, property seizures, etc.) against you.

Overview of the most common penalties. The “failure to file” penalty accrues at the rate of 5% per month or part of a month (to a maximum of 25%, reached after five months) on the amount of tax your return should show you owe. The “failure to pay” penalty is gentler, accruing at the rate of only 0.5% per month or part of a month (to a maximum of 25%, reached after fifty months) on the amount actually shown as due on the return. If both apply, the failure to file penalty drops to 4.5% per month, so the total combined penalty remains at 5%—thus, the maximum combined penalty for the first five months is 25%. Thereafter, the failure to pay penalty can continue at 0.5% per month for 45 more months, yielding an additional 22.5%. In total, these combined penalties can reach 47.5% of your unpaid liability in less than five years.

Both of these penalties are in addition to the interest that you will be charged for your late payment. If you also missed estimated tax payments, 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. This penalty is computed at 3% above the fluctuating federal short-term interest rate for the period.

Borrowing money to pay taxes. Given the rate at which the above-mentioned penalties and interest accrues, it might be a good idea to borrow money to pay the taxes. In many situations, the rate of interest that you would pay to a family member, or even to a bank, is less overall than that which you would have to pay the IRS.
Loans from relatives or friends are often the simplest method to pay the bill. One advantage of such loans is that the interest rate will probably be low, but you must also consider that loans over $10,000 at below-market interest rates may trigger tax consequences. When loans from individuals are not available, a loan from a bank or other commercial source could be sought, but such loans are not likely to be made on favorable terms to a hard-pressed taxpayer. Moreover, interest on a loan to pay taxes is nondeductible personal interest. In contrast, if you can take out a home equity loan and use the proceeds to pay off your tax debts, you will probably be paying at a lower rate

than with other types of loans, and the interest payments will be deductible even if the loan proceeds aren't used in connection with the house.

Credit cards. It is relatively quick and easy to use credit cards to pay the income tax bill, whether you file your income tax return by mailing a paper copy or by computer. In addition, three companies (Official Payments Corporation at 888-872-9829, Link2Gov Corporation at 888-729-1040, and RBS WorldPay, Inc. at 888-972-9829) are authorized service providers for purposes of accepting credit card charges from both electronic and paper filers. However, credit card loans are likely to be at relatively high interest rates and the interest is not deductible. Moreover, the service providers typically charge an additional fee based on the amount you are paying.

Installment agreement request. If you cannot or prefer not to take out a loan, you might be able to defer your tax payments by requesting that the IRS enter into an installment payment agreement with you. This request is made on Form 9465 or by applying for a payment agreement online. There are various options for making your monthly installment agreement payments, including the direct debit and payroll deduction methods, both of which are made automatically and thus reduce the risk of default.

If you file and request a payment agreement online, there are three available payment options: (1) payment in full within 10 days (which saves on interest and penalties); (2) short-term extension of up to 120 days (for which no fee is charged, but additional penalties and interest accrue); or (3) monthly payment plan (which carries a user fee in addition to the continued accrual of penalties and interest).

You can also request an installment agreement on Form 9465, which can be filed along with either an e-filed or paper return. If the liability is under $25,000, you will not be required to submit financial statements. Even if your request to pay in installments is granted, you will be charged interest on any tax not paid by its due date. However, the late payment penalty will be half the usual rate (0.25% instead of 0.5%) if you file your return by the due date (including extensions).

The IRS charges a fee for installment agreements, which will be deducted from your first payment after your request is approved. The fee for entering into an installment agreement is regularly $105, but it is reduced to $52 when the taxpayer pays by way of a direct debit from the taxpayer's bank account. Notwithstanding the method of payment, the fee is $43 if the taxpayer is an eligible low-income taxpayer. There is a $45 fee to restructure or reinstate an established installment agreement that applies regardless of income levels or method of payment.

Note that an installment agreement request can be made after the expiration of a hardship extension period (described below). Additionally, the IRS has the authority to enter into an installment agreement calling for less than full payment of the tax liability over the term of the agreement if it determines that such an agreement will facilitate partial collection of the liability.

The installment agreement may terminate, and all your taxes become due immediately, under certain circumstances (for example, if you stop making payments).

The IRS is required to enter into an installment agreement at your request (a "guaranteed installment agreement") if the following apply:

- the tax liability is $10,000 or less (not counting interest and penalties);
- within the prior 5 years you have not (i) failed to file returns or pay taxes, or (ii) entered into a previous installment agreement;
- the IRS determines the tax liability cannot be paid in full;
- the installment agreement provides for full payment within 3 years; and
- you agree to comply with the tax laws during the agreement period.

As a matter of policy, the IRS often grants guaranteed installment agreements even if taxpayers are able to fully pay their accounts.

Undue hardship extensions. You may also qualify for an extension of time to pay if you can show that payment would cause "undue hardship." An undue hardship extension is applied for with Form 1127, to which you must attach a statement of assets and liabilities as well as an itemized list of receipts and disbursements for the 3 months preceding the tax due date.

If you qualify for an undue hardship extension, you will be given an extra six months to pay the tax shown as due on your tax return. You will avoid the failure to pay penalty, but you will still be charged interest. If the IRS determines a "deficiency" (i.e., that you owe taxes in excess of the amount shown on your return), the undue hardship extension can be as long as 18 months and, in exceptional cases, another 12 months can be tacked on. However, no extension will be granted if the deficiency was the result of negligence, intentional disregard of the tax rules, or fraud.

To establish undue hardship, it is not enough to show that it would just be inconvenient to pay your tax when due. For example, if you would have to sell property at a "sacrifice" price, you may qualify for an undue hardship extension. However, if a market exists, having to sell property at the current market price is not viewed as resulting in an undue hardship.

To qualify for an extension, you would have to: (i) show that you do not have enough cash and assets convertible into cash in excess of current working capital to meet your tax obligations; (ii) show you cannot borrow the amount needed except on terms that would inflict serious loss and hardship; and (iii) provide security for the tax debt. The determination of the kind of security—such as a bond, filing a notice of lien, mortgage, pledge, deed of trust, personal surety, or other form of security—will depend on the particular circumstances involved. However, no collateral is required if you have no assets.

Offer-in-compromise. Another potential way to deal with unpaid taxes is by using an offer-in-compromise, which is a technique that may allow you to settle your tax debt for a fraction of its face value. This option is available only if you have already filed your return but are unable to pay your taxes—in other words, it can't be requested prospectively.

Like any creditor, the IRS prefers a partial payment to no payment at all. Thus, the IRS might be willing to settle your liability for less than the full amount if: (a) you aren't able to pay the full amount, (b) there is doubt as to how much the tax liability is, (c) collection of the liability would create economic hardship for you (for instance, if you are out of work due to health problems, or if sale of your assets to pay the tax would leave you without enough money to meet basic living expenses), or (d) compelling public policy or equity considerations exist, and due to the exceptional circumstances (such as a medical condition that prevents proper management of financial affairs, or reliance on erroneous advice from the IRS), the IRS's collection of the full liability would undermine public confidence in the fair and equitable administration of tax laws.

The process is started by actually making an offer-in-compromise. If the offer is based on any reason other than doubt as to how much the tax liability is, you must submit your financial information along with the offer. If it is grounded on doubt as to the liability, the IRS is not permitted to request a financial statement. Partial payments must be made to the IRS while a periodic payment offer is being considered. For lump-sum offers, or offers involving five or fewer installments, a 20% down payment (of the total offer amount) must be made with the application.

In order to obtain an offer-in-compromise based on any of the above mentioned grounds except doubt as to liability, you must agree to comply with all tax law rules on filing returns and paying taxes for the longer of five years or until the offered amount is paid. If you don't comply with these rules, the compromise will terminate and the IRS can seek collection of the original liability amount.

Innocent spouse relief. If you are unable to pay liabilities that are attributable to your spouse, it might be worth exploring whether you are eligible for relief under the “innocent spouse” provisions. Under limited circumstances, a taxpayer can be relieved from liabilities shown on a joint return filed with a spouse. In general, relief is potentially available for: erroneous items attributable to the other spouse of which you had no knowledge or reason to know; the separate liabilities of a spouse to whom you are no longer married or with whom you no longer reside (including deceased spouses); and liabilities for which it would otherwise be inequitable to hold you liable. This is a very specialized type of relief that carries many procedural and substantive requirements, but it's important that you're aware of it because there are strict time restrictions associated with claiming innocent spouse relief.

Avoiding more serious consequences. Many taxpayers ignore their tax liabilities when they run into financial difficulties—for example, by failing to file their tax returns. However, tax liabilities do not go away if left unaddressed, and failing to deal with the problem often exacerbates it. It is very important that you timely file a properly prepared return, even if full payment cannot be made. Include as large a partial payment as you can with the return, and start working with the IRS on one (or more) of the options discussed above as soon as possible. Otherwise, you may face escalating penalties, the risk of having liens assessed against your assets and income, or even seizure and sale of your property. In many cases, these tax nightmares can be avoided by taking advantage of the arrangements offered by the IRS.

Of course, we are available to discuss all of these matters with you on a strictly confidential basis and to offer advice and assistance. Please don't hesitate to call us at 978-854-5656.

Very truly yours,

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