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# Does the Failure to Timely Issue Notice and Demand Impact the Underlying Assessment Rather Than the Just Liens or Levies?

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# Does the Failure to Timely Issue Notice and Demand Impact the Underlying Assessment Rather Than the Just Liens or Levies?

By Keith Fogg

Keith Fogg analyzes the impact a failure to send notice and demand might have on the validity of an assessment.

**N**otice and demand, like assessment, generally provides a mundane step in the collection process that few pay any attention. A recent Ninth Circuit opinion brings back into focus the Tax Court decision which through its silence suggested that some life may still exist in arguments that an IRS foot fault at this stage has meaningful consequences with respect to the assessment made against a taxpayer instead of just the collection actions taken thereafter.<sup>1</sup> On appeal the taxpayer abandoned the argument that failure to send notice and demand rendered the assessment invalid and focused instead on arguments of *ex parte* and the inability of the Collection Due Process notice required by Code Sec. 6330 to serve as the notice and demand required by Code Sec. 6303. The taxpayer failed but the issues in the case deserve some discussion.

Because an assessment must occur within a specific time frame, knocking out the assessment due to a default in the process of making or completing the notice and demand could eliminate the liability altogether. The problem frequently comes to light after the time for making assessment for that tax period has expired. So, the IRS has a strong interest in making sure that post assessment problems, such as the timely issuance of notice and demand, do not invalidate the assessment itself but only impact post assessment options available to the IRS. Even if a delay in sending out notice and demand does not knock out the assessment, it could significantly impact the collection options available to the IRS—or not.

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A look at this case and the cases decided in the past few decades may provide insight to some in this dusty corner of tax procedure.

## Background of Notice and Demand Provisions

When the IRS makes an assessment, Code Sec. 6303(a) provides that it “shall, as soon as practicable, and within 60 days after the making of an assessment of a tax pursuant to § 6203, give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof. Such notice shall be left at the dwelling or usual place of business of such person, or shall be sent by mail to such

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person’s last known address.”<sup>2</sup> Subsection (b) of this section permits delay in sending the notice where the assessment occurs prior to the last date prescribed for payment, *e.g.*, where a balance due return for individual income taxes is filed in February. Notice and demand usually takes the form of a letter informing the taxpayer that an unpaid assessment exists and requesting that the taxpayer please pay it within 10 days. Most taxpayers and practitioners think of it, assuming they think of it at all, as the first notice in the series of collection notices that the IRS sends before it takes serious collection action such as filing a notice of federal tax lien or initiating a levy.

While the language of Code Sec. 6303 contains the directive “shall,” the regulations implementing the statute adopt a much more forgiving approach. The implementing regulation generally tracks the precise language of the statute but contains an additional sentence — “However, the failure to give notice within 60 days does not invalidate the notice.”<sup>3</sup> Case law, as discussed below, has adopted the approach of the regulation and found the failure to send the notice and demand within 60 days as something that the IRS can generally cure by sending out the notice and demand after the 60-day period. Consequences do exist for failure to send out the notice and demand letter within 60 days; however, those consequences are generally not

thought to extend to invalidating the underlying assessment. Most courts have separated notice and demand from the assessment process and made it a part of the lien process. The *Nakano* case does not find the assessment invalid; however, it reaches that conclusion by finding an untraditional notice and demand letter rather than simply saying that the failure to send notice and demand does not impact assessment.

## The Assessment Process

To set the scene for the discussion of the consequences of an IRS failure to send notice and demand, it helps to think about the legal and practical issues surrounding assessment. Assessment of federal taxes serves several purposes. It primarily serves as the mechanism for the IRS to record a liability on its books and records. Until an assessment occurs, the IRS generally cannot take any collection action and it has no mechanism for recording the existence of a liability. For most people, assessment of tax serves the important purpose of allowing them to obtain a refund because it is the assessment of tax coupled with the credits sitting on the account that creates the overpayment of tax generating a refund. From 1978 to 1994, the IRS made the institutional decision to violate the automatic stay of the Bankruptcy Code in Bankruptcy Code section 362(a)(6) barring assessment in order to allow taxpayers in bankruptcy to obtain their refunds.<sup>4</sup> Not one taxpayer ever complained about this stay violation and in 1994, Congress finally realized that by barring the IRS from making assessments in bankruptcy cases, it was keeping the IRS from recording liabilities in the only statutory method it had.

In well over 90 percent, probably closer to 99 percent of cases, the IRS makes an assessment because the taxpayer files a tax return and consents to assessment. In the other cases, assessment results from the taxpayer signing a consent to assessment during audit, the math error process, a default of a notice of deficiency or a partial or complete loss in Tax Court. No matter how it occurs, the IRS will search the specific account period and tax type for which the assessment occurs to determine if credits (payments) exist on that account. If credits exist, the IRS will satisfy the assessment with the credits and refund to the taxpayer any excess of credits (assuming the offset provisions are not triggered by an outstanding federal tax or other qualifying debt). If credits do not exist, the IRS will (should) send out a notice and demand letter within 60 days of the assessment for the difference between the amount of the credits on the account and the amount of the assessment. Most taxpayers have withholding credits

or estimated tax payments on their account or they remit the known balance with their return, and they never see a notice and demand letter.

In the small minority of cases in which the credits on the account do not equal the amount of the assessment, the IRS issues the notice and demand letter. The IRS knows of the need for this letter before it makes the assessment based on the process it has developed. It almost always makes assessments on Mondays and it almost always sends out the notice and demand letter on the Saturday before the Monday (postdating the letter to Monday) in order for the taxpayer to have as much notice as possible in order to pay the balance within 10 days after notice and demand and avoid the federal tax lien.<sup>5</sup> As with all systems, sometimes it fails and notice and demand does not go out within 60 days of the assessment or, and this is not the issue in *Nakano*, the notice and demand letter does not go to the taxpayer's last known address.

## Consequences of Failing to Send Notice and Demand Letter

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The courts have previously addressed what happens when the IRS fails to send out notice and demand.<sup>6</sup> The cases generally hold that the failure to send the notice and demand does not invalidate the underlying assessment but rather prevents the federal tax lien from coming into existence and prevents the IRS from taking administrative collection action.<sup>7</sup>

Courts have agreed with the regulation and allowed the IRS to issue the notice and demand letter late and begin administrative collection action/notice of tax lien filing thereafter. The consequence to the IRS of not sending the notice and demand letter is not to destroy its right to tax administrative collection action but merely to postpone it. Courts have also found that different types of IRS correspondence other than the narrowly tailored notice and demand letter of Code Sec. 6303 can meet the statutory requirement.

The focus on the federal tax lien rather than assessment exists because the assessment provisions of Code Secs. 6201, 6202 and 6203 do not mention notice and demand. Section 6201 provides the general authority for assessment.<sup>8</sup> In Code Secs. 6202 and 6203 Congress granted broad authority to the IRS to establish the mode and time of assessment and the method of assessment, respectively.<sup>9</sup> Like the statutory provisions, the regulations under these sections do not mention notice and demand. I believe they do not because notice and demand is a post-assessment process not linked to the validity of the

assessment itself. The regulations under Code Sec. 6203 were written in 1954 and last amended over 30 years ago. They set up a procedure for assessment officers in service centers who sign summary records as the method of making assessments.

## The Role of Notice and Demand in Creating the Federal Tax Lien

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In contrast to the assessment process, which does not mention notice and demand, the federal tax lien provisions in Code Secs. 6321 and 6322 peg their existence to the failure of the taxpayer to pay the tax after the IRS makes its demand.<sup>10</sup> Once neglect or refusal to pay occurs after the making of notice and demand, the federal tax arises and, pursuant to Code Sec. 6322 arises (or relates back to) the date of assessment. Without notice and demand, the federal tax lien cannot arise. If the federal tax lien does not arise, the IRS has an assessment but no means for securing the assessment, protecting the priority of its position in the assets of the taxpayer or moving forward with administrative collection.

## Notice and Demand as a Predicate to Levy

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Similarly, the notice and demand provisions play a pivotal role in the other main collection tool of the IRS—the levy. Code Sec. 6331(a) makes notice and demand a predicate to levy—“If any person liable to pay any tax neglects or refuses to pay the same within 10 days after notice and demand, it shall be lawful for the Secretary to collect such tax by levy ... .” Code Sec. 6330 places an additional requirement restricting levy “unless the Secretary has notified such person in writing of their right to a hearing under this section before such levy is made.”

## Application of the Failure to Send Notice and Demand Letter in Code Sec. 6320 Case

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At the Tax Court two cases were consolidated because both individuals were responsible officers of the same corporation even though they had different issues before the Tax Court. In addition to the *Nakano* case, the Tax Court also decided the *Conroy* case. I will talk about the *Conroy* case first because the IRS chose not to appeal it. Then I will discuss the *Nakano* case.

Mr. Nakano's co-worker, Mr. Conroy, also had a huge trust fund recovery penalty assessed against him, and he had a parallel issue regarding notice and demand. Somehow the IRS failed to send either individual a traditional, timely, notice and demand letter. For Mr. Conroy, the IRS filed a notice of federal tax lien first before sending the traditional notice and demand. The Settlement Officer ultimately determined, after being directed to do so by the team chief, that the Code Sec. 6320 notice sent following the filing of the notice of federal tax lien served as the notice and demand in Mr. Conroy's case and, therefore, the notice of federal tax lien was valid. IRS Counsel argued this position in the Tax Court. This is an extraordinary argument since without notice and demand no lien exists. If no federal tax lien exists, no basis for filing a notice of federal tax lien exists and the filing of the notice of federal tax lien would appear to be a violation of the disclosure provisions giving rise to a penalty against the IRS pursuant to Code Sec. 7431.<sup>11</sup>

The Tax Court declined the invitation of the IRS to hold that the issuance of the Code Sec. 6320 notice satisfied notice and demand. The IRS chose not to appeal this decision even though the taxpayer appealed the companion decision and the IRS was already going to be making arguments in the Circuit Court. So, the Conroy case and the extraordinary argument of the IRS that a Code Sec. 6320 notice could satisfy the notice and demand requirement for an already filed notice of federal tax lien ended with the Tax Court decision.

## Application of the Failure to Send Notice and Demand Letter in Code Sec. 6330 Case

All of this sets the scene for the Ninth Circuit's decision in the *Nakano* case in which the IRS failed to send the traditional notice and demand letter prior to seeking to take levy action. The issue arose in the context of a collection due process (CDP) case. CDP did not exist in the 1980s when the primary wave of challenges to the timely issuance of notice and demand occurred. It came into existence in the Revenue Reform Act of 1998. Because CDP did not exist at that time and the Tax Court was then almost exclusively a pre-assessment forum, the Tax Court did not face the issue of the impact of failing to send out the notice and demand letter timely when the cases cited above were decided. Perhaps for that reason, the Tax Court treated its opinion on this issue as a full Tax Court opinion indicating that it thought its decision was novel or precedent setting. The insight of the Tax Court

will bring a new perspective to this issue. I think the Court reached the right result here although it did so on the basis of a factual argument rather than directly addressing the legal issue of the effect of the failure to timely issue the notice and demand letter on the underlying assessment.

The IRS determined that Mr. Nakano failed to pay over taxes collected by the company, National Airlines, Inc., where he served as the Chief Financial Officer. It therefore assessed against him the trust fund recovery penalty in an amount equal to the unpaid trust fund taxes. A couple of items about his trust fund recovery liability deserve note. First, his liability does not stem, or at least not primarily, from unpaid employment taxes, the traditional route to this penalty, but rather for unpaid airline excise taxes. The trust fund recovery penalty applies in any situation in which a responsible officer does not pay over federal taxes collected on behalf of the IRS by an entity. Excise taxes can cause this liability as well as employment taxes but do so much less frequently. Second, the liabilities at issue were for quarters in 2000 and 2001 yet the trust fund recovery penalty assessment did not occur until March 28, 2006, over five years later. Interest did not run on Mr. Nakano's trust fund recovery penalty until assessment. This is a consequence of placing the trust fund recovery penalty statute in the assessable penalties section of the Internal Revenue Code, which, I believe, is a mistake Congress should correct.<sup>12</sup>

When the IRS assessed the trust fund recovery penalty against Mr. Nakano on March 28, 2006, it apparently failed to send him a notice and demand letter until June 6, 2006, 70 days after assessment. Because of the size of his liabilities, almost \$9 million, his case did not take the normal route through the collection process. In most cases the IRS will follow the notice and demand letter with one or two other letters sent six to eight weeks after each other. These letters are not required by statute but are designed by the IRS to convince the taxpayer to pay without triggering the more serious steps of filing the notice of federal tax lien or issuing a levy. Here, the size of the liability caused the IRS to collapse its normal process and move very quickly to levy, or at least the threat of levy. Here, the IRS issued the Notice of Intent to Levy letter, required by Code Secs. 6330 and 6331, on May 22, 2006, within the 60-day period after assessment. The Ninth Circuit, sustaining the Tax Court, determined that the notice of intent to levy served the purpose of the notice and demand letter.

The Tax Court looked at Code Sec. 6303 to determine what information should go into a notice and demand. It determined that the statute required that a notice and demand state the amount of the unpaid tax and demand

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