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The Legal Consequences of Noncompliance with Federal Tax Laws

Allen Madison

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The Legal Consequences of Noncompliance with Federal Tax Laws

ALLEN D. MADISON

Abstract

This Article addresses the legal consequences a taxpayer should consider when deciding whether to comply with the basic requirements of the federal income tax laws. A taxpayer considering noncompliance should consider the government’s authority to assert criminal liability, impose civil tax penalties, and forcibly collect any unpaid tax. Although there are numerous criminal tax offenses, the potential offenses that may affect a taxpayer’s decision whether to comply are the failure to file and failure to pay misdemeanors, tax perjury felony, and attempted tax evasion felony. Similarly, the civil tax penalties that are intended to deter basic noncompliance are the failure to file addition to tax, failure to pay addition to tax, and civil fraud penalty. The remaining penalties (over 100 of them) target various types of behavior engaged in by people other than the taxpayer or that occur after a taxpayer has already decided to file a tax return. Thus, a taxpayer deciding whether to file a tax return or attempt to defraud the government need only consider these three. A taxpayer must also consider that the government is authorized, after satisfying certain procedural requirements, to forcibly collect the tax the taxpayer owes.

In the study of tax controversy, it is unusual to group these topics—collection, penalties, and criminal liability—together under the umbrella of noncompliance. Prior to this Article, a taxpayer inquiring about these considerations and their impact would not have found these topics presented together with the purpose of responding to the inquiry. The Code disperses these topics throughout its procedural subtitle. Treasury regulations are organized by Code provision, so they are of no help either. Moreover, secondary sources organize tax controversy chronologically based on events that may occur in the process. Although tax controversy events rarely flow chronologically, the decisions and determinations that taxpayers and the government make flow sequentially. The first decision a taxpayer makes is whether to comply with the tax laws. Thus, it makes sense to discuss criminal liability, penalties, and collection before the discussing the decision to file a return or the procedures for determining a deficiency.

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Introduction

The study of tax controversy begins with the taxpayer’s decision on whether to comply with the tax laws. In making this decision, a taxpayer must consider the consequences of not complying. If a taxpayer engages in basic noncompliance—not filing a required return, not paying a tax due, or committing fraud—the government is authorized to collect the amount owed with interest, impose penalties, and, if warranted, send the noncompliant taxpayer to jail. The negative societal and infrastructure consequences of taxpayer noncompliance, although potentially devastating to society, are beyond the scope of this Article.

It may seem unusual to examine collection actions, penalties, and criminal sanctions before discussing the Service’s return review process. These consequences of noncompliance typically flow from an examination of a taxpayer’s books and records. The taxpayer’s consideration, however, occurs in his head, before the Service has any books and records to examine.

Another reason to discuss noncompliance consequences first—especially the collection process—is that the procedures set up to provide notice to taxpayers of a Service investigation, determination, and assessment sometimes fail to get the taxpayer’s attention. It is common that the first time the taxpayer becomes aware the Service has determined he owes more tax is when the Service begins to collect it through collection procedures set forth below. Noncompliant taxpayers tend to take note when their paychecks or their bank accounts begin to shrink.

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1 This Article focuses on taxpayers who have not yet decided whether to comply with the tax laws. Although there are negative consequences for sloppy or negligent reporting, the taxpayer in such a case has already decided to comply with the tax laws. Such consequences are not discussed here because the focus is on rules that apply before making the decision whether to comply.

2 The theoretical literature about the decision whether to comply with the tax laws suggests a number of taxpayer considerations. See Jose A. Noguera, et al., Tax Compliance, Rational Choice, and Social Influence: An Agent-Based Model, 55 Revue Francaise de Sociologie 765 (2014); Donna D. Bobek, et al., Analyzing the Role of Social Norms in Tax Compliance Behavior, 115 J. Bus. Ethics 451 (2013); James Andreoni, et al., Tax Compliance, 36 J. Econ. Lit. 818 (1998). It is not necessary to address such theoretical considerations in this Article because this Article discusses the decision in the larger context of tax controversy.


4 Unless otherwise stated, the term “he” is intended to simplify references to “he or she.”
Prior to the discussion of the various consequences of noncompliance, this Article describes the importance of assessment to the procedures the Service has for addressing noncompliance in Part I. Next, this Article provides the background for noncompliance topics. Part II details the Service’s collection process, Part III sets forth basic civil tax penalties, and Part IV discusses the government’s procedures for imposing criminal liability. Part V concludes.

I. Assessment and Noncompliance

Assessment is generally integral to the enforcement mechanisms giving rise to the consequences of noncompliance. In most cases, it begins the collection process. Moreover, it is a prerequisite for the Service to impose certain civil tax penalties.

A tax liability develops by operation of law on the due date of a tax return. Before the Service may begin collecting a tax liability, it still must establish the existence and amount of the liability. It is the assessment that establishes the liability of the taxpayer. The official assessment occurs when the assessment officer signs the assessment record identifying the taxpayer, the amount owed, and the character of the liability.

There are various types of assessments. The first is the summary assessment. This type of assessment can take place without an investigation. The Service uses it to assess tax liabilities reported on tax returns as well as to assess additional amounts resulting from clerical errors. Under the summary assessment procedures, the Service assesses the liabilities and then sends a notice.

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5 See United States v. Dack, 747 F.2d 1172, 1174 (7th Cir. 1984) (“[A] tax deficiency . . . is deemed to arise by operation of law on the date the return is due.”).

6 See I.R.C. § 6502 (“Where the assessment of any tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by levy or by a proceeding in court . . . .”); United States v. Galletti, 541 U.S. 114, 122 (2004) (“To be sure, the assessment of a tax triggers certain consequences. After the amount of liability has been established and recorded, the IRS can employ administrative enforcement methods to collect the tax.”).

7 See § 6502; Galletti, 541 U.S. at 122.

8 See I.R.C. § 6203 (“The assessment shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary.”); Reg. § 301.6203-1.

9 Two rare types of assessments are the jeopardy assessment and termination assessment. See I.R.C. §§ 6861, 6851. The Service may rely on the authority under these provisions where it suspects the taxpayer may hide himself, his assets, or in some other way substantially decrease his ability to pay a tax due. See §§ 6861, 6851.

10 It is called a summary assessment because it takes place without an investigation. See Bryan T. Camp, The Mysteries of Erroneous Refunds, 114 Tax Notes (TA) 231, 234 (Jan. 15, 2007) (“It is called the summary procedure because the IRS simply and summarily records the taxpayer’s liability, payments, and credits, based on the information before it, and then notifies the taxpayer if there is a balance due.”).

11 See I.R.C. § 6201(a)(1) (“The Secretary is authorized and required to make the . . . assessments of all taxes . . . imposed by this title [including] all taxes determined by the taxpayer or by the Secretary as to which returns or lists are made under this title.”).
to the taxpayer if the liability is not fully paid. The summary assessment is considered the general rule, while the other types of assessments are exceptions to the Service’s summary assessment authority.

The second type is the deficiency assessment. This type of assessment occurs after the Service has investigated a tax return and determined the taxpayer owes more tax. Prior to a deficiency assessment, the taxpayer has the opportunity to dispute the Service’s determination of a deficiency in the Tax Court. The Service must first send the taxpayer a statutory notice of deficiency giving the taxpayer 90 days to file a Tax Court petition. The Service may not assess until the taxpayer either fails to file a petition in Tax Court or the Tax Court proceeding has come to a final decision.

The third type of assessment is a penalty assessment. The Service may immediately assess certain penalties without going through its deficiency procedures. One example of an immediately assessable penalty is the delinquency penalty under certain circumstances. The Code also imposes immediately assessable penalties on taxes held in trust for the Service. These are called assessable penalties because the imposition of the penalty constitutes an independent assessment of a taxpayer’s liability for the penalty with no restrictions.

In general, the Service has three years from the filing of a tax return to assess the tax. Where a taxpayer has substantially omitted tax items from a tax return, the Service has a six-year statutory time period to assess the tax. If the taxpayer does not file a tax return, the Service has an unlimited amount

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12 See Camp, supra note 10, at 234.
13 See Camp, supra note 10, at 234.
14 See I.R.C. § 6213 (describing the assessment of a deficiency).
15 See I.R.C. § 6212 (describing the Service’s deficiency procedures).
16 See § 6213.
17 See § 6213. Note that a taxpayer who is outside the country has 150 days to respond to the notice.
18 See § 6213.
20 See C.C.N. CC-2002-002 (Oct. 17, 2001) (holding that whether a delinquency penalty is immediately assessable “depend[s] upon whether the penalty is based upon a delinquency reflected on the return or upon a deficiency (with or without a filed return)”).
21 See §§ 6672–6720C (Chapter 68, Subchapter B of the Code).
22 See Saltzman & Book, supra note 3, at ¶ 7B.01 (“Assessable penalties are penalties the Service may assess without restrictions applicable in deficiency cases.”).
23 See I.R.C. § 6501(a) (“Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed.”).
24 See § 6501(e)(1)(A) (“If the taxpayer omits from gross income an amount properly includible therein and . . . such amount is in excess of 25 percent of the amount of gross income stated in the return . . . the tax may be assessed . . . at any time within 6 years after the return was filed.”).
of time to collect a tax liability because no limitations period has begun. In such a case, the amount does not even need to be assessed.

To establish the liability in the case where the taxpayer did not file a return, the Service may prepare a return for the taxpayer. Such a return—substitute for return—does not start the limitations period on assessment, thus the time-period for the Service to assess remains unbounded. Also, there is no time limit for the Service to assess tax reported on a false return filed knowingly with the intent to evade tax.

II. Collection

In determining whether to comply with the tax laws, a taxpayer must consider that the government may forcibly take the tax. The Service may collect the tax owed with interest where the amount remains unpaid. The Service’s administrative collection authority is extraordinary. The Service’s assessment is analogous to a judgment on which the government may collect without going to court. In *Bull v. United States*, the Supreme Court explained the rationale for expedient collection of taxes:

> [T]axes are the lifeblood of the government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to . . . drastic means of collection. The assessment is given the force of a judgment, and if the amount assessed is not paid when due, the administrative officials may seize the debtor’s property to satisfy the debt.

When the Service employs its administrative collection authority, it summarily exercises the power of the sovereign. Some of the actions have the potential to cause financial harm the taxpayer by damaging the taxpayer’s

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25 See § 6501(c)(3) (“In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.”).

26 See § 6501(c)(3).

27 See I.R.C. § 6020(b) (“If any person fails to make any [required] return . . . the Secretary shall make such return from his own knowledge and from such information as he can obtain . . . .”).

28 See § 6020(b); I.R.M. 4.12.1.8.2.1.1(B) (referring to section 6020(b) and providing, “This is an SFR.”).

29 See § 6501(b)(3) (“[T]he execution of a return by the Secretary pursuant to the authority conferred by [section 6020(b)] shall not start the running of the period of limitations on assessment and collection.”).

30 See § 6501(c)(1) (“In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.”).

31 See I.R.C. § 6601(a) (requiring payment of interest on unpaid taxes); see infra Part II.A.

32 See *Saltzman & Book*, supra note 3, at ¶ 14.01.

33 See *Cohen v. Gross*, 316 F.2d 521, 522-23 (3d Cir. 1963) (“[A]ssessment is a prescribed procedure for officially recording the fact and the amount of a taxpayer’s administratively determined tax liability, with consequences somewhat similar to the reduction of a claim for judgment.”); *Bull v. United States*, 295 U.S. 247, 259-60 (1934).

34 *Bull*, 295 U.S. at 259-60.
credit rating, making the taxpayer insolvent, or leaving the taxpayer homeless. As a matter of sound tax policy, the Service should have no interest in causing such drastic harm because it impairs a taxpayer's ability to pay the tax liability.

A. Overview of the Administrative Collection Process

Taxpayers have a number of opportunities to become current with their tax liabilities even during the collection process. If the taxpayer persists in refusing to pay, the Service takes the following steps after assessing the tax liability:

1. Notice & demand – the Service must issue notice of the amount due and demand for payment.\(^35\)

2. Federal tax lien – a lien arises by operation of law if no payment is made within ten days of the notice and demand.\(^36\)

3. Notice of federal tax lien – the Service files a notice of the lien if necessary to gain priority over certain creditors.\(^37\)

4. Levy – the Service may take the taxpayer’s assets and sell them if any amount is still owed.\(^38\)

The Service has 60 days after assessment to issue a notice of the liability and demand for payment.\(^39\) The failure to pay on notice and demand triggers a federal tax lien on all of the taxpayer’s property and rights to property.\(^40\) The Service may then gain priority over more creditors by filing a Notice of

\(^35\)See I.R.C. § 6303(a) (“[T]he Secretary shall, as soon as practicable, and within 60 days, after the making of an assessment of a tax pursuant to section 6203, give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof.”).

\(^36\)See I.R.C. § 6321 (“If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.”); I.R.C. § 6331(a) (“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.”).

\(^37\)See I.R.C. § 6320(a)(1) (“The Secretary shall notify in writing the person [who has failed to pay after notice and demand] described in section 6321 of the filing of a notice of lien under section 6323.”).

\(^38\)See I.R.C. § 6331(b) (“In any case in which the Secretary may levy upon property or rights to property, he may seize and sell such property or rights to property.”). The Service’s authority to levy is subject to limitations. See, e.g., I.R.C. §§ 6330 (right to pre-levy hearing), 6334 (property exempt from levy), 6337 (redemption rights).

\(^39\)See § 6303 (“[T]he Secretary shall, as soon as practicable, and within 60 days, after the making of an assessment of a tax pursuant to section 6203, give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof.”).

\(^40\)See § 6321 (“If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property . . . whether real or personal, belonging to such person.”).
Federal Tax Lien\(^{41}\) (NFTL) and informing the taxpayer it has done so.\(^{42}\) If the Service files an NFTL, the Service must also notify the taxpayer of the right to a collection due process (CDP) hearing.\(^{43}\) If the above efforts have not yielded payment from the taxpayer, the Service may levy the taxpayer’s property,\(^{44}\) but must first issue a notice of intent to levy.\(^{45}\) The notice of intent to levy also includes a notification of the right to a CDP hearing.\(^{46}\) Once the levy is instituted, the Service may seize and sell the taxpayer’s property to satisfy any outstanding liabilities.\(^{47}\)

Throughout the collection process, the Service attempts to contact the taxpayer to make arrangements to pay the liability.\(^{48}\) Some of the statutory notices the Service sends to a taxpayer notify him of the right to a CDP hearing.\(^{49}\) Both the correspondence with the taxpayer and the CDP hearings provide the opportunity for a taxpayer to discuss payment alternatives that would end the collection process.

Once the Service assesses a tax, the Code provides the Service a ten-year period to collect the tax by levy or judicial proceeding.\(^{50}\) The collection statute extends in a few circumstances. For example, an installment agreement between the Service and the taxpayer can extend the statutory period.\(^{51}\) The Service and the taxpayer may agree on a period of collection in an installment agreement, after which the Service has another 90 days to continue collection efforts.\(^{52}\) The Service may also complete a judicial proceeding that starts prior to the expiration of the statutory period.\(^{53}\)

\(^{41}\) See I.R.C. § 6323 (b), (f) (requiring the Service to file a notice of the lien with state or local recording offices to obtain priority among certain creditors).

\(^{42}\) See § 6320(a)(1) (“The Secretary shall notify in writing the person [who has failed to pay after notice and demand] described in section 6321 of the filing of a notice of lien under section 6323.”).

\(^{43}\) See § 6320(a)(3)(B) (“The notice required . . . shall include . . . the right of the person to request a [collection due process] hearing.”).

\(^{44}\) See I.R.C. § 6331(a) (“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 upon all property and rights to property . . . belonging to such person or on which there is a lien provided in this chapter for the payment of such tax.”).

\(^{45}\) See § 6331(d) (“Levy may be made under subsection (a) upon the salary or wages or other property of any person with respect to any unpaid tax only after the Secretary has notified such person in writing of his intention to make such levy.”).

\(^{46}\) See I.R.C. § 6330(a)(3)(B) (“The notice required . . . shall include . . . the right of the person to request a [collection due process] hearing . . . .”).

\(^{47}\) See § 6331(b) (“In any case in which the Secretary may levy upon property or rights to property, he may seize and sell such property or rights to property.”).

\(^{48}\) See Saltzman & Book, supra note 3, at ¶ 14A.03[3]-[4] (noting the Service’s practice of sending multiple follow up letters, making follow-up telephone calls, and attempting to meet the taxpayer in person).


\(^{50}\) See I.R.C. § 6502(a)(1).

\(^{51}\) See § 6502(a)(2)(A).

\(^{52}\) See § 6502(a)(2)(A).

\(^{53}\) See § 6502(a)(2).
B. **Liens and Levies**

The Service’s administrative collection authority permits the Service to collect tax without judicial action. Ordinary creditors must go to court to collect on a judgment. The Service is no ordinary creditor—the Code provides powerful administrative procedures that make judicial action unnecessary for collection. A federal tax lien attaches to a taxpayer’s assets if the Service receives no payment after the Service has informed the taxpayer of the tax due and demanded payment. Everything is in place at that point for the Service to take the taxpayer’s assets to satisfy the tax. Technically, the Service could just wait the statutory length of time and issue a levy. But if an investigation shows there are competing creditors, the Service may issue an NFTL before initiating a levy action to take the taxpayer’s assets.

1. **Notice and Demand**

The Service’s collection efforts begin in earnest with a notice of liability and demand for payment, referred to as notice and demand. The Service has 60 days after assessment to send the taxpayer a notice and demand letter. Included in the letter is a notification of how much the taxpayer owes for a particular tax year. After the notice and demand, the taxpayer has ten days to pay the tax. Failure to respond within 21 days of the notice triggers a penalty for failing to pay the tax demanded. Although not required, the Service’s practice after the notice and demand is to send a number of

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55 See I.R.C. § 6331(a) (“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 . . . .”).

56 See I.R.C. § 6303(a) (“[T]he Secretary shall, as soon as practicable, and within 60 days, after the making of an assessment of a tax . . . give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof.”). The 60-day period is a soft deadline. The tax liability still exists for the Service to collect through judicial enforcement even if it fails to give notice and demand payment within the statutory period. See Blackston v. United States, 778 F. Supp. 244, 247 (D. Md. 1991) (“[T]his Court concludes . . . that the appropriate ‘sanction’ against the I.R.S. for its failure to comply with the § 6303(a) notice and demand requirement is to take away its awesome nonjudicial collection powers.”).

57 See § 6303(a).

58 See § 6331(a).

59 See I.R.C. § 6651(a)(3) (“In case of failure . . . to pay any amount in respect of any tax required to be shown on a return . . . within 21 calendar days from the date of notice and demand therefor . . . there shall be added to the amount of tax stated in such notice and demand 0.5 percent of the amount of such tax . . . .”).
follow-up letters, make multiple phone calls, and, if possible, see the taxpayer in person prior to taking the next step in collecting the liability.\textsuperscript{60} The failure of the Service to issue a notice and demand within 60 days does not invalidate the underlying tax assessment.\textsuperscript{61} The Service may still collect the tax. After the 60-day period, the Service loses its “awesome” administrative summary collection authority.\textsuperscript{62} But while the assessment remains, the Service retains the option to institute a judicial collection proceeding to collect the liability.\textsuperscript{63}

2. Federal Tax Lien

The failure to pay the amount owed after notice and demand triggers a federal tax lien by operation of law.\textsuperscript{64} The lien relates back to the date of the assessment and stays in place until paid or the statutory collection period expires.\textsuperscript{65} It attaches to all property and rights to property of the taxpayer, including certain property acquired after the lien.\textsuperscript{66} The Service may enforce this lien by seizing the property subject to the lien\textsuperscript{67} as discussed in more detail below in Part II.B.4.

The federal tax lien can attach to property that state law would protect from other creditors.\textsuperscript{68} Drye v. United States is an example.\textsuperscript{69} There, the taxpayer owed $325,000.\textsuperscript{70} The Service had assessed this amount and filed notices of federal tax liens to collect it.\textsuperscript{71} To avoid the Service’s reach, the taxpayer disclaimed an inheritance that would have been subject to the lien under state law.\textsuperscript{72} Under Arkansas law, however, an heir’s disclaimer of a share of an inheritance protects the property from the reach of the disclaimant’s creditors.\textsuperscript{73}

The Court found that the state law protection did not protect taxpayers under a federal tax lien.\textsuperscript{74} Section 6321\textsuperscript{75} authorizes the government to impose

\textsuperscript{60}\textit{See} Saltzman & Book, supra note 3, at ¶ 14.03.

\textsuperscript{61}\textit{See} Blackston, 778 F. Supp. at 247.

\textsuperscript{62}\textit{See id.}

\textsuperscript{63}\textit{See id.}

\textsuperscript{64}\textit{See} I.R.C. § 6321 (“If any person liable to pay any tax neglects . . . to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.”).

\textsuperscript{65}\textit{See} I.R.C. § 6322 (“[T]he lien imposed by section 6321 shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed . . . is satisfied or becomes unenforceable by reason of lapse of time.”).

\textsuperscript{66}\textit{See Reg. § 301.6321-1.}

\textsuperscript{67}\textit{See} I.R.C. § 6331.

\textsuperscript{68}\textit{See, e.g.,} Drye v. United States, 528 U.S. 49, 61 (1999) (attaching to a disclaimed inheritance).

\textsuperscript{69}\textit{See id.} at 58.

\textsuperscript{70}\textit{Id.} at 52-53.

\textsuperscript{71}\textit{Id.}

\textsuperscript{72}\textit{Id.}

\textsuperscript{73}\textit{Id.}

\textsuperscript{74}\textit{Id.} at 61.

\textsuperscript{75}Unless otherwise stated, all section references are to the Code as amended.
a lien on property or rights to property belonging to a delinquent taxpayer.\textsuperscript{76} Section 6331 authorizes a levy on any property on which there is a lien to pay the tax.\textsuperscript{77} Section 6334(a) lists categories of items exempt from levy and inherited property is not one of the exemptions.\textsuperscript{78} State law determines what rights exist; federal law determines whether such rights are property or rights to property under section 6321.\textsuperscript{79} The taxpayer had a property or right to property because he had control of disposition of the inheritance.\textsuperscript{80} Thus, he had property or a right to property for purposes of the federal tax lien.\textsuperscript{81} The lien attached to the disclaimed property.\textsuperscript{82}

The federal tax lien may also attach to jointly held property.\textsuperscript{83} \textit{United States v. Craft} is an example.\textsuperscript{84} There, the taxpayer and his wife owned real property as tenants by the entirety.\textsuperscript{85} The Service had assessed the taxpayer’s tax liability.\textsuperscript{86} Section 6321 authorizes the government to impose a lien on property or rights to property belonging to a delinquent taxpayer.\textsuperscript{87} State law determines what rights exist; federal law determines whether such rights are property or rights to property under section 6321.\textsuperscript{88} Tenancy by the entirety is a joint ownership between a married couple with a right of survivorship for each spouse.\textsuperscript{89} The taxpayer had the right to use the property, exclude people from it, and share income produced from it.\textsuperscript{90} These rights gave the taxpayer a sufficient level of control for the property interest to be considered property under section 6321.\textsuperscript{91} It is not necessary to be able to sell the property unilaterally for property rights to attach.\textsuperscript{92} It would also be absurd to allow a married couple to defeat tax collection merely by classifying a piece of property as a tenancy by the entirety.\textsuperscript{93} Therefore, the taxpayer had “rights to property” so the federal tax lien attached to it.\textsuperscript{94}

\textsuperscript{76}See I.R.C. § 6321; \textit{Drye}, 528 U.S. at 55.
\textsuperscript{77}See I.R.C. § 6331; \textit{Drye}, 528 U.S. at 55.
\textsuperscript{78}See I.R.C. § 6334(a); \textit{Drye}, 528 U.S. at 56.
\textsuperscript{79}See \textit{Drye}, 528 U.S. at 58-59 (“We look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach, then to federal law to determine whether the taxpayer’s state-delineated rights qualify as ‘property’ or ‘rights to property’ within the compass of the federal tax lien legislation.”).
\textsuperscript{80}See id. at 59.
\textsuperscript{81}See id. at 60.
\textsuperscript{82}See id. at 61.
\textsuperscript{84}See id.
\textsuperscript{85}See id. at 276.
\textsuperscript{86}See id.
\textsuperscript{87}I.R.C. § 6321; see \textit{Craft}, 535 U.S. at 276.
\textsuperscript{88}See \textit{Crafti}, 535 U.S. at 278 (quoting \textit{Drye v. United States}, 528 U.S. 49, 58 (1999)).
\textsuperscript{89}See \textit{Craft}, 535 U.S. at 285.
\textsuperscript{90}Id. at 283.
\textsuperscript{91}See id.
\textsuperscript{92}See id. at 284-85.
\textsuperscript{93}Id. at 285.
\textsuperscript{94}See id. at 288.
The federal tax lien encumbers all property and rights to property of the taxpayer without the government recording the lien in the state and local recording offices.\(^95\) That means that other creditors and credit reporting agencies are not on notice that the government has a lien on the property. A federal tax lien is sometimes referred to as a secret lien because there is no notice requirement.\(^96\) Even without notice, the lien gives the government priority over other secured creditors or interests in the property.\(^97\) However, the federal tax lien does not give the government priority over subsequent purchasers, mechanics lienors, or judgment creditors.\(^98\) To take priority over these creditors, the Service must file an NFTL.\(^99\)

3. **Notice of Federal Tax Lien**

Although the Service may enforce the federal tax lien by levy with no further action, to obtain priority over subsequent purchasers, mechanics lienors, or judgment creditors, the Service must file an NFTL in the relevant state and local recording offices.\(^100\) The act of filing the NFTL announces to the public—including other creditors and credit reporting agencies—that the Service has a lien on the taxpayer’s property. The post-notice lien still does not take priority over certain third parties’ interests who had no knowledge of the NFTL.\(^101\)

The Service may defer the filing of the NFTL where filing it would impair the taxpayer’s ability to pay the tax.\(^102\) Filing the NFTL may make it difficult for the taxpayer to get a loan to pay the debt because the NFTL becomes a

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\(^95\) See I.R.C. § 6321.

\(^96\) See I.R.C. § 6323(a) (“The lien imposed by section 6321 shall not be valid against any purchaser, holder of a security interest, mechanic’s lienor, or judgment lien creditor . . . .”).

\(^97\) See § 6321.

\(^98\) See §§ 6321(a), 6323(a), (f) (“Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid . . . With respect to [the purchaser unaware of the NFTL] of a security, . . . a motor vehicle, . . . property purchased at retail, . . . household goods . . . in a casual sale, . . . tangible personal property subject to a [repair] lien, . . .”). This provision also cedes priority to state tax liens, certain types of mechanic liens, and attorney liens. See § 6323(b).

\(^99\) See I.R.C. §§ 6321(a), 6323(a), (f).

\(^100\) See §§ 6321(a), 6323(b) (“Even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid . . . With respect to [the purchaser unaware of the NFTL] of a security, . . . a motor vehicle, . . . property purchased at retail, . . . household goods . . . in a casual sale, . . . tangible personal property subject to a [repair] lien, . . .”). This provision also cedes priority to state tax liens, certain types of mechanic liens, and attorney liens. See § 6323(b).

\(^101\) See I.R.C. § 6323(b) (“A decision may be made to defer the filing of an NFTL when the revenue officer can substantiate with reasonable certainty and supported with documentation from the taxpayer, that filing the NFTL will hamper collection.” (emphasis omitted)).
public record. Revenue officers often wait to file the NFTL until they have given a taxpayer the opportunity to work out a plan to pay.

A taxpayer who believes the Service filed an erroneous NFTL has a vested interest in filing an administrative appeal because the NFTL has serious consequences. In such an appeal, the taxpayer may not challenge a deficiency determination. If the taxpayer prevails, the Service will release the lien. This kind of appeal would be appropriate, for example, where the Service filed an NFTL for the wrong taxpayer.

The taxpayer may also have an interest in requesting the withdrawal of a lien rather than merely a release. In a lien withdrawal, the Service will alert the credit reporting agencies of the withdrawal and treat the lien as though it never happened. In other words, the lien is removed from the taxpayer’s credit report. In contrast, a tax lien release—which occurs automatically 30 days after the debt is paid—does not remove the prior existence of the lien from the taxpayer’s credit history.

4. Levy

If the bill, notice and demand for payment, lien, notice of lien, and phone calls from the Service fail to motivate the taxpayer to act, the Service may institute a levy action. In a levy action, the Service may seize the taxpayer’s property and rights to property as well as property encumbered by the federal

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103 See § 6323(f) (detailing where the Service files the NFTL). The Service informs taxpayers that the NFTL may have a negative effect on their credit on the educational part of their web site. See IRS Tax Topic 201, The Balance Due Collection Process (2005), http://www.irs.gov/taxtopics/tc201.html (“The filing of a Notice of Federal Tax Lien may appear on your credit report and may harm your credit rating.”).

104 See I.R.M. 5.12.2.3(3) (“The determination to defer filing the NFTL because it will hamper collection must be part of an agreed resolution between the [Revenue Officer] and the taxpayer that deferral will both facilitate collection and be in the best interest of the government and the public.”).

105 See I.R.C. § 6326 (“[A]ny person shall be allowed to appeal to the Secretary after the filing of a notice of a lien under this subchapter on the property or the rights to property of such person for a release of such lien alleging an error in the filing of the notice of such lien.”).

106 See Reg. § 301.6326-1(a) (“Any person may appeal . . . a notice of federal tax lien . . . for a release of lien alleging an error in the filing of notice of lien [but may not] challenge the underlying deficiency that led to the imposition of a lien.”).

107 See id.

108 See § 6323(j)(1) (“The Secretary may withdraw a notice of a lien filed under this section and this chapter shall be applied as if the withdrawn notice had not been filed . . . ”); Reg. § 301.6323(j)-1(a).

109 See I.R.C. § 6325(a) (“[T]he Secretary shall issue a certificate of release of any lien imposed with respect to any internal revenue tax not later than 30 days after the day on which . . . the liability . . . has been fully satisfied . . . or [the IRS has] accepted . . . a bond [for payment of] the amount assessed.”).

110 See I.R.C. § 6331(a) (“If any person . . . neglects or refuses to pay [a tax owed] within 10 days after notice and demand, it shall be lawful for the Secretary to collect such tax . . . by levy upon all property and rights to property . . . belonging to such person or on which there is a lien provided in this chapter for the payment of such tax.”).
Once the Service has possession of the property, the Service may sell it to cover the taxpayer's unpaid liabilities.\footnote{See § 6331(a).}

Nonetheless, the Service must execute various steps before instituting the levy. First, the Service must wait for ten days after it sends the taxpayer a notice and demand for payment.\footnote{See § 6331(a).} Second, the Service must wait for 30 days after it has issued a notice of intent to levy.\footnote{See § 6331(a).} The notice of intent to levy must describe the statutory and administrative procedures relating to levy and sale alternatives that might be available to prevent the levy.\footnote{See § 6331(d)(2) (“The notice [of intent to levy] shall be . . . given in person, . . . left at the [taxpayer’s] dwelling . . ., or sent by . . . mail . . . no less than 30 days before the day of the levy.”).} Third, the Service must inform the taxpayer of the right to a CDP hearing.\footnote{See § 6331(d)(4).}

Two of the most common items the Service levies are bank accounts and wages. A taxpayer who has ignored or not received the notice and demand, the notice of lien, and the notice of intent to levy might not be aware of a tax liability until the Service levies on the taxpayer’s bank account\footnote{See I.R.C. § 6331(e) (“The effect of a levy on salary or wages payable to or received by a taxpayer shall be continuous from the date such levy is first made until such levy is released.”).} or wages.\footnote{See I.R.C. § 6330(a)(1) (“No levy may be made on any property or right to property of any person unless the Secretary has notified such person in writing of their right to a hearing under this section before such levy is made.”).}

The Service is authorized to levy nonexempt property that exists at the time it issues the notice of levy.\footnote{See Reg. § 301.6331-1(a)(1) (“A levy on a bank reaches any interest that accrues on the taxpayer’s balance under the terms of the banks agreement with the depositor during the 21-day holding period provided for in section 6332(c).”).} Many life necessities are exempt from the Service’s levy authority.\footnote{See § 6331(b) (“Except [as to wages and salaries], a levy shall extend only to property possessed and obligations existing at the time thereof.”); Reg. § 301.6331-1(a)(1) (“Except as provided . . . with regard to a levy on salary or wages, a levy extends only to property possessed and obligations which exist at the time of the levy.”).} These exemptions protect a taxpayer from, among other things, being stripped of clothing and crucial household items, means to carry on a business, and the ability to support family members.\footnote{See § 6334(a).}
After instituting a proper levy, the Service may take the levied property.\textsuperscript{124} The Service can take the taxpayer’s property or property subject to the federal tax lien held by a third party.\textsuperscript{125} The Code imposes steep penalties and personal liability for the value of the property for failing to surrender levied property on demand.\textsuperscript{126}

The Service must issue a notice of sale before selling a taxpayer’s seized property.\textsuperscript{127} It must also investigate the facts and circumstances surrounding the taxpayer’s account and the value of the property.\textsuperscript{128} The sale must take place no sooner than ten days after the notice and no later than 40 days.\textsuperscript{129} If the proceeds exceed the liability and costs, the excess is returned to the taxpayer or another party who can prove he owns an interest in the property.\textsuperscript{130} Once real estate is sold, the taxpayer still has 180 days to redeem the property.\textsuperscript{131}

The Code provides taxpayers an opportunity to be heard at certain points in the collection process. When the taxpayer receives a notification letter—the taxpayer is entitled to at least one for the lien and another for the levy—the Service includes information on the right to a CDP hearing.\textsuperscript{132} The CDP hearing provides, among other things, the opportunity for the taxpayer to negotiate settlement options of the debt or enter into a payment plan.\textsuperscript{133}

\begin{itemize}
\item \textsuperscript{124} See § 6331(b) (“The term ‘levy’ as used in this title includes the power of distraint and seizure by any means. . . . In any case in which the Secretary may levy upon property or rights to property, he may seize and sell such property or rights to property . . . .”).
\item \textsuperscript{125} See § 6331(a) (“If any person . . . neglects or refuses to pay [a tax owed] within 10 days after notice and demand, it shall be lawful for the Secretary to collect such tax . . . by levy upon all property and rights to property . . . belonging to such person or on which there is a lien provided in this chapter for the payment of such tax.”).
\item \textsuperscript{126} See I.R.C. § 6332(d)(1), (2) (“Any person who fails . . . to surrender any property . . . subject to levy, upon demand by the Secretary, shall be liable in his own person . . . in a sum equal to the value of the property . . . not so surrendered. . . . In addition to . . . personal liability, . . . if any person required to surrender property . . . without reasonable cause, such person shall be liable for a penalty equal to 50 percent of the amount recoverable under paragraph (1).”).
\item \textsuperscript{127} See I.R.C. § 6335(b) (“The Secretary shall as soon as practicable after the seizure of the property give notice to the owner . . . and shall cause a notification to be published in some newspaper . . . within the county wherein such seizure is made . . . . Such notice shall specify the property to be sold, and the time, place, manner, and conditions of the sale thereof.”).
\item \textsuperscript{128} See § 6331(j).
\item \textsuperscript{129} See I.R.C. § 6335(d) (“The time of sale shall not be less than 10 days nor more than 40 days from the time of [publishing the notice of sale] . . . .”).
\item \textsuperscript{130} See I.R.C. § 6342(b) (“Any surplus proceeds remaining after the [satisfying the tax liability and costs] shall . . . be credited . . . to the person or persons legally entitled thereto.”).
\item \textsuperscript{131} See I.R.C. § 6337(b)(1) (“The owners of any real property sold [by the Service] shall be permitted to redeem the property sold . . . at any time within 180 days after the sale thereof.”).
\item \textsuperscript{132} See I.R.C. §§ 6320(a)(3)(B) (notice of lien), 6330(a)(3)(B) (notice of intent to levy).
\item \textsuperscript{133} See Reg. § 301.6330-1(e)(1) (providing that at a CDP hearing, a taxpayer may raise issues regarding “collection alternatives”); accord Reg. § 301.6320-1(e)(1).
\end{itemize}
C. Collection Due Process Rights

Before the Service can levy on a taxpayer’s property, it must give the taxpayer an opportunity for administrative review of the Service’s collection actions by the Appeals Office, also known as a CDP hearing.\(^{134}\) Once the Appeals Office issues a notice of determination, the taxpayer may appeal to the Tax Court.\(^{135}\) These procedures provide the taxpayer an opportunity to resolve most concerns regarding the lien and levy process and to negotiate with the Service over whether and how the collection action should proceed.\(^{136}\)

The Service is required to notify the taxpayer of the right to request a CDP hearing around the time the Service files an NFTL and around the time it files a notice of intent to levy.\(^{137}\) For the years addressed in a CDP notice, a taxpayer is entitled to request one lien hearing and one levy hearing.\(^{138}\) The taxpayer must request the CDP hearing in writing within 30 days of the CDP notice.\(^{139}\)

If the request is made after the deadline, the Service generally permits an “equivalent hearing” but that cannot be appealed to the Tax Court.\(^{140}\) An

\(^{134}\) See § 6330(b)(1) (“If the person [who has received a Notice of Intent to Levy] requests a [CDP] hearing in writing . . . and states the grounds for the requested hearing, such hearing shall be held by the Internal Revenue Service Office of Appeals.”). This Article does not discuss the Appeals Office procedures in detail because the collection process is a secondary responsibility of the Appeals Office. The Appeals Office’s primary and traditional responsibility is to hear appeals from Service examinations or investigations.

\(^{135}\) See § 6330(d)(1) (“The person [who requested a CDP hearing after receiving a Notice of Intent to Levy] may, within 30 days of a determination under this section, petition the Tax Court for review of such determination . . . .”)

\(^{136}\) See Reg. §§ 301.6330-1(c), 301.6330-1(i)(1) (“A taxpayer who fails to make a timely request for a CDP hearing is not entitled to a CDP hearing. Such a taxpayer may nevertheless request an administrative hearing with Appeals, which is referred to herein as an ‘equivalent hearing.’”), 301.6330-1(i)(2) Q&A-16 (“Section 6330 does not authorize a taxpayer to appeal the decision of Appeals with respect to an equivalent hearing.”).
equivalent hearing, if granted, is, as the name suggests, equivalent to a CDP hearing, except that the Appeals Office will document the outcome differently.\textsuperscript{141} The period to request an equivalent hearing with respect to an NFTL is one year and five days after the filing of the NFTL.\textsuperscript{142}

While the Appeals Office considers a CDP request, the Service suspends its administrative collection activities.\textsuperscript{143} At the same time, the collection statute stops running.\textsuperscript{144} The tolling of the limitations period begins on the request for a CDP hearing and extends through resolution.\textsuperscript{145}

In a CDP hearing, a taxpayer may dispute the underlying tax liability in limited circumstances.\textsuperscript{146} The taxpayer may challenge the Service’s determination only when he did not actually receive the Statutory Notice of Deficiency or had no other chance to dispute the underlying tax liability.\textsuperscript{147} Accordingly, the Tax Court has permitted a taxpayer couple who had filed a tax return and had not otherwise disputed their tax liability to dispute their underlying liability in a CDP hearing.\textsuperscript{148}

There are three ways that the collection process concludes. First, the collection process ends when the Service has collected the liability in full. Second, the process ends when the Service receives an agreed upon partial payment to resolve the account. Third, the process ends when the collection statute has expired.\textsuperscript{149}

D. Payment and Settlement Mechanisms

For purposes of collection, the Code provides payment and settlement options for four types of taxpayers. First, there are taxpayers who can pay

\textsuperscript{141} See Reg. § 301.6330-1(i)(1) (“The equivalent hearing will be held by Appeals and generally will follow Appeals procedures for a CDP hearing. Appeals will not, however, issue a Notice of Determination. Under such circumstances, Appeals will issue a Decision Letter.”).

\textsuperscript{142} See Reg. § 301.6320-1(i)(2), Q&A-I7 (“For a CDP Notice issued under section 6320, a taxpayer must submit a written request for an equivalent hearing within the one-year period commencing the day after the end of the five-business-day period following the filing of the NFTL.”).

\textsuperscript{143} See §§ 6320(c), 6330(e). (making § 6330(e) applicable in the lien context).

\textsuperscript{144} See §§ 6320(c), 6330(e).

\textsuperscript{145} See §§ 6320(c), 6330(e).\textsuperscript{146} See § 6330(c)(2)(B) (“The person may also raise at the hearing challenges to the existence or amount of the underlying tax liability for any tax period if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability.”).

\textsuperscript{147} See § 6330(c)(2)(B).

\textsuperscript{148} See Montgomery v. Commissioner, 122 T.C. 1, 8-9 (2004) (“[I]f Congress had intended to preclude taxpayers from challenging in a collection review proceeding taxes that were assessed pursuant to [summary tax return assessment procedures], the statute would have been drafted to clearly so provide.”).

the full liability all at once. Second, there are taxpayers who can pay the full liability as long as the Service lets them pay over a period of time rather than all at once. Third, there are taxpayers who can pay part of the liability, but will likely never be able to pay the full liability without suffering undue hardship. Fourth, there are taxpayers who cannot pay any of their liability without suffering undue hardship.

Negotiation options exist for each of these taxpayers. The Code and the Service’s guidance refer to these options as “collection alternatives.” A taxpayer who can pay his tax liability all at once should do so or the Service will collect it through its summary collection procedures. If the taxpayer has paid or the Service has collected the payment in full, the collection actions will stop. Next, a taxpayer with steady income but scarce liquid resources (i.e., someone who cannot pay right away, can enter into an installment agreement with the Service). Another type of taxpayer is one with sporadic income and scarce liquid resources (i.e., someone who cannot pay an entire liability without hardship, can enter into an “offer in compromise,” or “OIC”). Finally, a taxpayer with little or no income as well as a lack of other resources (i.e., someone who cannot pay the Service anything at all and may already be suffering hardship, can request that the Service remove the account from its collection inventory and reclassify the liability as “currently uncollectible,” or “CNC”). Taxpayers have other options as well—Taxpayer Assistance Orders, audit reconsideration, or bankruptcy.

1. Installment Agreements

A taxpayer that does not have a sufficient amount of money on hand to pay a tax debt, but can pay soon or over time may enter into an installment agreement. The Code “authorizes” the Service to enter into installment agreements. Thus, generally the Service has discretion, but is not required, to accept an installment agreement proposal. In some cases, however, the Code requires the Service to accept proposals that meet certain statutory requirements.

150 See § 6330(c)(2)(A)(iii) (referring to “offers of collection alternatives, which may include the posting of a bond, the substitution of other assets, an installment agreement, or an offer-in-compromise”); Publication 594, supra note 149, at 4.

151 See I.R.C. § 6159(a) (“The Secretary is authorized to enter into written agreements with any taxpayer under which such taxpayer is allowed to make payment on any tax in installment payments if the Secretary determines that such agreement will facilitate full or partial collection of such liability.”).

152 See I.R.C. § 7122(a) (“The Secretary may compromise any civil . . . case arising under the internal revenue laws . . . .”).

153 See § 6159(a) (“The Secretary is authorized to enter into written agreements with any taxpayer under which such taxpayer is allowed to make payment on any tax in installment payments if the Secretary determines that such agreement will facilitate full or partial collection of such liability.”).

154 See § 6159(a).
The Service refers to installment agreement proposals it is required to accept as “Guaranteed Installment Agreements.” A proposal is “guaranteed” acceptance if the individual owes less than $10,000 (excluding penalties and interest), demonstrates to the Service the inability to pay at the time, has remained in compliance for the last five years, agrees to pay within three years, and agrees to remain in compliance while the payment plan is in effect.

The Service has automated or “streamlined” its discretion in some cases. The Service’s policies for streamlined installment agreements provide for acceptance of a proposal where the taxpayer’s liability is $50,000 or less (including unpaid penalties and interest) and the taxpayer agrees to complete payments in six years. A streamlined installment agreement proposal requires no management approval and no financial statements for acceptance.

For proposals involving a liability over $50,000, the Service exercises its discretion on the basis of the taxpayer’s circumstances. The Service ascertains the taxpayer’s circumstances from the financial statements the taxpayer must include with the proposal. The Service carefully considers the taxpayer’s financial statements when deciding whether to accept a proposal.

The Service has the discretion to reject an installment agreement proposal. A taxpayer may file for an administrative appeal of the proposal rejection within 30 days of notice. The Appeals Office considers the appeal, and the taxpayer may further appeal that decision to the Tax Court.

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155 See I.R.M. 5.14.5.3(1) (“Guaranteed Installment Agreements—Internal Revenue Code (IRC) section 6159(c) requires the Service to accept proposals of installment agreements under certain circumstances.”).

156 See § 6159(c); I.R.M. 5.14.5.3(1).


159 See I.R.M. 5.14.1.4(2) (instructing Service personnel as follows: “If taxpayers do not qualify for Guaranteed [or] Streamlined . . . installment agreements determine a plan for resolving the balance due accounts based on the Collection Information Statement (CIS) and supporting documentation provided by the taxpayer.”).

160 See id.

161 See Haubrich v. Commissioner, 97 T.C.M. (CCH) 1192, 1195, 2009 T.C.M. (RIA) ¶ 2009-045, at 281 (“Accepting or rejecting an installment agreement proposed by a taxpayer is within the discretion of the Commissioner.”); Reg. § 301.6159-1(d)(1) (“A proposed installment agreement has not been rejected until the IRS notifies the taxpayer or the taxpayer’s representative of the rejection, the reason(s) for rejection, and the right to an appeal.”).

162 See Reg. § 301.6159-1(d)(3) (“The taxpayer may administratively appeal a rejection of a proposed installment agreement to the IRS Office of Appeals . . . if, within the 30-day period commencing the day after the taxpayer is notified of the rejection, the taxpayer requests an appeal in the manner provided by the Commissioner.”).

163 See id.; see also I.R.C. § 6330 (providing for judicial review of pre-levy hearings that may involve “offers of collection alternatives, which may include . . . an installment agreement”).
Applying for an installment agreement suspends the Service’s collection statute while under consideration.\footnote{164}{See Reg. § 301.6159-1(g) ("The statute of limitations under section 6502 for collection of any liability shall be suspended during the period that a proposed installment agreement relating to that liability is pending with the IRS. . . .").} During an installment agreement, collection actions are also suspended, though the Service does not revoke a lien if there is already one in place.\footnote{165}{See I.R.C. § 6331(k)(2)-(3) ("No levy may be made . . . on the property or rights to property of any person . . . during the period that an offer by such person for an installment agreement under section 6159 for payment of such unpaid tax is pending with the Secretary.").} The collection statute resumes 30 days after a rejection or termination.\footnote{166}{See § 6331(k)(2)-(3).}

2. Offers in Compromise

A taxpayer with limited income and scarce liquid resources (\textit{i.e.}, someone who cannot pay an entire liability without hardship) can submit an OIC.\footnote{167}{See I.R.C. § 7122(a) ("The Secretary may compromise any civil . . . case arising under the internal revenue laws . . .").} An offer in compromise is a taxpayer request for the Service to accept less than the full tax liability and relieve the taxpayer of the remaining unpaid liability. Such settlements with the government help benefit both the government and the taxpayer. The government can collect the maximum amount possible without causing financial ruin on the taxpayer.

The Service considers offers in compromise on three bases: (1) collection potential, (2) liability, and (3) equity. Treasury regulations provide parameters for when the Service may accept an offer on these bases.\footnote{168}{See generally Reg. § 301.7122-1.} The Service will not, however, accept an offer in compromise from a taxpayer who has not kept current with return filing and tax payments subsequent to the period covered by the offer.\footnote{169}{See generally Reg. § 301.7122-1.}

When considering collection potential, the Service may accept an offer where there is “doubt as to collectibility.”\footnote{170}{See Reg. § 301.7122-1(b)(2).}
on these grounds where the taxpayer has neither sufficient income nor sufficient assets to pay the tax liability.\textsuperscript{171} Doubt as to collectibility means there is doubt as to “reasonable collection potential” of the taxpayer’s full tax liability within the ten-year statute on collection.\textsuperscript{172} Essentially, doubt exists as to whether the taxpayer can pay. The taxpayer must fill out financial statements listing his assets, liabilities, and earning potential.\textsuperscript{173} The Service makes its determination on the basis of these financial statements.\textsuperscript{174}

The Service may also accept an offer where there is “doubt as to liability.”\textsuperscript{175} The Service may accept an offer on these grounds only where there is a legitimate dispute as to whether the taxpayer owes tax.\textsuperscript{176} The Service does not accept offers on these grounds where the taxpayer has already had an opportunity to dispute the underlying tax liability. And by the time the taxpayer is in collections and offering to compromise because of doubt as to liability, the taxpayer has usually had numerous opportunities to dispute the liability.\textsuperscript{177} The taxpayer need not include a financial statement with this type of offer.\textsuperscript{178}

When considering equity grounds for accepting an offer, the Service looks for opportunities to promote “effective tax administration.”\textsuperscript{179} The Service may accept an effective tax administration offer where a taxpayer technically has the ability to pay the tax liability, but rejecting the offer would make the taxpayer suffer economic hardship.\textsuperscript{180} A hardship situation may occur because the taxpayer has limited resources due to long-term illness, medical

\textsuperscript{171} See id. (“Doubt as to collectibility exists in any case where the taxpayer’s assets and income are less than the full amount of the liability.”).

\textsuperscript{172} See, e.g., Samuel v. Commissioner, 94 T.C.M. (CCH) 392, 2007 T.C.M. (RIA) ¶ 2007-312 (the Service and the taxpayer disagreeing on the “reasonable collection potential” under the taxpayer’s circumstances).

\textsuperscript{173} See, e.g., Nash v. Commissioner, 96 T.C.M. (CCH) 318, 2008 T.C.M. (RIA) ¶ 2008-250 (taxpayer failing to fill out financial statements the Service requires for consideration of an offer in compromise for doubt as to collectibility).

\textsuperscript{174} See, e.g., id.

\textsuperscript{175} See Reg. § 301.7122-1(b)(1).

\textsuperscript{176} See id. (“Doubt as to liability exists where there is a genuine dispute as to the existence or amount of the correct tax liability under the law. Doubt as to liability does not exist where the liability has been established by a final court decision or judgment concerning the existence or amount of the liability.”).

\textsuperscript{177} Before a collection action has begun, the taxpayer has likely had an audit of his return under section 7602, likely had the opportunity for an administrative appeal to the Appeals Office under section 601.106 of the Treasury Regulations, and had an opportunity to petition the U.S. Tax Court under section 6213.

\textsuperscript{178} See I.R.C. § 7122(d)(3)(B)(ii) (requiring that the Service’s guidelines for evaluating “an offer-in-compromise which relates only to issues of liability of the taxpayer” include a provision that “the taxpayer shall not be required to provide a financial statement”).

\textsuperscript{179} See Reg. § 301.7122-1(b)(3).

\textsuperscript{180} See id. (“A compromise may be entered into to promote effective tax administration when the Secretary determines that, although collection in full could be achieved, collection of the full liability would cause the taxpayer economic hardship . . . .”).
conditions, disabilities, or similar circumstances. Another hardship where the Service might be inclined to accept an offer on grounds of effective tax administration occurs where paying the tax would prevent the taxpayer from meeting basic living expenses. Acceptance on this basis is only available where the taxpayer cannot qualify for an acceptance on the basis of doubt as to collectibility.

The taxpayer may appeal the rejection of an offer in compromise to the Tax Court. The Tax Court reviews Offers in Compromise determinations under an abuse of discretion standard. In Samuel, the question was whether the Service abused its discretion when it rejected the taxpayer’s offer in compromise. The offered grounds were doubt as to collectibility. Some bad business decisions in starting up his own practice had left the taxpayer in financial trouble. He offered the Service $30,000 on a $773,368 tax liability. Seeing the required minimum offer as $163,000, the Service rejected the taxpayer’s offer. The Tax Court found the Service abused its discretion because the Tax Court’s own computation showed the appropriate minimum offer as $107,000.

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181 See Reg. § 301.7122-1(c)(3)(i)(A) (providing that under compromises to promote effective tax administration, the Service may consider that the “[t]axpayer is incapable of earning a living because of a long term illness, medical condition, or disability, and it is reasonably foreseeable that [the condition will exhaust] the taxpayer’s financial resources”).

182 See Reg. § 301.7122-1(c)(3)(i)(C) (“providing that under compromises to promote effective tax administration, the IRS may consider that “[a]lthough taxpayer has certain assets . . . liquidation . . . to pay outstanding tax liabilities would render the taxpayer unable to meet basic living expenses”).


184 See Samuel, 94 T.C.M. (CCH) at 396, 2007 T.C.M. (RIA) ¶ 2007–312 at 1711 (“Where, as here, the underlying tax liability is not at issue, our review of the notice of determination under section 6330 is for abuse of discretion.”).

185 Id. at 393, 2007 T.C.M. (RIA) ¶ 2007–312 at 1707 (“The issue for decision is whether respondent’s rejection of petitioner’s offer-in-compromise was an abuse of discretion.”).

186 Id. at 394, 2007 T.C.M. (RIA) ¶ 2007–312 at 1708 (“Petitioner submitted the offer on the basis of ‘doubt as to collectability.’”) (quoting taxpayer).

187 Id. at 394, 2007 T.C.M. (RIA) ¶ 2007–312 at 1710 (“In his [response to the IRS’s preliminary determination] he said that when he ‘lost his job’ practicing with another urologist in 2002, he accumulated substantial debt setting up his new medical practice and paying necessary living expenses and fell behind on his child support payments.”).


189 Id. at 395, 2007 T.C.M. (RIA) ¶ 2007–312 at 1710 (after requesting the taxpayer increase his offer to $163,158, which the taxpayer did not do, the Service issued a determination letter, stating: “your offer-in-compromise does not outweigh the government’s need for efficient collection of your tax liabilities. Your collection alternative was considered however we find that it is not a viable alternative given the facts and evidence raised.”).

190 Id. at 398, 2007 T.C.M. (RIA) ¶ 2007–312 at 1713 (“In the present case, petitioner should have been advised that . . . an acceptable [offer] would be . . . $107,094. Appeals’ failure to do so was an abuse of discretion, and we so hold.”).
The Service is not required to accept an offer where doing so would be against public policy. In *Barnes*, the Service rejected an offer of $32,000 to settle a $400,000 liability. The grounds for the offer were doubt as to collectibility with special circumstances and effective tax administration.\(^{191}\) The Service rejected Barnes’ effective tax administration offer because the regulations require that the taxpayer have a sufficient amount of assets to pay the offer.\(^{192}\) The Service also rejected the doubt as to collectibility offer, because the taxpayers could afford to pay more than their minimum offer.\(^{193}\)

One of the arguments the taxpayers made was that the Service should have accepted their offer on the grounds of effective tax administration because they were fraud victims.\(^{195}\) The taxpayers had been involved in “Hoyt” tax shelter partnerships.\(^{196}\) Mr. Hoyt was a tax shelter promoter who told investors he had 38,000 head of cattle for breeding, when in reality he had fewer than 5,000.\(^{197}\) He procured investments in this imaginary cattle herd for tax benefits.\(^{198}\) Over 3,000 investors were defrauded.\(^{199}\) He sold these cows with inflated values to limited partnerships, including a partnership with

\(^{191}\) See *Barnes v. Commissioner*, 92 T.C.M. (CCH) 31, 31, 2006 T.C.M. (RIA) ¶ 2006-150, at 1014 (“Petitioners argue that Appeals was required to accept their offer of $32,000 to compromise what they estimate is their approximately $400,000 Federal income tax liability.”).

\(^{192}\) See *id.* at 34, 2006 T.C.M. (RIA) ¶ 2006-150 at 1018 (“Petitioners made their offer-in-compromise due to doubt as to collectibility with special circumstances and to promote effective tax administration.”).

\(^{193}\) See *id.* at 34, 2006 T.C.M. (RIA) ¶ 2006-150 at 1018 (“Cochran [the Service Appeals Officer] determined that petitioners’ offer did not qualify as an offer-in-compromise to promote effective tax administration because petitioners were unable to pay their liability in full.”).

\(^{194}\) See *id.* at 34, 2006 T.C.M. (RIA) ¶ 2006-150 at 1018 (“Cochran [the Service Appeals Officer] determined that petitioners’ offer [on the grounds of doubtful collectability] was unacceptable because they were able to pay more than the $32,000 that they offered to compromise their tax liability.”).

\(^{195}\) See *id.* at 36, 2006 T.C.M. (RIA) ¶ 2006-150 at 1021 (“[P]etitioners argue that public policy demands that their offer-in-compromise be accepted because they were victims of fraud.”).

\(^{196}\) See *id.* at 33, 2006 T.C.M. (RIA) ¶ 2006-150 at 1017 (“This case is one in a long list of cases brought in this Court involving respondent’s proposal to levy on the assets of a partner in a Hoyt partnership to collect Federal income taxes attributable to the partner’s participation in the partnership.”).

\(^{197}\) See *Durham Farms No. 1 v. Commissioner*, 79 T.C.M. (CCH) 2009, 2016, 2000 T.C.M. (RIA) ¶ 2000-150-159, at 887 (“In the cattle count he performed from fall 1992 through spring 1993, Mr. Daily determined there were a total of . . . 4,764 . . . mature breeding cattle.”), aff’d, 59 Fed. Appx. 952 (9th Cir. 2003); *Press Release, Dep’t of Justice Exec. Office for U.S. Trs.*, *Indictment Charges 54 Counts of Fraud in Oregon “Phantom Cow” Investment Scheme: Grand Jury Alleges Investors Lost $100,000* (June 7, 1999) (“[W]hile 38,000 adult female breeding cows were sold to investors, the defendants knew that they never had more than approximately 5,000 of such cows on hand. ‘In short,’ the indictment stated, ‘Defendants sold thousands of cows they never had and which did not exist.’”).

\(^{198}\) See *Durham Farms*, 79 T.C.M. (CCH) at 2029, 2000 T.C.M. (RIA) ¶ 2000-150 at 902 (“The Hoyt organization greatly inflated the stated purchase prices in order to increase the potential tax benefits for investors.”)

\(^{199}\) See *Press Release, Dep’t of Justice Exec. Office for U.S. Trs.*, *supra* note 197.
the taxpayer, and then managed the herd. Taxpayers who invested claimed deductions for expenses allocated to them under the partnership agreements. With respect to Barnes, the court determined it was against public policy to compromise tax liabilities for those who owe taxes due to attempts to hide their tax liabilities as Barnes did by investing in Hoyt partnerships.

3. Currently Not Collectible

A taxpayer with little or no income as well as a lack of other resources (i.e., someone who cannot pay the Service anything at all and may already be suffering hardship) can request that the Service suspend its collection efforts reclassify the liability as CNC. Classifying the account as CNC removes the liability from collection inventory. The Service may also classify an account as CNC where it has lost track of the taxpayer. If the taxpayer does not make a financial recovery and the liability is not settled, the CNC status will remain in effect until the collection statute runs out.

4. Combined Alternatives

The above three alternatives—installment agreements, OICs, and reclassification as CNC—can apply separately or together. For example, an installment agreement and an offer in compromise can combine. As part of an offer in compromise, a taxpayer may enter into an installment agreement that will pay only part of the tax liability while the Service compromises the rest.

Another example is the combination of reclassifying an account as CNC and submitting an offer in compromise. Such a combination works well

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200 See Durham Farms, 79 T.C.M (CCH) at 2029, 2000 T.C.M. (RIA) ¶ 2000-159 at 901–02 (“Jay Hoyt, as managing general partner, represented each partnership in these transactions and other Hoyt organization entities ‘sold’ and then ‘managed’ the ‘breeding cattle’ that a partnership had purportedly purchased. The Hoyt organization greatly inflated the stated purchase prices in order to increase the potential tax benefits for investors.”).

201 See Press Release, Dept of Justice Exec. Office for U.S. Trs., supra note 197 (“Investment returns were to come from tax deductions and profits on the herd sale.”).

202 See Barnes v. Commissioner, 92 T.C.M. (CCH) 31, 36, 2006 T.C.M. (RIA) ¶ 2006-150, at 1021 (“Reducing the risks of participating in tax shelters [by compromising the liabilities arising from disallowing the benefits from the tax shelters] would encourage more taxpayers to run those risks, thus undermining rather than enhancing compliance with the tax laws.”).

203 See Willis v. Commissioner, 86 T.C.M. (CCH) 506, 507, 2003 T.C.M. (RIA) ¶ 2003-302, at 1672 (“Generally, currently not collectible (CNC) status may be available when a taxpayer has no ability to make payments. A taxpayer’s ability to make payments is determined by calculating the excess of income over necessary living expenses.”).

204 See I.R.M. 5.16.1.1(1) (instructing Service personnel that “[a]ccounts can be removed from active inventory after taking the necessary steps in the collection process”). Note that the taxpayer can be taken out of CNC if his situation improves. See I.R.M. 5.16.1.2(7) (“Hardship [CNC] cases can be reactivated if it appears there is a change in the taxpayer’s ability to pay indicating collectibility.”). Also, the Service may apply refunds to the liability even though collection is not actively being sought. See I.R.M. 5.16.1.9(14).

205 See I.R.M. 5.16.1.2(1) (providing that one of the codes for closing a case as CNC is “inability to locate the taxpayer or assets”).
where the Service has placed an account in CNC, but the taxpayer anticipates or hopes that he will return to the workforce. Once the account is in CNC, the taxpayer may make an offer in compromise so that when the taxpayer does regain taxpaying ability, he has a truly fresh start. The OIC in such a case is important because the CNC reclassification does not clear the underlying tax liability. In some cases, the continued liability does not matter. If the Service has reclassified a taxpayer’s account as CNC because of a permanent injury, the possibility exists that the taxpayer will never regain the ability to pay the tax so the collection statute eventually expires.

5. **Taxpayer Assistance Orders**

Another settlement mechanism is the Taxpayer Assistance Order (TAO). A taxpayer who is currently suffering or imminently going to suffer a “significant hardship” resulting from a Service administrative action may apply for a TAO with the National Taxpayer Advocate (NTA).\(^{206}\) Hardship in this context means an adverse Service action, an excessive Service delay in handling a taxpayer account issues, the likely incurrence of costly representation absent relief, or suffering of serious harm absent relief.\(^{207}\) The TAO can force the Service to release levied property, cease, take, or refrain from any action in the collection, bankruptcy, investigation process, or any other process as seen fit by the NTA.\(^{208}\) Applying for a TAO to prevent a collection action suspends the ten-year collection statute until the NTA issues the TAO.\(^{209}\)

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\(^{206}\) See I.R.C. § 7811(a)(1)(A) ("Upon application filed by a taxpayer with the Office of the Taxpayer Advocate . . . the National Taxpayer Advocate [(NTA)] may issue a [TAO] if . . . the [NTA] determines the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the Secretary.").

\(^{207}\) See § 7811(a)(2) ("[A] significant hardship shall include (A) an immediate threat of adverse action; (B) a delay of more than 30 days in resolving taxpayer account problems; (C) the incurring by the taxpayer of significant costs (including fees for professional representation) if relief is not granted; or (D) irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted.").

\(^{208}\) See § 7811(b)(2)(A) ("The terms of a Taxpayer Assistance Order may require the Secretary within a specified time period to cease any action, take any action as permitted by law, or refrain from taking any action, with respect to the taxpayer under chapter 64 (relating to collection)").

\(^{209}\) See § 7811(d)(1) ("The running of any period of limitation with respect to any action [such as a collection action] shall be suspended for the period beginning on the date of the taxpayer’s application [for a TAO] and ending on the date of the National Taxpayer Advocate’s decision . . . ").
6. Audit Reconsideration

A taxpayer who has not had the opportunity to dispute the underlying tax liability prior to a proposed collection action, may request audit reconsideration. The Service has the authority to reconsider an audit. In an audit reconsideration, the Service literally reviews the underlying tax liability. The Service may reconsider the underlying tax liability on request for audit reconsideration where the taxpayer has discovered new documentation or the Service has made an error in the process of assessing the taxpayer’s liability. The process is somewhat informal for income tax issues because although the Service may abate any tax, taxpayers may not file a claim for abatement of income tax.

III. Civil Penalties

A. Background

One of the potential consequences of noncompliance with the tax laws is the imposition of civil penalties. The Code authorizes the government to impose over 100 civil tax penalties. In the federal tax system—which relies on voluntary compliance—penalties are important. Without them, it is doubtful taxpayers would ever voluntarily comply.

This Article focuses on penalties the taxpayer must consider in the process of determining whether to comply with the tax laws. In deciding whether to comply, a taxpayer must focus on the basic penalties. It is not necessary to consider all 100 penalties when deciding whether to file a tax return, pay a tax

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210 By the time the Service begins the collection process, the taxpayer has generally had the opportunity to dispute the underlying tax liability. The Service investigates the return pursuant to section 7602, which is an interactive process where the taxpayer can dispute the Service’s findings, and then the taxpayer has an opportunity to dispute the Service’s final determination in Tax Court. See I.R.C. § 6213 (“Within 90 days . . . after the notice of deficiency [issued after a Service examination] is mailed . . . the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency.”).


212 § 6404(a); see Tucker, 135 T.C. at 148 (“Audit reconsideration is the process the IRS uses to reevaluate the results of a prior audit where additional tax was assessed and remains unpaid, or a tax credit was reversed.”).

213 See § 6404(a).

214 See § 6404(a) (“The Secretary is authorized to abate the unpaid portion of the assessment of any tax or any liability in respect thereof.”).

215 See § 6404(b) (“No claim for abatement shall be filed by a taxpayer in respect of any assessment of any tax imposed under subtitle A [income taxes].”).

216 See generally I.R.C. §§ 6651–6725.

owed, or report all taxable income. Rather, an individual taxpayer need only consider the basic tax filing, paying, and fraud penalties.

B. Basic Penalties

1. Failure to File

Section 6651(a)(1) imposes a penalty for failing to file a required tax return.\(^{218}\) This penalty applies at a rate of five percent of the correct tax liability.\(^{219}\) It then increases by five percent every month up to 25%.\(^{220}\) The penalty amount is based on the taxpayer’s actual net tax liability arising out of operation of law.\(^{221}\) For income tax returns (i.e., not estate, gift, excise, or other taxes) filed more than 60 days late, the penalty cannot be less than $205 or 100% of the correct tax liability.\(^{222}\)

Generally a taxpayer must file a prescribed tax return to avoid the filing penalty, but there is an exception. A taxpayer may file an informal statement as a tentative return.\(^{223}\) If a taxpayer files a tentative return, a proper return must follow, or the Service will impose the filing penalty.\(^{224}\)

A taxpayer may not avoid the filing penalty by filing a “return” with insufficient information or on an altered form that masks the information relevant to determining the return’s accuracy.\(^{225}\) In Beard v. Commissioner, the

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\(^{218}\) See § 6651(a)(1) (“In case of failure to file any [tax] return . . . on the date prescribed therefor . . . there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax . . . .”). But see infra note 239 and accompanying text.

\(^{219}\) See § 6651(a)(1) (“The penalty delinquency penalties apply to the correct tax liability in, described as “the amount required to be shown on the return.”). For standard-of-care penalties not discussed here, such as the section 6662 “accuracy-related” penalty, the penalty applies only to the amount the taxpayer underpaid. See I.R.C, § 6662(a) (“If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.”).

\(^{220}\) See § 6651(a)(1) (The filing penalty increases “an additional 5 percent for each additional month . . . during which such failure continues, not exceeding 25 percent in the aggregate . . . .”).

\(^{221}\) See § 6651(b)(1) (“[T]he amount of tax required to be shown on the return [for the filing penalty] shall be reduced by the amount of any part of the tax which is paid . . . . and by the amount of any credit . . . .”).

\(^{222}\) See § 6651(a) (“In the case of a failure to file a return of [income] tax . . . within 60 days of the [due date], the addition to tax . . . shall not be less than the lesser of $205 or 100 percent . . . .”).

\(^{223}\) See Reg. § 1.6011-1(b) (permitting a taxpayer to file a tentative return “disclosing his gross income and the deductions,” which will “relieve the taxpayer from liability” regarding the delinquency penalty if a proper return is filed soon after).

\(^{224}\) See id.

\(^{225}\) See Beard v. Commissioner, 82 T.C. 766, 769, 780 (1984), aff’d, 793 F.2d 139 (6th Cir. 1986) (“Section 6651(a)(1) provides that an addition to tax is due if a taxpayer fails to timely file a return unless such failure is due to reasonable cause and not due to willful neglect. The evidence is clear that petitioner’s actions were deliberate, intentional and in complete disregard of the statute and respondent’s regulations. Petitioner made no attempt to file an authentic tax return, as he did for 1979, and offers no excuse for his failure to do so.”).
taxpayer altered a Form 1040 by relabeling it such that his income was offset by an artificial amount of “nontaxable receipts” that exceeded the amount of his income.\(^{226}\) With this modification, the Form 1040 showed no taxable income, so the taxpayer requested a refund of his withholdings in the amount of $1,770.\(^{227}\) The Service refused to accept it as a return and imposed a failure to file penalty under section 6651(a)(1).

The Tax Court held that for a document filed with the Service to constitute a return for purposes of the “failure to file” penalty, the document must contain enough information for the Service to determine the amount of tax owed, purport to be a tax return, represent a sincere effort to comply with the tax laws, and reflect a signature made under penalty of perjury.\(^{228}\)

According to the court, the taxpayer’s document did not satisfy all the requirements of a tax return.\(^{229}\) The document did not reflect a sincere effort to comply with the tax laws because it contained false information labeled “nontaxable receipts.”\(^{230}\) And this false information appeared in the return to deceive the Service.\(^{231}\)

The document satisfied some of the requirements of a tax return. It was on a Form 1040, so it purported to be a return.\(^{232}\) The document contained the taxpayer’s actual income so there was technically sufficient information for the Service to compute the tax.\(^{233}\) It was even signed under penalty of perjury.\(^{234}\) However, satisfying these requirements was insufficient to overcome the

\(^{226}\) See id. at 769 (“On line 7 entitled ‘Wages, salaries, tips, etc.’ taxpayer inserted the amount of $24,401.89. On line 23, under the category of ‘Non-taxable receipts,’ petitioner claimed an adjustment to ‘Receipts’ of $29,401.89.”).

\(^{227}\) See id. (“He therefore showed a tax liability of zero. On line 55, entitled ‘Total Federal income tax withheld,’ he showed an amount of $1,770.75. The total $1,770.75 that had been withheld from his wages was claimed as a refund.”).

\(^{228}\) See id. at 777 (considering what constitutes a return in the context of a number of issues including the filing penalty, providing as follows: “First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury.”).

\(^{229}\) See id.

\(^{230}\) See id. at 769 (“Petitioner’s scheme in submitting this tampered form apparently was to conceal from the Service Center operators the fact that his inclusion of his wages on the tampered form was negated by his fabrication of ‘Non-taxable receipts’ on line 23.”).

\(^{231}\) See id. at 769, 779 (noting that the taxpayer’s “scheme in submitting this tampered form apparently was to conceal from the Service Center operators the fact that his inclusion of his wages on the tampered form was negated by his fabrication of ‘Non-taxable receipts’” and holding that “[t]he critical requirement that there must be an honest and reasonable attempt to satisfy the requirements of the Federal income tax law clearly is not met”).

\(^{232}\) See id. at 778 (“The tampered form before us may purport to be a return in that it may ‘convey, imply or profess outwardly’ to be a return.”).

\(^{233}\) See id. at 786 (Chabot, J., dissenting on this issue) (“The Form 1040 in question shows the necessary income information, and does so on the correct line, and that line has not been altered.”).

\(^{234}\) See id. at 778 (majority opinion) (“It [the income tax return] was also sworn to.”).
Accordingly, the court held that the document did not constitute an income tax return for purposes of avoiding the failure to file penalty.\(^{236}\)

2. Failure to Pay

Section 6651(a)(2) imposes a penalty for failure to pay a tax due.\(^{237}\) The penalty applies at a rate of .5% of the correct tax liability.\(^{238}\) It increases, like the filing penalty, by .5% every month up to 25%.\(^{239}\) It is notable that the penalty rate for a failure to pay a tax is substantially lower than the penalty for failure to file a tax return. One can infer from the difference in penalty rates that legislators place more importance on filing a return for penalty purposes. Perhaps legislators accord more importance to the filing penalty because if no return is filed the Service has to spend time and resources to find the taxpayer, determine the amount that the taxpayer should have reported without any information, and collect the tax. Where a taxpayer has filed a return, the taxpayer has made himself known, provided income information to verify, and all that may remain is collection.

3. Reasonable Cause for Delinquency

As a general matter, a penalty will not be imposed for delinquency if it is shown that the failure to file or pay is “due to reasonable cause and not due to willful neglect.”\(^{240}\) There are two ways to establish reasonable cause. One way that a taxpayer might show reasonable cause is to show that he was unable to comply with his disclosure obligation due to factors beyond his control.\(^{241}\) An example would be the loss of records due to an accidental fire. Another way, a taxpayer might establish reasonable cause is by showing he made reasonable efforts to comply with the law.\(^{242}\) Under this standard, an honest and reasonable misunderstanding of fact or law might sometimes support a finding of reasonable cause.\(^{243}\)

\(^{235}\) See id. at 779 (“It [the document] in fact makes a mockery of the requirements for a tax return, both as to form and content.”).

\(^{236}\) See id. at 781.

\(^{237}\) I.R.C. § 6651(a)(2) (“In case of failure to pay the amount shown as tax on any [tax] return . . . on or before the [due] date . . . there shall be added to the amount shown as tax on such return 0.5 percent . . . .). But see infra note 239 and accompanying text.

\(^{238}\) See § 6651(a)(2).

\(^{239}\) See § 6651(a)(2) (The payment penalty increases “an additional 0.5 percent for each additional month . . . during which such failure continues, not exceeding 25 percent in the aggregate . . . .”).

\(^{240}\) See § 6651(a) (The quoted language appears in each paragraph of subsection (a).).

\(^{241}\) See Reg. § 301.6651-1(c)(1) (A taxpayer who has exercised ordinary care and business prudence but was unable to file on time or was unable to pay tax on time, has acted with reasonable cause.).

\(^{242}\) See Reg. § 1.6664-4(b) (regarding a taxpayer’s underpayment of tax).

\(^{243}\) See id.
On occasion, taxpayers have taken the “reasonable efforts to comply” rule too far. In United States v. Boyle, the question was whether reliance on an attorney or advisor constitutes reasonable cause for a failure to file in a timely manner. The Court held that relying on an attorney or advisor does not excuse delinquency where the issue is one that does not require the expertise of an attorney or advisor. An executor of his mother’s will relied on an attorney for filing an estate tax return due nine months after the date of death. The attorney filed the tax return late. The Court held reliance on an attorney cannot constitute reasonable cause for a nontechnical issue requiring no advice from an expert, like not keeping track of the deadline. Reliance on an attorney can constitute reasonable cause, however, for a legal question where expert advice may help like whether a taxpayer is required to file a return or not.

4. Civil Fraud

Another basic penalty is for civil fraud. This penalty is imposed on the portion of the underpayment due to fraud. It applies at rate of 75% of the underpayment. However, the penalty applies to the whole underpayment if the taxpayer fails to demonstrate that only a portion of the underpayment occurred due to fraud.

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244 See 469 U.S. 241, 242 (1985) (stating the issue as “whether a taxpayer’s reliance on an attorney to prepare and file a tax return constitutes ‘reasonable cause’ under § 6651(a)(1) of the Internal Revenue Code, so as to defeat a statutory penalty incurred because of a late filing”).

245 See id. at 251 (“[T]ax returns imply deadlines. Reliance by a lay person on a lawyer is of course common; but that reliance cannot function as a substitute for compliance with an unambiguous statute.”).

246 See id. at 242 (“Robert W. Boyle, was appointed executor of the will of his mother; . . . [Boyle] retained Ronald Keyser to serve as attorney for the estate . . . . [T]he return was due within nine months of the decedent’s death . . . .”).

247 See id. at 243 (“When respondent called Keyser on September 6, 1979, he learned for the first time that the return was by then overdue. Apparently, Keyser had overlooked the matter because of a clerical oversight in omitting the filing date from Keyser’s master calendar.”).

248 See id. at 251–52.

249 See id. at 251 (“When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney.”).

250 See I.R.C. § 6663(a) (“If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.”).

251 See § 6663(a).

252 See § 6663(a).

253 See § 6663(b) (“If the Secretary establishes that any portion of an underpayment is attributable to fraud, the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes . . . is not attributable to fraud.”).
In a Tax Court proceeding, the Service has the burden of presenting clear and convincing evidence of fraud.\textsuperscript{254} Taxpayers often fail to respond to the fraud penalty in pleadings so they essentially concede the fraud penalty if they lose the case, and the Service does not have to present any evidence.\textsuperscript{255} If the case is properly pleaded and the Service introduces some evidence, the taxpayer will have the burden of producing responsive evidence or lose the issue.

IV. Criminal Liability

Criminal liability is the last of the three major consequences of noncompliance. In addition to seizure of assets and penalties, the government can ultimately throw a taxpayer in jail. Potential jail time is an important consideration in the decision whether to comply with the tax laws.

A. Criminal Tax Enforcement

The process of investigating a tax crime is different than in other areas of the law. In other areas of criminal law, a crime is committed and authorities investigate to figure out who did it.\textsuperscript{256} For example, when a bank reports a robbery, the police investigate to determine who robbed it. Where a tax crime has taken place, the victim is a collective group—the people of the United States. An individual member of the collective group is unlikely to have any way of knowing the crime occurred. Thus, a criminal tax investigation must start with a taxpayer to determine whether he committed a crime.

Although the Service’s criminal investigators—special agents—and the Service’s civil investigators—revenue agents—have some overlapping tools, their investigations of the same tax stay somewhat separate to avoid due process problems. The Service may not trick a taxpayer into making a statement by conducting a criminal investigation under the guise of a civil tax audit.\textsuperscript{257}

The Service does not have sufficient resources to find and extinguish all criminal tax activity. Therefore, the Service has to make the most of the resources it has. The Service has to prove that a taxpayer was willful (i.e., that he was aware of his obligation to pay taxes).\textsuperscript{258} When it pursues a criminal case, there is usually a publicity angle to it. The Service will make examples

\textsuperscript{254}I.R.C. § 7454(a); see Tax Ct. R. Prac. & P. 142(b) (“In any case involving the issue of fraud with intent to evade tax, the burden of proof in respect of that issue is on the respondent, and that burden of proof is to be carried by clear and convincing evidence.”).

\textsuperscript{255}Tax Ct. R. Prac. & P. 37(c) (“Where a reply is filed, every affirmative allegation set out in the answer and not expressly admitted or denied in the reply shall be deemed to be admitted.”).

\textsuperscript{256}Andreoni, et. al, \textit{supra} note 2, at 818 (“Unlike other law enforcers . . . tax agents do not start from a crime and work backward to suspects, but scan tax records looking for evidence of evasion.”).

\textsuperscript{257}See United States v. Toussaint, 456 F. Supp. 1069, 1073 (S.D. Tex. 1978) (“[T]he Fourth Amendment is violated if a taxpayer’s cooperation is obtained through fraud or deceit.”).

\textsuperscript{258}Cheek v. United States, 498 U.S. 192, 201 (1991) (“Willfulness, as construed by our prior decisions in criminal tax cases, requires the Government to prove that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty.”); see \textit{infra} notes 274-75 and accompanying text.
out of high profile taxpayers. One example is celebrities. When a celebrity gets caught, the Service gets free publicity for its enforcement efforts. Another example is tax protesters. When tax protesters get caught, it sends a message to other tax protesters that their arguments have no merit. The Service gets the value for its money when it prosecutes a celebrity tax protester. Recently, Wesley Snipes was prosecuted for tax evasion and failure to file tax returns. He was acquitted of the evasion charges but still went to jail for three years for failing to file a tax return for three years.\(^\text{259}\)

B. \textit{Tax Crimes}

The Code creates a number of tax crimes. Here, the concern is with the tax crimes that constitute basic noncompliance that a taxpayer would consider in deciding whether to comply with the tax laws. The basic tax crimes are (1) willful failure to file a tax return, (2) attempted tax evasion, and (3) false statement.\(^\text{260}\)

Attempted tax evasion under section 7201 is the evasion provision. The elements of tax evasion are as follows: (1) a tax deficiency, (2) an attempt to evade or defeat the tax, and (3) willfulness.\(^\text{261}\) Tax evasion is a felony.\(^\text{262}\) The government may impose a fine up to a $100,000 for an individual or $500,000 for a corporation.\(^\text{263}\) In addition, the government may imprison a taxpayer for up to five years per violation.\(^\text{264}\) The five-year maximum can be misleading. Most often, the government prosecutes alleged tax evaders for more than one violation, which can lead to longer sentences.\(^\text{265}\)

The criminal failure to file a tax return is a misdemeanor.\(^\text{266}\) The elements of criminal failure to file a return are: (1) an obligation to file tax return, (2) failure to file, and (3) willfulness.\(^\text{267}\) It is punishable by a fine of $25,000 for individuals.\(^\text{268}\) The government may also imprison the perpetrator for up to

\(^{259}\) See United States v. Snipes, 611 F.3d 855, 863 (11th Cir. 2010).

\(^{260}\) I.R.C. §§ 7201-7203.

\(^{261}\) See § 7201; Sansone v. United States, 380 U.S. 343, 351 (1965) (“[T]he elements of § 7201 are will-fulness; the existence of a tax deficiency; and an affirmative act constituting an evasion or attempted evasion of the tax.” (citations omitted)).

\(^{262}\) § 7201.

\(^{263}\) § 7201.

\(^{264}\) § 7201.

\(^{265}\) See, e.g., United States v. Cohen, 510 F.3d 1114, 1117, 1117 n.2 (9th Cir. 2007) (noting that, in addition to tax evasion, the government convicted Mr. Irwin Schiff of conspiracy to defraud the government for the purpose of impeding and impairing the Service; five counts of aiding and assisting in the filing of false federal income tax returns, and six counts of filing false income tax returns). These multiple counts resulted in a prison sentence for Mr. Schiff of 13.5 years despite only one charge of evasion. See Allen D. Madison, \textit{The Futility of Tax Protester Arguments}, 36 T. Jefferson L. Rev. 253, 271 (2014).

\(^{266}\) I.R.C. § 7203 (“Any person required . . . to make a return . . . who willfully fails to . . . make such return . . . shall, in addition to other penalties provided by law, be guilty of a misdemeanor . . .”).

\(^{267}\) See § 7203.

\(^{268}\) § 7203.
one year.\textsuperscript{269} It should be noted that taking affirmative steps beyond merely not filing a tax return—such as requesting cash payments, holding deposits under a pseudonym, or keeping misleading records—could elevate the offense to tax evasion.\textsuperscript{270}

Another basic tax crime is fraud or false statements under section 7206.\textsuperscript{271} It is essentially a perjury provision. It makes the following actions all felonies: false declarations under penalty of perjury, aiding or assisting in filing a false return, fraudulently executing a document for tax purposes (like a bond or permit), moving or concealing assets to evade tax or defeat tax collection, or making false statements to the Service regarding financial condition.\textsuperscript{272} The most relevant part of the decision whether to comply with the tax laws is making a false declaration under penalty of perjury.

The elements of a false statement crime are: (1) the making of a false a return, statement, or other document, (2) a declaration under penalty of perjury, (3) the taxpayer’s belief that the return was not true and correct to every material matter, and (4) willfulness.\textsuperscript{273} A conviction carries a fine of up to $100,000 and imprisonment for up to three years.\textsuperscript{274} No affirmative act other than filing a return is required for a violation to occur.

\section*{C. Willfulness and Affirmative Acts}

A common component of punishable criminal tax behavior discussed here is willfulness. Willful in the criminal tax context means: “A voluntary, intentional violation of a known legal duty.”\textsuperscript{275} A taxpayer has not committed a crime, however, if he was unaware of his tax obligations when the act occurred.\textsuperscript{276} This is an exception to the rule that ignorance of the law is no defense.\textsuperscript{277} If a taxpayer subjectively believes his actions are legal, his actions are not willful.

In \textit{Cheek}, the taxpayer was a pilot who stopped filing tax returns in 1979. Prosecutors charged Mr. Cheek with six counts of willfully failing to file an income tax return and three counts of willfully attempting to evade his

\begin{itemize}
    \item \textsuperscript{269}§ 7203.
    \item \textsuperscript{270}See \textit{Spies v. United States}, 317 U.S. 492, 499 (1943).
    \item \textsuperscript{271}I.R.C. § 7206.
    \item \textsuperscript{272}§ 7206.
    \item \textsuperscript{273}See United States v. Bishop, 412 U.S. 346, 350 (1973) (“Section 7206(1) . . . is violated when one ‘(w)illfully makes and subscribes any return,’ under penalties of perjury, ‘which he does not believe to be true and correct as to every material matter.’”) (quoting § 7206(1)).
    \item \textsuperscript{274}§ 7206.
    \item \textsuperscript{275}United States v. Pomponio, 429 U.S. 10, 12 (1976).
    \item \textsuperscript{276}See \textit{Cheek v. United States}, 498 U.S. 192, 203 (1991) (holding that a taxpayer must be subjectively aware of the obligation to file a tax return to satisfy the willfulness element of felony evasion); United States v. Pensyl, 387 F.3d 456, 459 (6th Cir. 2004); United States v. Grunewald, 987 F.2d 531, 535-36 (8th Cir. 1993).
    \item \textsuperscript{277}See \textit{Cheek}, 498 U.S. at 199-200 (1991) (“[T]he Court almost 60 years ago interpreted the statutory term ‘willfully’ as used in the federal criminal tax statutes as carving out an exception to the [‘ignorance of the law is no defense’] rule.”).
\end{itemize}
income taxes. Cheek admitted he had not filed his returns. His position was, however, that he had not acted willfully because he sincerely believed his actions were lawful. The trial court instructed the jury that an honest but unreasonable belief is not a defense and does not negate willfulness, and, further, that Cheek’s beliefs that he did not owe tax were objectively unreasonable. The jury convicted him, and the court of appeals affirmed.

The Supreme Court reviewed the jury charge applying an objective standard of willfulness and the instruction negating Cheek’s subjective beliefs. The Court held that a good-faith misunderstanding of the law or a good-faith belief that one is not violating the law negates willfulness regardless of whether the belief or misunderstanding is objectively reasonable. The application of a subjective standard protects the average citizen from prosecution for innocent mistakes made due to the complexity of the tax laws. The Supreme Court remanded the case for a retrial.

Cheek holds that a good-faith belief need not be objectively reasonable. This is not, however, an invitation to convince one’s self that there is no obligation to comply with the tax laws. A taxpayer without subjective knowledge of his obligations may still have violated the law if his ignorance is deliberate and in bad faith.

Although felony evasion and misdemeanor failure to file a tax return have the same willfulness element, an element of evasion is a positive act rather than a mere omission. The positive act is the differentiating factor between a misdemeanor tax crime and a felony tax crime. In Spies, prosecutors convicted a taxpayer of felony tax evasion, which the appellate court affirmed. The taxpayer had failed to file a federal income tax return and pay the tax he owed. The conviction was for felony tax evasion, and his failure to file

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278 See id. at 196 (“Petitioner’s defense was that . . . he sincerely believed that the tax laws were being unconstitutionally enforced and that his actions during the 1980-1986 period were lawful. He therefore argued that he had acted without the willfulness required for conviction of the various offenses with which he was charged.”).


281 See United States v. Anthony, 545 F.3d 60, 65 (1st Cir. 2008); United States v. Dean, 487 F.3d 840, 851 (11th Cir. 2007) (per curiam); United States v. Bussey, 942 F.2d 1241, 1249 (8th Cir. 1991); United States v. Bissell, 954 F. Supp. 903, 927 (D.N.J. 1997); Madison, supra note 265, at 285-86 (noting with respect to willful ignorance of tax compliance obligations that “it would be difficult to live under the rule of law if it were so easy to bypass the law by choosing to be unaware of it”).

282 See Spies v. United States, 317 U.S. 492 (1943) (holding that a failure to file cannot be a felony without an affirmative act beyond inaction).

283 See id. at 492-93 (“Petitioner has been convicted of attempting to defeat and evade income tax [and] the Circuit Court of Appeals affirmed.”).

284 See id. at 493 (“Petitioner admitted at the opening of the trial that he had sufficient income during the year in question to place him under a statutory duty to file a return and to pay a tax, and that he failed to do either.”).
a return combined with his failure to pay together constituted the crime.\textsuperscript{285} Failure to file a tax return or pay tax, however, is a misdemeanor, but tax evasion is a felony.\textsuperscript{286} Rather than differentiate between the misdemeanor and felony acts, the trial court explicitly permitted the jury to find the taxpayer guilty of a felony on the mere failures to file a return and pay the tax.\textsuperscript{287} The Supreme Court held that the taxpayer was entitled to a jury charge that evasion required an affirmative act—which was not in the charge—and, therefore, reversed conviction.\textsuperscript{288}

D. Voluntary Disclosure Policy

The government generally will not prosecute a taxpayer who has made a voluntary disclosure.\textsuperscript{289} A voluntary disclosure is where a taxpayer voluntarily discloses a tax liability, and the disclosure is: (1) truthful, (2) timely (no criminal investigation has begun), (3) complete (accounts for all taxes due), and shows a willingness to cooperate regarding the determination of his tax liability.\textsuperscript{290}

Why is the government willing to forgive criminal activity when a taxpayer makes a voluntary disclosure? The first reason is that the government gets its money. The second reason is that it would be difficult to prevail in a prosecution because the taxpayer negates willfulness by voluntarily disclosing his tax liability.

There is more than one way to go about making a voluntary disclosure. One way—referred to as a quiet voluntary disclosure—is to file an amended return without contacting the government.\textsuperscript{291} Another way—referred to as a noisy voluntary disclosure—is to contact the Service or the department of justice to confirm that there is no current investigation of the taxpayer going

\textsuperscript{285} See id. at 494-95 (“It is the Government’s contention that a willful failure to file a return together with a willful failure to pay the tax may, without more, constitute an attempt to defeat or evade a tax.”).

\textsuperscript{286} Compare I.R.C. § 7201 (“Any person who willfully attempts . . . to evade . . . any tax . . . shall . . . be guilty of a felony. . . .”), \textit{with} I.R.C. § 7203 (“Any person required . . . to make a return . . . who willfully fails to . . . make such return . . . at the time . . . required by law . . . shall . . . be guilty of a misdemeanor.”).

\textsuperscript{287} See \textit{Spies}, 317 U.S. at 494 (“The Court refused a request to instruct that an affirmative act was necessary to constitute a willful attempt.”).

\textsuperscript{288} See id. at 500 (“\textit{W}e think a defendant is entitled to a charge which will point out the necessity for such an inference of willful attempt to defeat or evade tax from some proof in the case other than that necessary to make out the misdemeanors; and if the evidence fails to afford such an inference, the defendant should be acquitted.”).

\textsuperscript{289} See Allen D. Madison, \textit{An Analysis of the IRS’s Voluntary Disclosure Policy}, 54 Tax Law. 729, 731 (2001) (“In general, under certain circumstances the Service will not prosecute a taxpayer who has voluntarily disclosed particular tax indiscretions to the Service.”).

\textsuperscript{290} See Madison, \textit{supra} note 289, at 734; I.R.M. 38.3.1.3.1(3).

\textsuperscript{291} See Saltzman & Book, \textit{supra} note 3, at ¶ 12.06[2][b] (“Still another approach followed where there is no examination or investigation pending is preparing and filing delinquent or amended returns without drawing attention to them. The advantage of these ‘quiet disclosures’ is that the Service may not examine the returns after receipt.”).
This inquiry is important for timeliness. If a taxpayer is making a disclosure because he has been notified of an investigation, there is no negation of willfulness.

V. Conclusion

The study of tax controversies should include a discussion of what taxpayers must consider when deciding whether to comply with the tax laws. In deciding whether to comply, taxpayers should understand there are consequences the government imposes for not complying. A taxpayer should consider that the government has the authority to collect his tax liability, impose civil penalties, and, ultimately, imprison him.

Although it may seem obvious that these are the appropriate considerations for a taxpayer who asks about potential consequences of noncompliance, neither primary nor secondary sources direct a taxpayer or his representative to a cohesive answer to the question. The Code discusses collection, collection alternatives, penalties, and criminal sanctions in unrelated chapters in subtitle F. Moreover, the Code’s chapters for these topics either contain excessive amounts of noise or are overly cryptic. A taxpayer trying to figure out what constitutes basic noncompliance will have to wade through the over 100 penalties in the Code rather than the three discussed in this Article. A taxpayer trying to determine how to deal with a collection action will find in chapter 74 of the Code only that the Service is authorized to enter into closing agreements and compromise liabilities but no material on how to ask for either.

Secondary sources have not consolidated the topics on the consequences of failing to comply either. The leading secondary sources are organized chronologically based on the events that can occur throughout the controversy process. The events discussed in secondary sources, however, rarely occur chronologically. The decisions and determinations made in the tax controversy process, however, (whether to comply, how to comply, deficiency determinations, and judicial determinations) do occur sequentially.

The first step, the taxpayer’s decision whether to comply with the tax laws, occurs before the taxpayer prepares a return, the Service reviews it, and the taxpayer challenges it in court. The government’s authority to assert criminal liability, impose civil penalties, and collect any unpaid amounts are the important considerations for making the decision.

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292 See Scott D. Michel, Developments in Offshore Tax Compliance in - ss020 International Trust and Estate Planning, ALI-ABA Course of Study 801, 835 (2010) (“Noisy Disclosures. A second method is to contact [CID] in the appropriate district. . . . In some districts, the CID agent will accept the name of the taxpayer and confirm the taxpayer’s eligibility for a voluntary disclosure without seeking much more additional information.”).

293 See Chapters 64 (collection), 68 (additions to tax and penalties), 74 (compromises) and 75 (criminal offenses) of the Code.