

# When Disputing Taxes, Should You Pay First Or Wait Until It Is Resolved?

By Robert W. Wood

No one likes paying taxes. But we are all required to file tax returns and to pay taxes. Most people know that if you get a notice from the IRS or the FTB saying that you underpaid or that they audited you and you owe more, it usually isn't just the taxes you owe. They add interest, and in general, the IRS and the Franchise Tax Board will not waive or abate it, it is automatic. Often, it isn't just interest that is added, there are penalties too.

The penalties are more likely to be negotiable, but it can depend on the nature of the tax issue, the reasonableness of your position, who you relied on, and even how generous the IRS or FTB employee is in assessing your situation. In some cases, the government may use the penalties as a kind of inducement. For example, you might ask, "if I pay all the taxes and the interest today, will you waive the penalties?"

In many cases, of course, the taxpayer will want to contest a tax bill and push back on the amount due. I'm not talking about an amount that you clearly owe, such as where you file a tax return, report that you owe \$50,000 in taxes, but you can't pay it currently. Those are "self-assessed" taxes, and you'll want to pay those as soon as you can. Inevitably, there will be interest and penalties added.

But what about extra taxes? Say you reported something as capital gain, and the IRS sends you a notice saying it is ordinary income, please pay the difference (plus interest and penalties). Let's say you want to contest that notice. There is a path to do so, and if you prevail about the extra taxes the IRS or FTB is seeking, the interest and penalties should go away too.

On the other hand, if you fail, interest will continue to accrue. Some types of penalties stay the same, but there is interest on the penalties. Other penalties themselves can get larger over time, plus interest. In tax disputes, should you ever consider paying and continuing your dispute, or should you put it off payment as long as possible, hoping that you will never have to pay?

When the IRS or the California Franchise Tax Board proposes adjustments to your account, interest on the liability runs from the date the tax return was due. That interest keeps running until the date the IRS receives your payment of the entire amount, including taxes, penalties and interest. Of course, if you convince the IRS or FTB that they are wrong and no tax is due, there is no interest due, and no penalties.

But if you turn out to be wrong in whole or in part, you will owe the taxes, penalties if applicable, plus interest. And interest mounts quickly. Moreover, although you may think that interest is always tax deductible, it is not. Interest on tax deficiencies is not tax deductible (except for corporations). That can make the interest payments even more painful.

The interest compounds daily and runs at the short-term federal rate plus 3 percent. The IRS adjusts the federal short-term rate quarterly based on market rates. The IRS currently charges 7% annual interest on underpayments for

individuals, compounded daily. Interest starts accruing from the due date of the return and applies to unpaid taxes, penalties, and accumulated interest. These potentially significant interest charges add up.

Some taxpayers want to stop the bleeding and pay up, but still fight the underlying tax.

There is usually a way to do this, but the details matter. Moreover, tactics can clearly come into play. Who is holding the money is not supposed to impact the resolution of your tax dispute. However, many taxpayers and advisers worry that the IRS (or the FTB) will be more motivated to resolve your case favorably if they *do not* have possession of your money.

There is some personal preference on these issues, among taxpayers and among tax professionals. However, I believe it is usually possible to make deposits as a hedge without prejudice to your substantive tax dispute. Even so, it is best to get professional advice about your particular dispute and how it might play out.

To completely stop interest from running, you must pay the entire amount, including all interest that has accrued up to that point, as well as penalties. Otherwise, interest will continue to accrue on any excess tax, penalties and interest that may be assessed. If you win your tax dispute you should be able to get it back, provided that you follow the rules.

If you pay to stop the interest, you must specifically call it a *deposit* and follow IRS procedures. Otherwise, the IRS might think you're agreeing to the tax bill. The fact that you label it as a *deposit* is very important. For one thing, it may allow you to withdraw it upon request if you later determine that you need the money back. However, if you do withdraw your deposit, and it later turns out that you owe the tax, the IRS will charge you interest from the *original* due date of the tax return as if you never made a deposit.

If that seems unfair, it may well be. As you might suspect, in most tax cases people put off paying the amount the IRS says is due until it is clear the IRS has won. People worry about the change in dynamics in the dispute if the IRS has the money. Besides, people correctly figure that if they can defeat the IRS, the interest will go away too. Yet, there are some cases in which the taxpayer has no choice, and *must* pay in order to dispute the taxes.

For example, if you receive an IRS Notice of Deficiency (also called a 90-day letter), you have only 90 days to file in U.S. Tax Court to dispute the taxes. You don't want to miss that 90-day deadline. If you do, the only way you can keep disputing the taxes is if you pay the bill, and then file a claim for a refund. If the IRS denies or ignores your refund claim, you can sue for a refund in District Court or the Court of Claims.

In taxes, much is about procedure. No matter what, weigh your options and consider the dollars involved as well as the impact on your negotiating posture.

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