tax analysts | a pinch of SALT

Auditors Must Not Use Jeopardy Assessments to Coerce Taxpayers

by Marc A. Simonetti, Zachary T. Atkins, and Madison J. Barnett

Marc A. Simonetti Zachary T. Atkins Madison J. Barnett

In this A Pinch of SALT, we analyze a troubling state tax trend of the improper use of jeopardy assessments. Jeopardy assessment provisions are intended to protect the taxing jurisdiction from taxpayers who are impeding or escaping the rightful collection of tax. However, we have seen an increase in the use of jeopardy assessments for other purposes, including to force taxpayers to extend the statute of limitations, respond to overbroad information and document requests, and as leverage to compromise a case. We discuss the proper purposes for a jeopardy assessment, the varying state and federal statutory authority to issue a jeopardy assessment, the misuse of state jeopardy assessment provisions, and the practical considerations in dealing with a jeopardy assessment or the threat of one.

The story is becoming all too familiar — the state begins a tax audit by sending requests for information to which the taxpayer timely responds. Faced with budget cuts, an already overworked audit staff fails to complete the audit in a timely fashion. With the expiration of the statute of limitations imminent, the auditor seeks a waiver to extend the statute of limitations. The taxpayer, frustrated by months or years of delay, refuses to sign the waiver. In response, the state auditor threatens the taxpayer with an arbitrary and significant jeopardy assessment to encourage (or possibly coerce) the taxpayer to consent to waive the statute of limitations. Backed into a corner and faced with the daunting prospect of trying to challenge an unreasonable and arbitrary assessment, the taxpayer bows to the pressure and signs yet another waiver, continuing a waiver signing cycle of pain.

> ***We have seen an increase in the use of jeopardy assessments to force taxpayers to extend the statute of limitations, respond to overbroad information and document requests, and as leverage to compromise a case.***

When a taxpayer refuses to agree to the extension of a statute of limitations, the auditor will almost certainly issue a jeopardy assessment to prevent the expiration of the statute of limitations. A taxpayer that engages in the administrative dispute process invariably finds its matter returned to the auditor to continue audit work with an arbitrary jeopardy assessment hanging over its head. The taxpayer is put in a worse position than if it had agreed to the waiver of the expiration of the statute of limitations. What is a taxpayer to do, you ask? Challenge the validity of the jeopardy assessment! State tax administrators must have a reasonable belief that the collection of tax is jeopardized by delay based on the taxpayer's actions before issuing a jeopardy assessment.

What Is a Jeopardy Assessment and How Is It Properly Used?

A jeopardy assessment is a collection device used by federal and state taxing authorities to collect tax when the delay associated with ordinary prepayment deficiency procedures would jeopardize or endanger the collection of the tax.[1] West's *Tax Law Dictionary* defines jeopardy assessment for federal income tax purposes as follows:

---

[1]*See* Michael L. Saltzman, *IRS Practice and Procedure*, para. 10.05 (2011).

> Whenever proceedings to collect income tax for the current or the immediately preceding taxable year are or may be prejudiced or rendered ineffectual due to actions of a taxpayer who designs quickly to depart from the United States or remove his property or conceal himself or his property, or other such act, the [IRS] may immediately make a determination of tax for the current taxable year or for the preceding taxable year, or both, and that such tax is immediately due and payable.[2]

A jeopardy assessment is "an extraordinary measure, intended for exigent circumstances (hence the name jeopardy assessment)."[3]

Used properly, a jeopardy assessment is a powerful tool in the hands of tax administrators to prevent taxpayers from escaping the jurisdiction of federal or state tax authorities and thereby evading collection of taxes properly due. However, used improperly, the jeopardy assessment is akin to drawing a gun in a fist fight, threatening a taxpayer's constitutional due process rights and the basic concepts of equity and fair tax administration.

State Jeopardy Statutes

All states have some form of jeopardy assessment provision. Generally, state tax agencies are authorized to issue a jeopardy assessment when specific conditions are satisfied. State tax laws vary regarding the conditions necessary for a state to issue a jeopardy assessment, from the narrowly tailored to the very broad grant of authority. Generally, the narrowly tailored jeopardy assessment provisions require that the taxpayer's actions jeopardize the state's ability to assess or collect tax. In contrast, the broader jeopardy assessment provisions require only that the collection or assessment of tax be jeopardized by any delay.

Narrow Jeopardy Assessment Statutes

States that provide a narrowly tailored jeopardy assessment provision specify the actions that will trigger the use of such an assessment. New Jersey tax law provides an example of a narrowly tailored jeopardy assessment law.[4] The law states:

> If the commissioner finds that a *taxpayer* designs quickly to
>
> 1. depart from this state or to remove therefrom his property, or any property, or any property subject to any state tax, or
>
> 2. conceal himself or his property, or such other property, or
>
> 3. to discontinue business, or
>
> 4. to do any other act tending to prejudice or render wholly or partly ineffectual proceedings to assess or collect such tax, whereby it becomes important that such proceedings be brought without delay, the commissioner may immediately make an arbitrary assessment . . . and may proceed under such arbitrary assessment to collect the tax, or compel security for the same, and thereafter shall cause notice of such finding to be given to such taxpayer, together with a demand for an immediate report and immediate payment of such tax.[5]

Narrowly tailored jeopardy assessment provisions focus on the *actions of the taxpayer* to protect the state in situations in which a taxpayer puts the state's ability to collect the tax at risk, such as when the taxpayer is fleeing the state, removing property from the state, or hiding from authorities.

Broad Jeopardy Assessment Statutes

The most common type of state jeopardy assessment statute is a broadly worded grant of authority that permits state tax authorities to issue a jeopardy assessment on a finding that collection would be jeopardized by *delay*. Connecticut's jeopardy assessment statute, for example, states:

> If the commissioner believes that the collection of any tax or any amount of tax required to be collected and paid to the state or of any assessment will be *jeopardized by delay*, the commissioner shall make an assessment of the tax or amount of tax required to be collected, noting that fact on the assessment and serving written notice thereof.[6]

Other examples of states with similar statutes include California, Colorado, Illinois, New York, Texas, and Virginia.[7] The more broadly worded state jeopardy assessment provisions do not expressly focus on the actions of the taxpayer. Read most broadly, these statutes could authorize the state to issue a jeopardy assessment any time the state reasonably believes that a delay will put the state's ability to collect the tax at risk, regardless of which party caused the delay. However, even the broadly

---

[2] West's *Tax Law Dictionary*, section J40 (2010 ed.).

[3] *Modern Bookkeeping, Inc. v. United States*, 854 F. Supp. 475, 476 (E.D. Mich. 1994) (quoting *Penner v. United States*, 582 F. Supp. 432, 434 (S.D. Fla. 1984)).

[4] N.J. Stat. Ann. section 54:49-7. Other states with similarly narrow jeopardy assessment provisions include Georgia and Oregon. Ga. Code Ann. section 48-2-51(a); Ore. Rev. Stat. Ann. section 314.440(2).

[5] N.J. Stat. Ann. section 54:49-7. (emphasis added).

[6] Conn. Gen. Stat. Ann. section 12-417(1) (emphasis added).

[7] Calif. Revenue and Taxation Code section 19081; Colo. Rev. Stat. Ann. section 39-21-111; 35 ILCS section 5/1102(a)(1); N.Y. Tax Law section 694(a); Texas Tax Code Ann. section 111.022(a); Va. Code Ann. section 58.1-313.A.

worded statutes have been read to permit a jeopardy assessment only when the taxpayer's actions were the cause for the delay.[8]

In *Alexandre v. Law*, the court found that Connecticut's jeopardy assessment statute, quoted above, did not provide a basis for the commissioner's issuance of a jeopardy assessment against a taxpayer who refused to sign a waiver of the state of limitations. The taxpayer was an owner and operator of a local bar who owned substantial property in the state and was "very much a community-minded individual."[9] Following a protracted sales tax audit, the state auditor threatened the taxpayer that "if he did not sign a special consent to extend the statute of limitations, a jeopardy assessment would be issued against him."[10] In response, the taxpayer declined to sign the waiver but wisely documented the auditor's threat in a letter and reiterated his ties the community and that he was not a flight risk.

Even broad statutes do not authorize the issuance of a jeopardy assessment merely because a taxpayer declines to execute a waiver of the statute of limitations for assessment.

When the auditor followed through on his threat and issued the jeopardy assessment, the taxpayer eventually challenged the matter by bringing suit. The court, "recognizing that a jeopardy assessment is a powerful tool in the commissioner's hands" that "subject[s] the taxpayer to the cost and notoriety of the execution" and "impairs the public image of the taxpayer," stated, "It is clear that there was no basis for the auditor to conclude that the plaintiff contemplated removing assets from the jurisdiction. There also was no evidence that the collection process itself would be delayed or impaired once the final determination of the amount of taxes due was issued."[11] Accordingly, the state failed to demonstrate that the commissioner reasonably believed "that the plaintiff's action would delay or hamper the collection process," and the court found the issuance of the jeopardy assessment to be unfounded.[12]

It is important to note that even these broad statutes do not authorize the issuance of a jeopardy assessment merely because a taxpayer declines to execute a waiver of the statute of limitations for assessment. For many large corporate taxpayers with substantial assets within and outside a state, there can be no serious question whether the tax would be *collected* by the state if properly assessed within the applicable statute of limitations. Therefore, as long as the taxpayer is not responsible for the delay, the threat or use of a jeopardy assessment in response to a taxpayer's unwillingness to perpetually extend the statute of limitations is beyond the state's authority under a jeopardy assessment statute.

[8] *Alexandre v. Law*, 47 *Conn. L. Rptr.* 393, 2009 WL 941976.
[9] *Id.* at *7.
[10] *Id.* at *6.
[11] *Id.* at *7-8.
[12] *Id.* at *9.

Federal Jeopardy Assessments

The IRS jeopardy assessment procedure and authority is more well-defined than most state jeopardy assessment provisions. For corporate income tax purposes, the IRS derives its jeopardy assessment authority from IRC section 6861, which provides:[13]

> If the Secretary believes that the *assessment or collection* of a deficiency . . . will be *jeopardized by delay*, he shall . . . immediately assess such deficiency (together with all interest, additional amounts, and additions to the tax provided for by the law), and notice and demand shall be made by the Secretary for the payment thereof.[14]

Although this provision appears to provide a very broad, almost limitless, jeopardy assessment authority, the IRS guidelines qualify and temper the broad language in section 6861.[15] The Internal Revenue Manual states that "all jeopardy . . . assessments have a common characteristic: prior to assessment, a determination is made that collection will be endangered if regular assessment and collection

[13] The IRS may issue jeopardy assessments under IRC section 6861 (income, estate, gift, and some excise taxes), section 6862 (taxes other than income, estate, gift, and some excise taxes), and section 6867 (possessor of cash). The IRS is authorized to issue termination assessments under IRC section 6851 (income tax) and section 6867 (possessor of cash).
[14] IRC section 6861(a) (emphasis added).
[15] An additional federal tax provision authorizes the IRS to issue a jeopardy or termination assessment when: a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act . . . tending to prejudice or to render wholly or partially ineffectual proceedings to collect the income tax for the current or the immediately preceding taxable year unless such proceeding be brought without delay . . . to . . . IRC section 6851(a). One notable distinction between the jeopardy assessment statute and the termination assessment statute is that a jeopardy assessment under section 6861 is made for a prior year when the filing date has passed, while termination assessments under section 6851 are made for the current year or the preceding year when the filing date has not passed. Internal Revenue Manual section 4.15.1.4.1(1); 2(1)(2010).

procedures are followed."[16] The manual identifies the following examples of circumstances that justify the use of a jeopardy assessment:

- the taxpayer appears to intend to quickly leave the country or to conceal himself;
- the taxpayer appears to intend to place his property beyond the reach of the government by removing it from the country, concealing it, dissipating it, and/or transferring it to other persons; or
- the taxpayer's financial solvency appears to be imperiled.[17]

In other words, jeopardy assessments are appropriate when a taxing authority believes a taxpayer may take action that would imperil the ability of the taxing authority *to collect a tax that is properly due*, such as by fleeing the jurisdiction or removing or hiding assets.

The IRS has stated that jeopardy assessments are to be issued "sparingly" and must be "reasonable, appropriate, and limited to amounts which can be expected to protect the government."[18] That the statute of limitations for assessment is set to expire or the taxpayer refuses to consent to a waiver is insufficient, by itself, to justify making a jeopardy assessment.[19] Rather, those assessments are warranted only if the IRS believes the taxpayer is or plans to leave the United States or abscond with property, or the taxpayer's financial solvency is compromised.[20]

Several procedural safeguards have been implemented to protect taxpayers from the IRS improperly issuing a jeopardy assessment. Specifically, the manual provides that an abatement cannot be issued without the personal approval of the area director and written approval from chief counsel or his or her delegate.[21] In the event that the IRS makes a jeopardy assessment under section 6861 but it is later determined that jeopardy does not exist, the secretary is authorized to abate the assessment.[22]

One of the most significant features of the federal jeopardy assessment law is that it provides taxpayers with an expedited process for challenging a jeopardy assessment. Within five days of the jeopardy assessment, the secretary is required to provide the taxpayer with a written statement of the grounds on which the assessment was made.[23] Within 30 days of receiving the written statement, the taxpayer can request the secretary to review the assessment.[24] On review, the secretary must decide:

> (A) whether or not —
>
> (i) the making of the assessment . . . is *reasonable* under the circumstances, and
>
> (ii) the amount so assessed or demanded as a result of the [assessment] is *appropriate* under the circumstances, or
>
> (B) whether or not the levy . . . is *reasonable* under the circumstances.[25]

To the extent that an administrative review of the jeopardy assessment fails to yield a satisfactory result, the taxpayer can put the issue before a federal district court and, in some cases, the U.S. Tax Court.

> ***Perhaps the most important element of judicial review is that a jeopardy assessment does not carry the presumption of correctness afforded a standard tax assessment.***

The taxpayer may bring an action within 90 days after the earlier of the day the secretary notifies the taxpayer of the result of its administrative review or the 16th day after the taxpayer made its request for administrative review.[26] Within 20 days after the taxpayer commences the action, the court must determine whether the assessment was reasonable and whether the amount assessed or demanded is appropriate.[27] If the court finds that the assessment and the amount assessed were unreasonable, or that the levy was unreasonable, the court can invalidate or abate the assessment, redetermine the amount assessed, or take any other actions it deems appropriate.[28]

Perhaps the most important element of judicial review is that a jeopardy assessment does not carry the presumption of correctness afforded a standard tax assessment.[29] The *secretary* bears the burden of

[16] *Id.* section 4.15.1.2(2).

[17] Section 4.15.1.6. *See also* IRC section 6851(a)(1), 6861(a).

[18] Internal Revenue Manual section 4.15.1.2. Likewise, at least one federal court has recognized that jeopardy assessments, as an exception to the normal tax collection procedure, must be used in a proper manner and not as an added penalty. *Darnell v. Tomlinson*, 220 F.2d 894, 897 (5th Cir. 1955).

[19] IRS Pub. 10-35, at 4 (June 2007).

[20] Internal Revenue Manual section 4.15.1.6(1)(A)-(D).

[21] Section 4.15.1.3(1); IRS Policy Statement 4-88 (Jan. 6, 1999); IRS Policy Statement 4-89 (Jan. 6, 1999).

[22] IRC section 6861(g).

[23] IRC section 7429(a)(1)(B).

[24] IRC section 7429(a)(2).

[25] IRC section 7429(3)(A)-(B) (emphasis added).

[26] IRC section 7429(b)(1)(A)-(B).

[27] IRC section 7429(b)(3)(A)-(B).

[28] IRC section 7429(b)(4).

[29] IRC section 7429(g)(1). Note, however, that the taxpayer bears the burden of proving that the amount of the assessment was inappropriate under the circumstances. *Id.* section 7429(g)(2); *McWilliams v. Commissioner*, 103 T.C. 416 (1994).

proving that the making of a jeopardy assessment was reasonable. In *McWilliams v. Commisioner*, the IRS issued a notice of deficiency against the taxpayer, which the taxpayer disputed. Later, the taxpayer decided to move from New Mexico to Washington. The taxpayer established an escrow account from which to pay the disputed tax, if he were unsuccessful. Soon after moving to Washington, the taxpayer received a jeopardy assessment notice regarding the disputed tax that indicated that the IRS believed he intended to flee the country. The taxpayer petitioned for review of the jeopardy assessment under IRC section 7429.

The court held that a jeopardy assessment is valid only if one of three conditions is met: (1) the taxpayer designs to depart from the country; (2) the taxpayer intends to remove, conceal, or dissipate the property; or (3) the taxpayer faces financial insolvency.[30] The court noted, "In our review of jeopardy assessment cases we have found no case in which an assessment was upheld that did not contain at least one of the three conditions listed in the regulations."[31] The court found that the taxpayer never intended to flee the United States, because he had provided the IRS and the U.S. Postal Service with his new address and was communicating with the IRS through his attorney. Further, the court held that the taxpayer was not attempting to place assets out of the government's reach, because he funded an escrow account to pay the disputed taxes. Finally, the court ruled that the collection of tax was not imperiled by financial insolvency, because the court determined that the taxpayer had sufficient assets.

Because the IRS failed to prove that the jeopardy assessment was reasonable and premised on at least one of the three grounds provided in Treas. Reg. section 1.6851-1(a)(1)(i)-(iii), the court ordered the jeopardy assessment to be abated. Thus, federal jeopardy assessments are more clearly and narrowly constrained than state jeopardy assessments.

Practical Considerations

Recent experience suggests that states are increasingly using their jeopardy assessment authority — as a threat or in fact — to encourage (or coerce) taxpayers to comply with their unreasonable demands. Taxpayers must be familiar with the state jeopardy assessment statutes. Once the state has issued a jeopardy assessment, the taxpayer should carefully weigh the advantages and disadvantages of pursuing administrative appeals as opposed to judicial review.

In most states, the taxing authority continues to have the authority to modify a taxpayer's asserted deficiency during the administrative appeals process. As a result, auditors are unafraid to use the jeopardy assessment provision because the administrative appeal process will return the matter to the auditor to continue the audit, while the jeopardy assessment hangs over the taxpayer's head like the sword of Damocles. It is our opinion that judicial review is the better approach as long as the taxpayer has the means to challenge a jeopardy assessment in court.

> ***Once the state has issued a jeopardy assessment, the taxpayer should carefully weigh the advantages and disadvantages of pursuing administrative appeals as opposed to judicial review.***

If the taxpayer has complied with the auditor's information document requests and cooperates fully during audit, such conduct should not trigger a jeopardy assessment. A taxing authority should never be permitted to invoke its jeopardy assessment power to avoid the harsh effect of an expiring statute of limitations when the delay is caused by the authority's inability to complete an audit within the allotted time. Thus, a jeopardy assessment premised only on the threat of an expiring statute of limitations is likely invalid because it is inconsistent with the underlying purpose of the jeopardy assessment. Although the power to issue a jeopardy assessment is unquestionably legitimate and necessary because states have a genuine interest in protecting revenue threatened by a taxpayer's bad conduct, the use of a jeopardy assessment as leverage to coerce a taxpayer to act against its will is not permitted and, in fact, contrary to the purpose of jeopardy assessment laws. ✰

Marc A. Simonetti is a partner and Zachary T. Atkins and Madison J. Barnett are associates with Sutherland Asbill & Brennan LLP's State and Local Tax Practice.

Sutherland's SALT Practice is composed of more than 20 attorneys who focus on planning and controversy associated with income, franchise, sales and use, and property tax matters, as well as unclaimed property matters. Sutherland's SALT Practice also monitors and comments on state legislative and political efforts.

[30]Treas. reg. section 1.6851-1(a)(i)-(iii).
[31]*McWilliams*, 103 T.C. at 424.