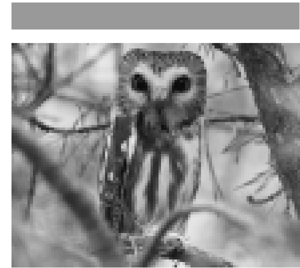

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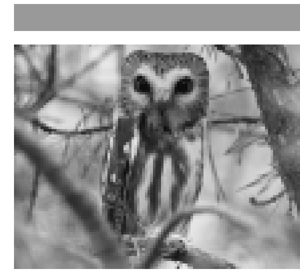

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COMPLIANCE ISSUES

This chapter addresses several IRS compliance initiatives, changes in the Offer in Compromise program, and an overview of the appeals process. Compliance initiatives include fraudulent trust schemes, the nonfiler initiative, Revenue Protection Strategy, and the Earned Income Credit Compliance Initiative.

ABUSIVE TRUST SCHEMES

INTRODUCTION

According to the *Journal of Accountancy,* more than $4.8 trillion in wealth will be inherited or transferred from one generation to the next by 2015, with much of it transferred through a variety of trusts. Trust and estate matters are the third highest areas of growth among top CPA firms. Domestic trusts filed 3.4 million Forms 1041, U.S. Income Tax Return for Estates and Trusts, returns in 1998 making it the third most frequently filed income tax return behind individual and corporate returns.

In the last few years there has been a proliferation of abusive trust tax evasion schemes. Abusive trust arrangements are typically promoted by the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. The promised benefits may include reduction or elimination of income subject to tax, deductions for personal expenses paid by the trust, depreciation deductions of an owner's personal residence and furnishings, a stepped-up basis for property transferred to the trust, the reduction or elimination of self-employment taxes, and the reduction or elimination of gift and estate taxes.

The trusts involved in the schemes are vertically layered, with each trust distributing income to the next layer. The result of this layered distribution of income is to fraudulently reduce taxable income to nominal amounts. Although these schemes give the appearance of the separation of responsibility and control from the benefits of ownership, assets in these schemes are in fact controlled and directed by the taxpayer.

A network of promoters and subpromoters, who may charge anywhere from $5,000 to $70,000 for a package, often sponsor such schemes. The fee enables taxpayers to have trust documents prepared, to utilize foreign and domestic trustees as offered by promoters, and to use foreign bank accounts and corporations.

BASIC TRUST TAXATION

A trust is a form of ownership that is controlled and managed by a designated independent trustee so as to completely separate the responsibility and control of assets from the benefits of ownership. There are numerous types of legal trust arrangements, and they are commonly used for estate planning, char-

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itable purposes, and holding assets for beneficiaries. An independent trustee manages the trust, holds legal title to trust assets, and exercises independent control.

All income that a trust receives, whether from foreign or domestic sources, is taxable to the trust, the beneficiary, or the taxpayers unless specifically exempted by the Internal Revenue Code (IRC).

Distributions. A legitimate trust is allowed to deduct distributions to beneficiaries from its taxable income, with a few modifications. Therefore, trusts can eliminate income by making distributions to other trusts or to other entities as long as they are named as beneficiaries. This distribution of income is key to understanding the fraudulent nature of the abusive schemes. **In fraudulent schemes, bogus expenses are charged against trust income at each trust layer.** After the deduction of these expenses, the remaining income is distributed to another trust, and the process is repeated. The result of the distributions and fraudulent deductions is to reduce the amount of income ultimately reported to the IRS.

Forms to File. A domestic trust must file a Form 1041 for each taxable year. If the trust is classified as a Domestic Grantor Trust, it is not generally required to file a Form 1041, provided the individual taxpayer reports all items of income on his or her Form 1040, U.S. Individual Income Tax Return. Thus, the individual pays the total tax liability upon the filing of his or her return for the taxable year. All income received by a trust, whether from foreign or domestic sources, is taxable to the trust, beneficiary, or taxpayer unless specifically exempted by the Internal Revenue Code.

Foreign trusts are subject to special filing requirements. If a trust has income that is effectively connected with a U.S. trade or business, it must file Form 1040NR, U.S. Nonresident Alien Income Tax Return. Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Foreign Gifts, must be filed on the creation of or transfer of property to certain foreign trusts. Form 3520-A, Annual Information Return of Foreign Trusts With U.S. Owner, must also be filed annually.

Foreign trusts may be required to file other forms as well. Foreign trusts to which a U.S. taxpayer has transferred property are treated as grantor trusts as long as the trust has at least one U.S. beneficiary. The income the trust earns is taxable to the transferor under the grantor trust rules. Grantor trusts are not recognized as separate taxable entities because, under the terms of the trust, the grantor retains one or more powers and remains the owner of the trust income. In such a case, the trust income is taxed to the grantor.

In addition to filing trust returns as just described, a taxpayer may be required to file U.S. Treasury Form TD 90-22.1, Foreign Bank and Financial Accounts Report, if the taxpayer has an interest of over $10,000 in foreign bank accounts, securities, or other financial accounts. Also, a taxpayer may be required to acknowledge an interest in a foreign bank account, security account, or foreign trust on Schedule B, Interest and Dividend Income, which is attached to Form 1040.

ABUSIVE DOMESTIC TRUST SCHEMES

As stated above, trust schemes are usually offered in a series of trusts that are layered upon one another. They are typically promoted by the promise of tax benefits with no meaningful change in the taxpayer's control over or benefit from the taxpayer's income or assets. These trusts can include the following:

1. Asset Management Company. In many promotions, taxpayers are advised to create an **Asset Management Company (AMC).** The AMC, which lists the taxpayer as the director, is formed as a domestic trust. An individual on the promoter's staff is usually the trustee of the AMC, but the taxpayer quickly replaces this individual. The purpose of the AMC is to give the appearance that the taxpayer is not managing his or her business and to start the layering process.

2. Business Trust. The next step is to form a business trust, also a domestic trust. In effect, the client elects to **change the structure of the business from either a sole proprietorship or corporation**

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to a trust. The AMC is the trustee of the business trust. Administrative expenses may be deducted from the trust as a means of reducing taxable income. The scheme gives the appearance that the taxpayer has given up control of the business to a trust; however, in reality the taxpayer is still running the day-to-day activities of the business and is controlling its income stream.

3. Equipment or Service Trust. An equipment or service trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The business trust reduces its income by claiming deductions for payments to the equipment trust.

4. Family Residence Trust. In some instances, taxpayers are being advised to distribute remaining income from the business trust to a family residence trust. Family residences, including furnishings, are transferred to this trust. These trusts sometimes rent the family residence back to the owner. These trusts may attempt to deduct depreciation and such expenses of maintaining and operating the residence as gardening, pool service, and utilities.

5. Charitable Trust. In many promotions, the **last layer** of trust is the charitable trust. These trusts or "charitable organizations" pay for personal, educational, or recreational expenses on behalf of the taxpayer or family members. The payments are then claimed as "charitable" deductions on the trust tax return. After personal and nonallowable expenses are deducted from the charitable trust, any remaining balance of income, usually a nominal amount, is distributed to the taxpayer.

ABUSIVE FOREIGN TRUST SCHEMES

Similar to the domestic arrangements, foreign packages usually start off with an AMC–a business trust–and distribute income to several trust layers. These foreign promotions, however, also attempt to take funds offshore and outside U.S. jurisdiction. These schemes involve offshore bank accounts, trusts, and International Business Corporations (IBCs) created in "tax haven" countries.

Practitioner Note. An IBC is a corporation set up offshore in a jurisdiction where the tracing of ownership by U.S. authorities is very difficult. Due to the difficulty in tracing the ownership of IBCs, these entities are used quite often in tax evasion schemes.

1. AMC. As with the domestic arrangement, the first step in these schemes is for the taxpayer to form an AMC.

2. Business Trust. The next step is to form the business trust, again very similar to the domestic scheme.

3. Foreign Trust One. Next, a foreign trust is formed in a tax haven country, and the income from the business trust is distributed to this trust. For our purposes, this foreign trust will be referred to as "foreign trust one." In many cases, the AMC will be the trustee of foreign trust one. Due to the fact that the source of the income is U.S. based, and there is a U.S. trustee, this foreign trust has filing requirements as discussed above.

4. Foreign Trust Two. The next step is to form a second foreign trust or "foreign trust two." All the income of foreign trust one is distributed to foreign trust two. Either foreign trust one or a foreign member of the promoter's staff becomes the trustee of foreign trust two. (If the trustee is foreign trust one, the taxpayer still controls foreign trust two by the fact that he or she is in control of foreign trust one's trustee, through the directorship of the AMC.) If a foreigner is the trustee of foreign trust two, the taxpayer is empowered by the promoter to overrule any decisions by this trustee. In either case, the taxpayer is in control of foreign trust two.

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Promoters will claim to taxpayers that since the trustee and the source of income are now foreign, there are no U.S. filing requirements. Promoters also advise taxpayers that since the trusts are formed in tax haven countries it is impossible for the IRS to determine who is in control of the trusts. In actuality, the taxpayer has never relinquished control of his or her business, but has set up, with the assistance of a promoter, an elaborate scheme to subvert and evade U.S. tax laws.

SUBSTANCE—NOT FORM—CONTROLS TAXATION

The Supreme Court of the United States has consistently stated that the substance, rather than the form, of the transaction is controlling for tax purposes. See, for example, *Gregory v. Helvering*, 293 U.S. 465 (1935); *Helvering v. Clifford*, 309 U.S. 331 (1940). Under this doctrine, **abusive trust arrangements may be viewed as sham transactions,** and the IRS may ignore the trust and its transactions for federal tax purposes.

In *Markosian v. Commissioner*, 73 T.C. 1235 (1980), the court held that the trust was a **sham** because the parties did not comply with the terms of the trust, and the supporting documents and the relationship of the grantors to the property transferred did not differ in any material aspect after the creation of the trust.

In *Zmuda v. Commissioner,* 731 F.2nd 1417 (9th Cir. 1984), the income and assets of the business trust, the equipment in the equipment trust, the residence in the family residence trust, and the assets in the foreign trust were all being treated as belonging directly to the owner.

IRS ENFORCEMENT STRATEGY

Individuals involved in abusive trust schemes that seek to evade tax are still liable for taxes, interest, and civil penalties. Violations of the Internal Revenue Code with the intent to evade income taxes may result in a civil fraud penalty or criminal prosecutions. Civil fraud can include a penalty of up to 75% of the underpayment of tax attributable to fraud, in addition to the taxes owed. Criminal convictions of promoters and investors may result in fines up to $250,000 and up to five years in prison.

The IRS has recently undertaken a national, coordinated strategy to address fraudulent trust schemes. The enforcement strategy for combating these schemes is to focus primarily on promoters and on clients who have willfully used the promotion to egregiously evade tax.

> **Practitioner Note.** See pages 621–622 in the 1999 *Farm Income Tax Book* for a successful example of IRS enforcement.

FALSE CLAIMS USED BY PROMOTERS

1. False Claim. Establishing a trust will reduce or eliminate income taxes or self-employment taxes.

Truth. Taxes must be paid on the income or assets held in trust, including the income generated by property held in trust. The responsibility to pay taxes may fall to the trust, the beneficiary, or the transferor.

2. False Claim. Individuals will retain complete control over income and assets with the establishment of a trust.

Truth. Under legal trust arrangements, individuals must give up significant control over income and assets. An independent trustee is designated to hold legal title to the trust assets, to exercise independent control over the trust, and to manage the trust.

3. False Claim. Taxpayers may deduct personal expenses paid by the trust on their tax return.

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Truth. Nondeductible personal living expenses cannot be transformed into deductible expenses by virtue of assigning assets and income to a trust.

4. False Claim. Taxpayers can depreciate their personal residence and furnishings and take them as deductions on their tax return.

Truth. Depreciation of a taxpayer's residence and furnishings used solely for personal use does not become deductible by virtue of assigning the residence to a trust.

RECENT CRIMINAL CONVICTIONS

1. CHAPPELL, ET AL. INVESTIGATION

In May 1999, Ronald Chappell, a former CPA from Roseville, California, was sentenced to **87 months imprisonment** for defrauding the IRS by promoting bogus trusts. In addition to Chappell, Todd Gaskill, an attorney, Martin Goodrich, and Lloyd Winburn, a former legislative aide in Sacramento, were sentenced to 58, 37, and 63 months of imprisonment, respectively, for their involvement in the scam.

The men sold packages of **bogus trusts** to clients and advised them on how to use trusts to generate fraudulent tax deductions. Clients of these individuals put businesses, homes, and other assets in trusts, but in fact continued to control those assets. On their tax returns, clients claimed various personal expenses related to the bogus trusts, including depreciation of personal residences, lawn care, house cleaning, and scholarships for their children.

In another scheme directed at high-income taxpayers, Chappell, Gaskill, and Goodrich instructed clients to conceal income from the IRS through a series of bank accounts in the U.S. and the Caribbean. The judge in the case found that the trust scheme deprived the federal and state governments of more than $2.5 million in tax revenue.

2. BRADLEY INVESTIGATION

In June 1999, Edgar Bradley and his sons, Edgar Bradley II and Roy Bradley were sentenced to 60, 57, and 46 months of imprisonment, respectively, followed by three years supervised release, for conspiracy to defraud the IRS and for failing to file tax returns.

In an attempt to conceal income, the Bradleys, who were found guilty by a federal jury, assigned their income to several nominees and purported irrevocable trusts that had no economic substance. As part of the conspiracy, the Bradleys used several bank accounts opened in trust and other names to conceal insurance commission receipts and proceeds from the sale of certificates of deposit and coins.

The Bradleys also attempted to conceal their assets from the IRS by the conveyance of real property from their names to purported trusts and nominees. **In addition to their imprisonment, the judge in the case ordered the Bradleys to pay fines of $413,500 and restitution in excess of $636,000 to the IRS.**

3. RIVERA INVESTIGATION

In January 1999, Pedro Ivan Rivera, a physician in Carrollton, Texas, was sentenced to 37 months of imprisonment, followed by three years supervised release, and was ordered to pay $414,819 in restitution to the IRS for **tax evasion** for the years 1992 through 1996. Rivera created trusts, including one for his family residence, that he controlled and used to conceal his income.

In addition, Rivera transferred funds among trusts, offshore corporations, and their corresponding bank accounts located in the U.S., the Bahamas, and the Channel Islands, in order to conceal taxable income.

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4. MORRIS INVESTIGATION

In July 1999, James C. Morris of Cincinnati, Ohio, was sentenced to 24 months of imprisonment followed by three years supervised release for **tax evasion** and for attempting to interfere with the administration of the IRS. Morris, who pleaded guilty, admitted that he did not file a Federal income tax return or pay substantial tax due for 1992 on the sale of certificates of deposit.

As part of his scheme, Morris used nominee trusts to conceal his income and assets from the IRS. Morris admitted that he impeded the IRS by **selling sham** trusts that were used to conceal assets and income from the IRS and others. Morris also admitted that he was a member of the Liberty Foundation, an organization that sold "untaxing packages" and assisted its members in circumventing the filing of Federal income tax returns and payment of Federal income tax. Morris sold these "untaxing packages" and sham trusts through his business, Excellence in Planning Associates. In addition to imprisonment, the judge ordered Morris to pay a $5,000 fine and restitution to the IRS in the amount of $41,686.

ADDITIONAL INFORMATION

More information about trusts can be found on the IRS Web site at www.irs.gov. Information on the IRS policy regarding fraudulent trusts can be found in Public Announcement Notice 97-24 and Publication 2193, *Too Good to Be True Trusts,* contains information on **abusive trust schemes** that advertise bogus benefits. Both of these documents are also available on the IRS Web site.

> **Practitioner Note.** To report abusive trust tax evasion schemes call (800) 829-0433.

OFFER IN COMPROMISE

An Offer in Compromise (OIC) is an agreement between a taxpayer and the IRS that resolves the taxpayer's tax liability. The IRS has the authority to settle, or compromise, federal tax liabilities by accepting less than full payment under certain circumstances. The IRS may legally compromise for one of the following reasons:

- **Doubt as to liability**—Doubt exists that the assessed tax is correct.
- **Doubt as to collectibility**—Doubt exists that the amount could ever be paid in full.
- **Effective tax administration**—There is no doubt the tax is correct and no doubt the amount owed could be collected, but an exceptional circumstance exists that allows the IRS to consider an offer. To be eligible for compromise on this basis, the taxpayer must demonstrate that collection of the tax would create an economic hardship or would be unfair or inequitable.

ELIGIBILITY FOR CONSIDERATION

A taxpayer may be eligible for consideration of an Offer in Compromise if

1. In the taxpayer's judgment, he or she does not owe the tax liability (**doubt as to liability**). Taxpayers must submit a detailed written statement explaining why they believe they do not owe the tax liability they want to compromise. They will not be required to submit a financial statement if they are submitting an offer on this basis alone.

2. In the taxpayer's judgment, he or she cannot pay the entire tax liability in full (**doubt as to collectibility**). The taxpayer must submit a statement showing his or her current financial situation.

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3. The taxpayer agrees that the tax liability is correct and he or she is able to pay the balance due in full, but he or she has exceptional circumstances that he or she would like the IRS to consider, including situations involving severe or unusual economic hardship (**effective tax administration**). To receive consideration on this basis the taxpayer must submit
   a. A financial statement and
   b. A detailed written narrative. The narrative must explain the exceptional circumstances and why paying the tax liability in full would either create an economic hardship or would be unfair and inequitable.

   The IRS will also consider the taxpayer's overall history of filing returns and paying taxes.

INELIGIBILITY FOR CONSIDERATION

A taxpayer is not eligible for consideration of an Offer in Compromise on the basis of **doubt as to collectibility** or **effective tax administration** if

1. The taxpayer has not filed all federal tax returns, or
2. The taxpayer is involved in an open bankruptcy proceeding.

> **Practitioner Note.** An in-business taxpayer must have timely filed and timely deposited all employment taxes for the two prior quarters before the offer is submitted. He or she must have also timely made all federal tax deposits during the quarter in which the offer is being submitted.

SUBMITTING AN OFFER IN COMPROMISE

Form 656, Offer in Compromise, is the official compromise agreement. Substitute forms, whether computer-generated or photocopies, must affirm that

1. The substitute form is a verbatim duplicate of the official Form 656, and
2. The taxpayer agrees to be bound by all terms and conditions set forth in the official Form 656.

The taxpayer must initial and date all pages of the substitute form, in addition to signing and dating the signature page.

Additional Forms Required

- Form 433-A, Collection Information Statement for Individuals, if the taxpayer is submitting an offer as an individual
- Form 433-A and 433-B, Collection Information Statement for Businesses, if the taxpayer is submitting an offer as a self-employed person
- Form 433-B, if the taxpayer is submitting an offer as a corporation or other business taxpayer. The IRS may also require Forms 433-A from corporate officers and individual partners.

For a more detailed explanation of the information required to complete these forms, see page 4 of the instructions to Form 656. See page xx for the first page of the current Form 656.

> **Practitioner Note.** The taxpayer should personally sign the offer as well as any required information statements unless unusual circumstances prevent him or her from doing so. If an authorized power of attorney signs the offer because of unusual circumstances, a completed Form 2848, Power of Attorney and Declaration of Representative, must be included with the offer.

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All forms can be ordered by calling (800) 829-1040, by visiting the local IRS office, or by accessing the IRS web site at www.irs.gov.

DETERMINING PAYMENT TERMS

The Offer in Compromise program's purpose is to settle tax debts for the maximum amount that a taxpayer can pay. In some cases, the taxpayer is best able to settle the debt by paying it off over a period of time.

The IRS recently announced a new, simplified method of settling taxpayer debts by providing taxpayers a fixed monthly payment option.

This new method will assist taxpayers and practitioners in situations where taxpayers are willing to pay their debts, but the maximum amount they can pay is not sufficient to pay off the full amount of the debt. In this situation taxpayers are not eligible for ordinary installment agreements, but they will be eligible for the new, fixed monthly payment option.

Three Ways to Pay

- Cash (paid in 90 days or less)
- Short-term deferred payment (more than 90 days, up to 24 months)
- Deferred payment (offers with payment terms over the remaining statutory period for collecting the tax)

Cash Offer. The taxpayer must pay the cash offer **within 90 days** of acceptance of the offer.

The taxpayer should offer the realizable value of his or her assets plus the total amount the IRS could collect over 48 months of payments (or the remainder of the ten-year statutory period for collection, whichever is less).

> **Practitioner Note.** The IRS requires full payment of accepted **doubt as to liability** offers at the time of mutual agreement of the corrected liability. If the taxpayer is unable to pay the corrected amount, he or she must also request compromise on the basis of **doubt as to collectibility**.

Example 1. Mary Smith has $5,000 net realizable equity in assets. She has the ability to pay $50 per month and 80 months remain on the collection statute.

> **Practitioner Note.** The net realizable equity in assets and the amount the taxpayer can afford to pay per month result from complex computations included in the instructions to Form 656 (not illustrated here). In these examples, those numbers are assumed to have been computed as explained in the Form 656 instructions.

Computation of Acceptable Offer

Months	Payment	Value of Payments	
48	$50.00	$2,400.00	
Collection from future income (value of payments)			$2,400.00
Equity component of offer amount			+ $5,000.00
Acceptable offer			**$7,400.00**

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In this case the offer amount is based on the net realizable equity in assets plus the total amount that could be collected over 48 months of payments (the lesser of 48 months or the number of months remaining on the collection statute).

Short-Term Deferred Payment Offer. This option requires the taxpayer to pay the offer **within two years** of acceptance of the offer.

The offer must include the realizable value of assets plus the amount the IRS could collect over 60 months of payments (or the remainder of the ten-year statutory period for collection, whichever is less).

The IRS may file a Notice of Federal Tax Lien on tax liabilities compromised under short-term deferred payment offers.

Example 2. Using the facts in Example 1, this offer is based on the net realizable equity in assets plus the total amount that could be collected over 60 months of payments (or the number of months left on the statute **if less**).

Computation of Acceptable Offer

Months	Payment	Value of Payments	
60	$50.00	$3,000.00	
Collection from future income (value of payments)			$3,000.00
Equity component of offer amount			+ $5,000.00
Acceptable offer			**$8,000.00**

Deferred Payment Offer. This payment option requires the taxpayer to pay the offer amount **over the remaining statutory period** for collecting the tax.

The offer must include the realizable value of assets plus the amount the IRS could collect through monthly payments during the remaining life of the collection statute.

Example 3. Using the facts in Example 1:

Computation of Acceptable Offer

Months	Payment	Value of Payments	
80	$50.00	$4,000.00	
Collection from future income (value of payments)			$4,000.00
Equity component of offer amount			+ $5,000.00
Acceptable offer			**$9,000.00**

The deferred payment plan has three options:

Option One

- Full payment of the realizable value of assets within 90 days from the date the IRS accepts the offer, and
- The taxpayer's future income in monthly payments during the remaining life of the collection statute

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In the above example, $5,000 would have to be paid within 90 days and $4,000 would be paid in $50 monthly payments over 80 months.

Option Two

- Cash payment for a portion of the realizable value of assets within 90 days from the date the IRS accepts the offer, and
- Monthly payments during the remaining life of the collection statute for both the balance of the realizable value of assets and the taxpayer's future income

Using the example again, the taxpayer could pay $3,000 of the net realizable equity within 90 days and $6,000 (the remainder of the equity and the future income component) would be paid in $75 monthly payments over 80 months.

Option Three. The entire offer amount in monthly payments over the life of the collection statute.

In the example, $9,000 would be paid in $112.50 monthly payments over 80 months.

As with the short-term deferred payment offers, the IRS may file a Notice of Federal Tax Lien.

INTEREST

The latest change to streamline the Offer-in-Compromise program eliminates confusion associated with interest calculations for deferred payments.

Under the old system, the interest could be adjusted up to four times a year. With deferred payments spread out for up to 10 years, this created complicated calculations and uncertainty for the IRS, tax practitioners, and taxpayers. It also meant the IRS had to leave room at the back end of the deferred payment plan to factor in interest.

Under the new system, **interest is not charged on offered amounts.** The IRS will now be able to precisely calculate the exact amount the person will owe during the life of the Offer-in-Compromise payments, without any of the uncertainty and imprecision involved with fluctuating interest rates.

Policy Adopted for Other Options. The IRS has adopted the same fixed-payment policy for taxpayers choosing the other two Offer-in-Compromise payment options: cash or short-term payments.

The fixed payment combines all debts, including interest and penalty, owed by the taxpayer under the Offer in Compromise terms into a single payment that reflects the maximum the taxpayer can pay after covering basic living expenses.

Statutory Requirement for Interest. The statutory requirement for interest accrual will remain in place. **If the taxpayer defaults on the Offer-in-Compromise agreement, the entire tax liability will be reinstated, along with interest and penalties.** Taxpayers will also be responsible for interest accrued after they entered into the agreement.

WITHHOLDING COLLECTION ACTIVITIES

The IRS will withhold collection activities while the offer is being considered. It will not act to collect the tax liability

- While the IRS investigates and evaluates the offer.
- For 30 days after the IRS rejects the offer.
- While the taxpayer appeals an offer rejection.

Withholding collection will not apply if the IRS finds that the taxpayer submitted the offer to delay collection or if a delay will jeopardize its ability to collect the tax.

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Practitioner Note. Taxpayers who have an installment agreement when they submit an offer must continue making the agreed upon monthly payments while the IRS considers the offer.

Suspension of the Statute of Limitations. The collection statute of limitations is suspended for all tax periods on the taxpayer's offer, during the period the offer is pending. The offer is considered pending

- While the IRS investigates and evaluates the offer.
- For 30 days after the IRS rejects the offer.
- While the taxpayer appeals an offer rejection.

When taxpayers sign the offer, they agree to the suspension of the assessment statute of limitations for all tax periods included in the offer. The signature extends this statute

- During the time frames listed above.
- While the amount agreed to pay under an accepted agreement remains unpaid.
- While any other term or condition of the offer remains unsatisfied.

STEPS IN THE OFFER IN COMPROMISE PROCESS

Step One—Submission of the Offer in Compromise. The taxpayer submits a completed Form 656, Form 433A, and/or Form 433B. It is critical that the following information is included on or with the Form 656:

- signature,
- the tax liabilities to be compromised (tax years, tax form numbers, and amount) and
- the amount offered (this amount should be equal to or exceed the taxpayer's equity in assets).

Step Two—The Evaluation of the Offer in Compromise. An Offer in Compromise specialist will take the information submitted by the taxpayer, analyze the financial statement (Form 433A and/or Form 433B), perform an income and expense analysis, and make a determination as to whether the amount offered represents the taxpayer's equity in assets.

Step Three—Acceptance or Rejection of the Offer in Compromise. A decision will be made and communicated as to whether the offer should be accepted or rejected. If the offer is accepted, the taxpayer must remain current in filing tax returns and the payment of taxes for five subsequent years. Notification of the acceptance will be made by letter. The letter will include the terms of the offer.

If the offer is rejected, an independent reviewer will review the decision before the taxpayer is notified. The taxpayer will be notified by letter, and the letter will contain the reason for the rejection. The rejection letter will also outline the taxpayer's right to appeal the decision.

APPEALS PROCESS

The Appeals organization is one of the oldest and largest dispute settlement organizations in the United States. It has about 2,100 employees, of which 1,100 are Appeals Officers. It is part of the Office of the Commissioner of the Internal Revenue Service.

The success of the United States tax system is based on voluntary taxpayer compliance. An integral component of voluntary compliance is providing taxpayers with an effective means of resolving tax controversies without litigation. The Treasury Department, as a matter of policy, has always preferred

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to administratively settle rather than litigate most tax disputes because doing so saves substantial costs both to taxpayers and the government. There are very few instances where the government actively seeks to litigate a case; one such case would be the need for a precedent or the resolution of a conflict in the circuit courts.

Department of the Treasury
Internal Revenue Service

www.irs.gov

Form 656 (Rev. 1-2000)
Catalog Number 16728N

Form 656

Offer in Compromise

Item 1 — **Taxpayer's Name and Home or Business Address**

Name ______________________

Name ______________________

Street Address ______________________

City ______________ State ______________ ZIP Code ______________

Mailing Address *(if different from above)*

Street Address ______________________

City ______________ State ______________ ZIP Code ______________

Item 2 — **Social Security Numbers**

(a) Primary ______________________

(b) Secondary ______________________

Item 3 — **Employer Identification Number** *(included in offer)*

____

Item 4 — **Other Employer Identification Numbers** *(not included in offer)*

____

____

____

Item 5 — **To: Commissioner of Internal Revenue Service**

I/We (includes all types of taxpayers) submit this offer to compromise the tax liabilities plus any interest, penalties, additions to tax, and additional amounts required by law (tax liability) for the tax type and period marked below: (Please mark an "X" in the box for the correct description and fill-in the correct tax period(s), adding additional periods if needed).

❑ **1040/1120 Income Tax** — Year(s) ______________________

____

❑ **941 Employer's Quarterly Federal Tax Return** — Quarterly period(s) ______________________

____

❑ **940 Employer's Annual Federal Unemployment (FUTA) Tax Return** — Year(s) ______________________

____

❑ **Trust Fund Recovery Penalty** as a responsible person of (enter corporation name) ______________________

______________________ ,

for failure to pay withholding and Federal Insurance Contributions Act Taxes (Social Security taxes), for period(s) ending ______________________ .

❑ **Other Federal Tax(es)** [specify type(s) and period(s)] ________

____

Note: ***If you need more space, use another sheet titled "Attachment to Form 656 Dated ______________ ." Sign and date the attachment following the listing of the tax periods.***

Item 6 — **I/we submit this offer for the reason(s) checked below:**

❑ **Doubt as to Liability** — "I do not believe I owe this amount." You must include a detailed explanation of the reason(s) why you believe you do not owe the tax in Item 9.

❑ **Doubt as to Collectibility** — "I have insufficient assets and income to pay the full amount." You must include a complete financial statement, Form 433-A and/or Form 433-B.

❑ **Effective Tax Administration** — "I owe this amount and have sufficient assets to pay the full amount, but due to my exceptional circumstances, requiring full payment would cause an economic hardship or would be unfair and inequitable." You must include a complete financial statement, Form 433-A and/or Form 433B and complete Item 9.

Item 7

I/we offer to pay $ ______________

❑ Paid in full with this offer.

❑ Deposit of $ ______________ is attached to this offer.

❑ No deposit.

Note: Make all checks payable to: The United States Treasury

Check one of the following:

❑ **Cash Offer (Offered amount will be paid in 90 days or less.)**

Balance to be paid in: _______ 10, _______ 30, _______ 60, or _________ 90 days from notice of acceptance of the offer. If more than one payment will be made during the time frame checked, provide the amount and date of the payment on the line below.

____

❑ **Short Term Deferred Payment Offer (Offered amount paid in more than 90 days but within 24 months.)**

Amount of monthly payment ______________________

Monthly payment date ______________________

Date offered amount will be paid in full ______________________

Other terms for payment ______________________

❑ **Deferred Payment Offer (Offered amount will be paid over the life of the collection statute.)**

Amount of monthly payment ______________________

Monthly payment date ______________________

Other terms for payment ______________________

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HOW APPEALS WORKS

An Appeals Officer will review the strengths and weaknesses of the issues in a taxpayer's case and give them a *fresh look*. Appeals Office reviews are conducted in an informal manner, by correspondence, by telephone, or at a personal conference. Most differences are settled in these appeals conferences without expensive and time-consuming court trials. Appeals will consider any reason a taxpayer has for disagreeing with an issue, except for moral, religious, political, constitutional, conscientious objection, or similar grounds.

Most income tax cases go to Appeals when adjustments or penalties are proposed; a claim for a refund, credit, or abatement is disallowed; or the IRS takes enforcement action. The taxpayer can respond to proposed adjustments or assessments in one of four ways:

- The taxpayer may agree with the adjustment and pay the deficiency, closing the case; or
- The taxpayer may disagree and provide documentation or other support of his or her position sufficient to resolve the case; or
- The taxpayer may file a protest and have Appeals consider the dispute; or
- The IRS issues a Notice of Deficiency. A taxpayer may take the case to the U.S. Tax Court before paying the amount shown on the notice. It is important to recognize that even if the taxpayer chooses to file a U.S. Tax Court petition, the Chief Counsel will forward the case to Appeals for settlement consideration before trial.

Taxpayers are generally entitled to

- Appeal disputes arising under the Internal Revenue Code, regulations and procedures.
- An explanation of the Appeals process.
- A timely conference and resolution of their dispute.

Appeals commitments to the taxpayer are to

- Explain the appeal rights and the Appeals process.
- Listen to their concerns.
- Be courteous and professional.
- Be responsive (and allow the time needed to respond to any requests for information).
- Be fair and impartial.

Independence. The Commissioner has delegated the authority to settle tax controversies to Appeals. Appeals is separate from all other functions, such as Compliance and Counsel. The independent authority of Appeals ensures a fair and impartial review of protested tax adjustments. The National Director of Appeals has line authority over Appeals operations, and that fact promotes uniformity and consistency in settlements nationwide.

Settlement Authority. Within the Appeals organization, settlement authority is delegated to Appeals Chiefs, Associate Chiefs, and Team Chiefs in Appeals offices throughout the country. The appeals officers hold conferences, discuss issues, and consider proposals to settle disputes. Their recommendations are subject to approval by an Appeals Chief, Associate Chief, or Team Chief on behalf of the Service. Settlements may be related to the uncertainty of a factual dispute, or uncertainty as to the interpretation or application of the law to the facts of the case. **Appeals has authority to estimate "hazards of litigation" in negotiating a reasonable settlement of a case.**

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COLLECTION APPEALS

Administrative appeal rights for Collection issues have historically included Trust Fund Recovery Penalty cases, Offer in Compromise cases, and Penalty Appeals cases. The Collection Appeals Program (CAP) was started in April 1996 and allowed taxpayers to administratively appeal lien, levy, and seizure actions proposed or made by the IRS. Before this time, the only opportunity for taxpayers to appeal these Collection actions was through the Collection manager and up through the Collection chain of command. This is the first time in the history of U.S. taxation that an appeal on these collection actions was possible through an independent organization such as Appeals. For CAP issues, any taxpayer may request an appeal. The IRS **goal** is to reach a decision in five days. This assures taxpayers that collection activities will not be unnecessarily delayed. In January 1997, appeals of installment agreements proposed for termination, provided for in the Taxpayer Bill of Rights 2, were added to the program.

SERVICE CENTER

Appeals receives referrals from several service center functions. Those functions include Information Returns Processing, Service Center Correspondence Examination, Service Center Collections, and Adjustments. The issues involved in these cases are increases to income; simple examination issues such as deductions, credits and expenses; claims for refund, credit, or abatement; penalty assessment; or the requirement to file a tax return. Taxpayer's disputes with service center adjustments, assessments, or enforcement actions are handled through an Appeals conference, either by telephone or in person.

REPRESENTATION

Taxpayers may represent themselves in Appeals and may bring another person with them to support their position. If they want to be represented by someone, the person they choose to represent them must be an attorney, a certified public accountant, or an enrolled agent authorized to practice before the IRS. If they want the representative to talk to the IRS without the taxpayers present the IRS needs a copy of a completed Form 2848, Power of Attorney.

APPEALS CUSTOMER SERVICE PROGRAM

The Appeals Customer Service Program began in 1991 in the Denver District office with the goals of demonstrating responsiveness to taxpayer needs and improving customer satisfaction. The Denver test proved successful, and in 1992 it was expanded to include the Cheyenne District. In 1994, additional offices were included in the test. In 1998, the program became official nationwide, and Appeals Customer Service Representatives were selected in all thirty-three offices.

The duties of the Appeals Customer Service Representative include

1. Serving as proponents of the Appeals process;
2. Providing assistance to taxpayers during administrative appeal;
3. Handling taxpayers' complaints regarding Appeals;
4. Participating in National Problem Solving Days;
5. Coordinating with Taxpayer Advocate representatives on Appeals matters;
6. Performing Appeals education and outreach with the public, as well as other IRS functions;
7. Ensuring that taxpayers' rights are not abridged; and
8. Identifying problems and trends, including analyzing customer surveys and balanced measures results.

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Practitioner Note. The Appeals Customer Service Representative toll free number is 1-(877) 457-5055.

NONFILER INITIATIVE

One of the basic tenets of our tax system is the belief that all citizens comply with the requirements to file returns and pay taxes. Taxpayers who fail to file income tax returns pose a serious threat to tax administration and voluntary compliance. Their actions undermine public confidence in the IRS's ability to administer the tax laws fairly and effectively.

To address the growing number of nonfilers in this country, IRS has recently implemented a cross-functional, National Nonfiler Strategy. The overall goal of this strategy is to bring taxpayers back into compliance.

NATIONAL NONFILER STRATEGY

The National Nonfiler Strategy is a multi-functional, comprehensive, cohesive, and sustained effort to bring nonfilers into the system and keep them there. One component of the National Nonfiler Strategy is to provide assistance to nonfilers in resolving the issues that caused them to drop out of the system and to bring them back into compliance.

A second component is the enforcement of the tax laws for individuals who are not responsive to outreach efforts. IRS Criminal Investigation (CI) has devoted resources to identify these individuals and, in most cases, criminal prosecution has been recommended. CI is involved in projects aimed at identifying and investigating the egregious nonfilers in a variety of occupations and industries including wage earners, accountants, lawyers, doctors, public officials, self-employed persons, corporate officers, and narcotics traffickers. Additionally CI is involved in investigating those nonfilers who belong to groups that espouse militant anti-government and anti-taxation philosophies.

REVENUE PROTECTION STRATEGY

For the past six filing seasons, the IRS has continuously increased its efforts to guard against problematic returns. The Revenue Protection Strategy (RPS) is built on a four-pronged approach to address the problems associated with fraudulent and questionable returns:

Understanding. Research and analyze data in an ongoing effort to understand fraud and the various methods of abuse, with a special emphasis on emerging trends.

Prevention. Validate return information up-front to prevent fraudulent or questionable claims from entering the filing system.

Detection. Develop improved detection systems to identify multiple-return fraud schemes and patterns of abuse among groups of taxpayers.

Enforcement. Pursue criminal investigation and prosecution of fraudulent refund claims. In addition, conduct pre-refund audits to determine eligibility for certain tax benefits.

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RECENT INITIATIVES

Validation of Social Security Numbers. During 1999, validation of Social Security numbers (SSNs) and other tax identification numbers was a very noticeable portion of the fraud and abuse prevention effort. IRS expanded the validation of SSNs and Taxpayer Identification Numbers (TINs) to all forms and schedules requiring identification numbers.

Additionally, IRS identified dependent SSNs claimed on more than one return and improper claiming of children for the dependency exemption and/or earned income credit (EIC). Refunds were delayed for taxpayers with incomplete returns, invalid or duplicate SSNs, or returns evidencing patterns consistent with suspicious claims or profiles pursuant to “math error” procedures or audits.

Math Error Notices

Math error notices are issued if EIC is claimed on the return AND recertification is required, but Form 8862, Information to Claim Earned Income Credit After Disallowance, is not attached to the return. Recertification is also required if the tax return was audited in a prior year and the EIC was not allowed.

EARNED INCOME CREDIT COMPLIANCE INITIATIVES

In 1997 Congress provided a separate appropriation to concentrate on improving Earned Income Credit (EIC) compliance over a five-year period.

COMPLIANCE INITIATIVES

1. The **2000 EIC Compliance Study** will be the third in a series of five studies planned for returns claiming EIC. This study will involve 3,500 randomly selected 1999 returns. All returns in the study will be examined in district offices, and the refunds for these returns will be frozen. The primary objective of the study is to establish individual return accuracy and to determine current compliance levels for EIC eligibility requirements. By conducting these studies, the IRS can monitor the impact of strategies to improve compliance.
2. The **1999 EIC-Schedule C Project** was a new project to examine returns with certain types of Schedules C that also claim EIC. The Schedules C on these returns reflected no expenses. At the same time, there was little or no wage income on the returns, and there was a large EIC claim. Approximately 6,000 returns were examined in district offices, and 30,000 were examined by the service centers. Information from previous examinations and reports from the Social Security Administration indicated that taxpayers meeting the criteria of this project often received public assistance and/or could not provide verification of the income reflected on the Schedule C. Refunds for these cases were frozen.

   Because paid practitioners prepared 62% of returns claiming the EIC for 1998, and a large number of those returns had errors or over claims, the **1999 Preparer Compliance Visits** were conducted in the districts to assess preparer knowledge of and compliance with various laws affecting them. The goals of these visits were to educate preparers filing returns claiming EIC and to reduce errors and over-stated claims of EIC. Nearly 10,000 practitioners, who prepared 100 or more EIC returns, were visited prior to the start of the 2000 filing season. These one-on-one visits were both educational and evaluative with 973 preparers identified for enforcement action.
3. The **Preparer Compliance Visits will continue for the 2000 filing year** with education and outreach visits to new EIC return preparers and follow-up visits to some of last year’s participants.

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2000 Workbook

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2000 Income Tax School

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