IRS UPDATE

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OVERVIEW OF REORGANIZED IRS

Last year the IRS undertook the most extensive reorganization in its history, designed to transform an administrative agency into a world-class service organization. The new IRS mission statement–and new perspective–is to concentrate on helping people understand and meet their income tax filing responsibilities, while focusing its compliance efforts on the relative few who choose not to accept those responsibilities.

Major IRS areas of focus are meeting the specific needs of its customers, reducing customer burden, broadening the use of electronic interactions with its customers, addressing key areas of noncompliance, adapting to a global economy, and developing a quality workforce. IRS will measure its performance as an agency by using balanced criteria that match its strategic goals, including not only business results, but also customer and employee satisfaction, which are essential to the success of every service organization.

The IRS has four operating divisions: Large and Mid-Size Business (LMSB), Tax Exempt/Government Entities (TE/GE), Wage & Investment (W&I), and Small Business & Self-Employed (SB/SE). The last two divisions, responsible for more than 160 million taxpayers, have the greatest public visibility and direct substantial resources toward pre-filing assistance, including education, marketing of products and services (such as the IRS Web site), and pre-filing agreements with various taxpayer groups.

The majority of Wage and Investment (W&I) customers are taxpayers whose taxes are withheld by their employers. As a result, they tend to deal with the IRS only once a year when they file their tax returns. Compliance issues are usually the result of taxpayer confusion regarding the tax law.

Small Business/Self-Employed customers include filers of Form 1040 with Schedules C, E, or F or Form 2106, and partnerships and corporations with assets of $10 million or less.

It's important to remember, however, that the IRS is still one IRS. Each division specializes according to the needs of the people it serves, but all divisions continue to work together to meet the agency's overall goals. Each division is dependent on the others' success, and no division is more or less important than any other.

PRODUCTS AND SERVICES

SB/SE Web page. A new Small Business and Self-Employed Community Web site is a means to enhance customer service by reaching out electronically to its 40 million SB/SE taxpayers. Research shows that 85% of small businesses use the Internet. Access to the Web site is through the IRS home page www.irs.gov. Anyone may also link directly to the page at http://www.irs.gov/smallbiz/index.

The web site enables small business owners, self-employed individuals, and tax practitioners to have easy access to **industry specific information** to help small businesses and self-employed individuals comply with tax laws and regulations. The Web site provides links to IRS forms, publications, frequently asked questions, and revenue procedures. In addition, links to other government Web sites and many national associations and organizations offer the user complimentary and comprehensive information. Other features include a calendar listing of all IRS Small Business Workshops and the ability to download the SS-4 form to obtain an Employer Identification Number. Future enhancements will provide information on approximately 20 additional industries. Feedback from practitioner and taxpayer Web site users is strongly encouraged so that the IRS can continue to improve this product.

Tax Talk Today. "Tax Talk Today" is a free interactive series that allows tax practitioners across the country to consult with nationally recognized experts about current tax and business issues of critical importance to them. Each month, the 60-minute program delivers practical, balanced information from the nation's leading tax practitioners, preparer organizations, and other professionals, including IRS executives. The series is specifically designed to address the informational and continuing education needs of Enrolled Agents, CPA's, tax attorneys, and educators in law, business, and accounting.

All of the programs in this unique monthly series feature a panel discussion, live questions from viewers, a briefing on the latest tax news, and entertaining segments like Tax Teasers and Tax Tips that further encourage viewer involvement. The programs may be viewed live via Web case at 2:00 P.M. Eastern Time on the last Tuesday of each month.

Remaining 2001 dates and topics are:

November 27, 2001	Taxpayer Advocate: The New IRS Service
December 18, 2001	Tax Legislation

All programs are archived and available for viewing at any time over the Internet as soon as two hours after the live webcast concludes. Archived programs include: *Working with the IRS—Who to Call for What; Verification of Tax Returns: Not the Same Old Audit; Tax Administration Blues: The Penalties;* and *Ethics,* among others. Programs are also available on videotape at the "Tax Talk Today" Web site store.

Information concerning CPE/CLE credit on a state-by-state basis, as well as an application to enroll for CPE/CLE credit, can be found by going to www.TaxTalkToday.TV, and clicking on "Earn CPE/CLE credits." For a fee and depending on state CPE/CLE authority, tax practitioners can enroll to earn CPE/CLE credit for watching the program live or in archived format.

"Tax Talk Today" is not a part of the IRS reorganization; however, the reorganization has created many new questions for tax practitioners. The tax community has heard a great deal about the goals of the IRS reorganization: a new focus on the customer, greater accountability, improved efficiency, and increased productivity. The "Tax Talk Today" series is specifically designed to address these concerns and to promote an understanding of the IRS's new structure, the procedures that have been established in order to implement changes to the substantive tax law and taxpayer rights, and how practitioners can best serve their clients through a full understanding of the agency and its practices.

TAXPAYER ADVOCATE SERVICE

The National Taxpayer Advocate Service (formerly the Problem Resolution Office) has been delegated new authority that will provide taxpayers more efficient service on customer service cases. The IRS also has clarified the guidelines for issuing Taxpayer Assistance Orders.

The increased authority will permit the Taxpayer Advocate Service to fully resolve a large number of taxpayer cases without having to refer the cases to other parts of the IRS. The additional authority will generally permit employees of the Taxpayer Advocate Service to take the same actions as IRS Customer Service Representatives in cases that qualify for the Taxpayer Advocate Program. This includes adjustments and other account-related interactions that the IRS has with taxpayers.

The IRS also clarified the guidelines for issuing Taxpayer Assistance Orders (TAOs) by the Taxpayer Advocate Service. Consistent with statutory authority, these orders can be used to direct appropriate IRS units to either take an action to prevent a significant hardship or reconsider a determination made in a specific case. For example, the Taxpayer Advocate Service may issue a TAO to direct an IRS unit to release a taxpayer's property from levy or to require review of a decision made in an innocent spouse case. A TAO is Form 911.

Taxpayers who have been unsuccessful resolving issues with the IRS through normal channels can contact the Taxpayer Advocate at 1-877-777-4778. Additional information is available at www.irs.gov/ind_info/advocate.html.

RELIEF FOR INNOCENT SPOUSES

JOINT AND SEVERAL LIABILITY

Spouses **who file a joint return** are jointly and severally liable for liabilities, including tax, penalties, and interest arising from that return [I.R.C. §§6013(d)(3), 6665(a)(2), and 6601(e)(1)]. That is, the IRS may collect the entire liability from either spouse, without regard to whom the income, deductions, credit, or basis that gave rise to the liability is attributable. Additionally, both spouses are liable for any future liabilities that may arise from an examination without regard to whom the increases are attributed.

Example 1. Howard and Wanda Brown filed a joint return for the tax year 2000, reporting Howard's earnings as a self-employed plumber. Wanda did not work during 2000. In 2001, IRS examined the return and assessed additional tax of $1,000, due to Howard's unreported plumbing income of $5,000. Although Wanda did not earn the income, she is jointly and severally liable for the $1,000 in additional taxes because she filed a joint return.

IRS's authority to collect from either spouse under federal law takes precedence over provisions assigning or allocating responsibility for taxes that may be included in written instruments incident to divorce or separate maintenance decrees.

> **Observation.** The decision to file a joint return, the arrangements for any unpaid taxes, and the potential exposure from an ongoing or future examination should be carefully considered during divorce proceedings.

The innocent spouse provisions are one avenue that may be available to joint filers seeking relief from joint and several liability. Those provisions are discussed below.

> **Practitioner Note:** If the taxpayer did **not** file a joint return and lives in a community property state, I.R.C. §66 may provide relief from liability.

Other issues that may affect a taxpayer's liability include:

1. The taxpayer signed the joint return under duress.
2. The taxpayer's signature was forged on the joint return.
3. A fraud penalty was asserted against both spouses, but may not apply to both.
4. Validity of an assessment is questionable.

Observation. If the issue is doubt as to collectibility, an Offer in Compromise, Doubt as to Collectibility, might be the best approach to relieving the taxpayer of liability.

INNOCENT SPOUSE PROVISIONS

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) provides three avenues of relief for joint filers seeking relief from all or a portion of a joint liability:

1. An expanded innocent spouse provision that eliminates prior dollar limits contained in the prior innocent spouse provision of I.R.C. §6013(e) [I.R.C. §6015(b)].
2. A new election to allocate a deficiency for divorced, legally separated, widowed, or estranged spouses [I.R.C. §6015(c)].
3. New authority for IRS to grant equitable relief if relief is not available under the other two provisions [I.R.C. §6015(f)].

The IRS has issued two major pronouncements interpreting the innocent spouse provisions:

1. Revenue Procedure 2000-15, 2000-5 I.R.B. 447, which addresses the equitable relief provisions under I.R.C. §6015(f)
2. Proposed Regulations under I.R.C. §6015, which clarify the provisions of I.R.C. §§6015(b) and (c)

TYPE OF RELIEF DEPENDS ON CHARACTER OF LIABILITY

The type of liability from which relief is being sought affects which provisions are available for relief.

- If the liability is a **deficiency** (tax, penalties, or interest owing from an examination, information return matching adjustment, or math error adjustment), all three provisions may apply.
- If the liability is an **underpayment** (tax, penalties, or interest owing when an original or amended return is filed), relief may be granted only under the equitable relief provisions.

REQUESTING RELIEF

Relief should be requested on Form 8857, Request for Innocent Spouse Relief (and Separation of Liability and Equitable Relief), or by submitting a similar statement, signed under penalties of perjury. If relief is requested on Form 8857, multiple years may be listed on the same form. The type of relief requested should be identified by checking the appropriate box on the form.

The claim should generally be filed with the Cincinnati Service Center, where the majority of innocent spouse claims are considered. However, if the taxpayer has an active examination or collection matter pending, the claim should be filed directly with the IRS employee who is handling the matter. The Form 8857 should not be attached to an income tax return.

The claim form should be accurately completed with a detailed statement attached. The detailed statement should provide complete explanations of the reasons why the taxpayer believes he or she is entitled to innocent spouse relief. Each requirement and/or factor for each relief provision requested should be addressed. Incomplete claims will delay the consideration process.

Example 2. Charlie requests relief from an audit assessment under the relief provisions of I.R.C. §6015(c), election to allocate a deficiency, on Form 8857 for tax year 1999. Charlie attaches a detailed narrative explaining why he meets each of the requirements under I.R.C. §6015(c) (including joint return, marital status, attribution, and knowledge) and includes documentation to support it as follows:

1. I filed a joint return with Charlene for year 1999. A copy is attached.
2. I am currently divorced from Charlene. My divorce was final on June 25, 2000. A copy of my final divorce decree is attached.
3. The additional tax owed is due to Charlene's unreported wage income of $1,000 from a second job she had. A copy of the audit report showing the income was hers is attached.
4. I did not know about this income when I signed the joint return. Charlene and I separated in January 1999, and I never knew she had this second job.
5. I should be granted innocent spouse relief because this additional tax was from her income that I never even knew about and did not spend myself. When we got divorced, Charlene cleaned out our savings account and got the new car. She should have to pay her own taxes.

Practitioner Note. One of the most common errors found on claims is reporting the wrong year on line 1 of Form 8857. The correct year is the tax year for which the IRS is seeking additional taxes, not the year from which a refund was used to pay the taxes.

Example 3. Nancy filed her tax year 2000 using single filing status, showing an overpayment of $1,000. Instead of refunding that overpayment, IRS used it to reduce unpaid taxes from 1997—a year Nancy filed a joint return with Zeke. When Nancy completes Form 8857, she should list 1997 as the tax year for which relief is requested.

Form **8857**
(Rev. October 1999)
Department of the Treasury
Internal Revenue Service

Request for Innocent Spouse Relief
(And Separation of Liability and Equitable Relief)
► **Do not file with your tax return.** ► **See instructions.**

OMB No. 1545-1596

Your name	Your social security number
Nancy (Example 3)	
Your current address	Apt. no.
City, town or post office, state, and ZIP code. If a foreign address, see instructions.	Daytime phone no. (optional) ( )

Do not file this form if all or part of your overpayment was (or is expected to be) applied against your spouse's past-due debt (such as child support). Instead, file **Form 8379,** Injured Spouse Claim and Allocation, to have your share of the overpayment refunded to you.

TIP *The IRS can help you with your request. If you are working with an IRS employee, you can ask that employee, or you can call 1-800-829-1040.*

Part I **1** Enter the year(s) for which you are requesting relief from liability of tax . . . . . ► *1997*

LIMITED TIME TO REQUEST RELIEF

Under each of the relief provisions, the spouse must request relief no later than two years from the first collection activity by IRS, related to that spouse and that liability, after July 22, 1998 [I.R.C. §§6015(b)(1)(E) and 6015(c)(3)(B) and Rev. Proc. 2000-15, 2000-5 I.R.B. 447, §4.01(3)].

Collection activity is defined as an administrative levy or seizure to obtain the property of the requesting spouse, an offset of an overpayment of the requesting spouse, the filing of a suit or claim by the United States against the requesting spouse for the collection of the joint tax liability, or the filing of a suit or claim by the United States that involves property of the requesting spouse. It does not include notices of intent to levy, filing of a lien, or demand for payment of tax [Prop. Treas. Reg. §1.6015-5(2)(i)].

A common example is the offset of a spouse's subsequent year refund.

Example 4. Dale and Elaine Compton filed a joint return for 1995 showing a balance due. They divorced in 1996. The IRS offsets Elaine's refund from her separate 1996, 1997, and 1998 returns, filed timely before the due dates of April 15, 1997, April 15, 1998, and April 15, 1999, respectively. The first collection activity against Elaine after July 22, 1998, was the offset of her 1998 return refund. Elaine must request relief for the 1995 joint return year no later than two years after her 1998 refund was offset. (The date of offset is the date IRS actually processes the transfer to the joint year, not the due date of the return.)

EARLIEST TIME TO REQUEST RELIEF

A request can be made before **collection activity** starts. For example, a request can be made in connection with an examination of the joint return, or in connection with the pre-levy collection due process (CDP) hearing procedures. I.R.C. §§6320 and 6330 and Temp. Reg. §§301.6320-1T(e)(1) and (2) and 301.6330-1T(e)(1) and (2). However, the IRS will not consider a claim filed before a spouse receives notification of an audit or notice that there may be an outstanding liability [Prop. Treas. Reg. §1.6015-5(b)(3), (4), and (5)].

> **Practitioner Note.** This means "protective claims" cannot be filed in anticipation of an examination that does not yet exist.

PRIOR CLOSING AGREEMENT OR OFFER IN COMPROMISE

A requesting spouse is not entitled to relief under I.R.C. §6015 for any tax year for which the requesting spouse entered into a closing agreement or was a party to an accepted offer in compromise [Prop. Treas. Reg. §1.6015-1(c)]. There is an exception for closing agreements entered into pursuant to I.R.C. §6224(c) relating to partnership items.

COURT DECISIONS ARE FINAL EXCEPT . . .

A requesting spouse is not entitled to relief under I.R.C. §6015 for any tax year for which a court of competent jurisdiction rendered a final determination on the requesting spouse's tax liability if the requesting spouse materially participated in a proceeding, unless the final determination was made before July 22, 1998. Any final determinations by a court, regarding issues relevant to I.R.C. §6015, are conclusive and will not be reconsidered [Prop. Treas. Reg. §6015-1(e)].

Example 5. The Tax Court denied innocent spouse relief to Emily under the provisions of I.R.C. §6013(e), the prior innocent spouse provisions, in a decision that became final January 30, 1998. Emily may file a claim for I.R.C. §6015 relief since it was not available until its date of enactment, July 22, 1998. However, Emily would be precluded from raising issues or material facts litigated in the prior proceedings. For example, if the Court previously found it would not be inequitable to hold Emily liable under I.R.C. §6013(e), Emily could not file a claim under I.R.C. §6015(b) since it requires the claimant to show inequity. However, a claim could be filed under I.R.C. §6015(c) since inequity is not a requirement under that provision.

SUSPENSION OF COLLECTION ACTIVITY WHILE CLAIM UNDER CONSIDERATION

The IRS will discontinue collection activity against a requesting spouse from the time an innocent spouse claim is filed until the matter is finally concluded through all administrative and judicial appeals, unless the delay jeopardizes collection. As discussed previously, collection activity includes actual levies and seizures, but does not include mailing of notices or the filing of tax liens. This suspension is required by I.R.C. §6015(e)(1)(B)(i) for innocent spouse and election to allocate liability claims. The suspension is IRS policy for equitable relief cases.

Practitioner Note. IRS is not prohibited from offsetting refunds while an innocent spouse claim is pending. However, as a matter of policy IRS will not apply refunds from a different tax year to taxes due for a year in which a claim is pending. Taxpayers should **not** be advised to delay filing current income tax returns for fear their refunds will be offset. (Note, however, that if there is a balance owed on a year not under consideration for an innocent spouse claim, an offset will be made.)

SUSPENSION OF COLLECTION STATUTE OF LIMITATIONS

Filing an innocent spouse claim or an election to allocate a deficiency claim suspends the collection statute for the requesting spouse [I.R.C. §6015(e)(2)]. The statute is suspended during the time the IRS is prohibited from taking collection action plus an additional 60 days.

Example 6. Mike and Ellen Feldman filed a joint tax return for 1997. IRS audited the return, and as a result assessed additional taxes of $2,000 on February 15, 2000. Under I.R.C. §6502, the IRS has 10 years to collect the additional tax–until February 15, 2010. Mike filed a claim requesting relief under I.R.C. §6015(c) on April 24, 2000. IRS issued a final determination letter denying relief on March 2, 2001, giving Mike the opportunity to petition the Tax Court within 90 days after its mailing. Mike did not petition the Tax Court. IRS was prohibited from taking collection action while Mike's claim was pending, from claim filing, on April 24, 2000, until his 90 days to petition the Tax Court expired, on May 31, 2001. The collection statute of limitation is suspended from April 24, 2000, until 60 days after May 31, 2001, which is July 30, 2001. Therefore, the collection statute of limitations is suspended for 462 days. That means the deadline for the IRS to collect the tax from Mike is extended from February 15, 2010 to May 23, 2011.

Equitable relief claims do not suspend the statute.

Practitioner Note. If the collection statute is about to expire, it may be in the taxpayer's best interest to simply allow it to expire rather than filing a claim that will extend the time the IRS can collect the taxes.

PARTICIPATION BY THE NONREQUESTING SPOUSE

Congress wanted to ensure that relief was granted only where warranted and to protect the rights of the nonrequesting spouse. Therefore, the IRS is required to notify the spouse not requesting relief (the nonrequesting spouse) that a claim for relief has been filed and to offer that spouse an opportunity to participate in the proceedings.

At the administrative level, the nonrequesting spouse is notified that the claim has been filed, is asked to complete a questionnaire, and is asked to provide any information he or she thinks may be relevant to the determination. The nonrequesting spouse is not required to respond. The nonrequesting spouse is notified of IRS's final determination but currently has no appeal rights regarding IRS's decision. The nonrequesting spouse does have the right to file his or her own claim for relief.

If a claim is partially or fully disallowed and the requesting spouse petitions the Tax Court, the nonrequesting spouse will be notified of the proceedings and has the right to "intervene" (Interim Tax Court Rules, Title XXXI, Rule 325).

DOMESTIC ABUSE CONCERNS

IRS is required by law, without exception, to notify the nonrequesting spouse that a claim has been filed. However, domestic abuse and a fear of retaliation from the other spouse are sometimes a concern for spouses filing a claim. IRS Notice 1263 directs spouses to write "Potential Domestic Abuse Case" on the top of their claim form, if they fear reprisal from the other spouse. IRS will take special precautions to protect the privacy of the requesting spouse in these situations.

EXPANDED INNOCENT SPOUSE PROVISION, I.R.C. §6015(b)

In addition to the requirement to file a joint return and the time requirements for filing a claim, a spouse requesting relief under this provision must meet each of these additional requirements:

- There was an understatement attributable to erroneous items of the other spouse on the return
- In signing the return, the requesting spouse had no knowledge or reason to know of the understatement of tax, and
- Taking into consideration all the facts and circumstances, it is inequitable to hold the requesting spouse liable

These requirements are very similar to the prior innocent spouse provisions under I.R.C. §6013(e). The requesting spouse has the requisite knowledge under this provision if he or she actually knew of the erroneous item giving rise to the understatement, or a reasonable person under similar circumstances would have known of the item. A requesting spouse may be relieved of liability attributable to a portion of an item if he or she only knew of a portion. The proposed regulations cross-reference the guidance contained in Rev. Proc. 2000-15, as to whether it is inequitable to hold the requesting spouse liable [Prop. Treas. Reg. §1.6015-2(d)]. Prior law, from court cases involving I.R.C. §6013(e), is relevant under this expanded innocent spouse provision.

The **burden is on the taxpayer** to prove that he or she did not have actual or constructive knowledge under this provision. All of the facts and circumstances are considered in determining whether the requesting spouse had reason to know (constructive knowledge) of an understatement. These might include, but are not limited to, the following:

- The nature of the erroneous item and the amount of the erroneous item relative to other items
- The couple's financial situation
- The requesting spouse's educational background and business experience
- The extent of the requesting spouse's participation in the activity that resulted in the erroneous item
- Whether the requesting spouse failed to inquire, at or before the time the return was signed, about items on the return or omitted from the return that a reasonable person would question
- Whether the erroneous item represented a departure from a recurring pattern reflected in prior year returns

Example 7. Chad and Morgan Popp are married and file their 2004 joint income tax return in March 2005. In April 2006, Chad is convicted of embezzling $2 million from his employer during 2004. Chad kept all of his embezzlement income in an individual bank account, and he used most of the funds to support his gambling habit. Chad and Morgan had a joint bank account into which Chad and Morgan deposited all of their reported income. Each month during 2004, Chad transferred an additional $10,000 from his individual account to the couple's joint account. Morgan paid the household expenses using this joint account, and regularly received the bank statements relating to the account.

Morgan had no knowledge or reason to know of Chad's embezzling activities. However, Morgan did have knowledge and reason to know of $120,000 of the $2 million of Chad's embezzlement income at the time she signed the return because that amount passed through the couple's joint bank account. Therefore, Morgan may not be relieved of the liability related to the $120,000 of unreported embezzlement income of which she knew and had reason to know. However, she may be relieved of the liability for $1,880,000 of unreported embezzlement income of which she had no knowledge.

ELECTION TO ALLOCATE A DEFICIENCY, I.R.C. §6015(c)

A spouse who filed a joint return and meets the time requirements for filing a claim, may file an election to allocate a deficiency if all three of the following conditions are met:

- At the time of the election, the spouse is divorced, widowed, legally separated, or has not been a member of the same household as the other spouse at any time during the 12-month period preceding the claim. [See additional guidance on this marital status requirement in Prop. Treas. Reg. §1.6015-3(b).]
- The deficiency is attributable to the nonrequesting spouse.
- The spouse had no actual knowledge, at the time the return was signed, of the item giving rise to the deficiency.

Relief will be reduced by the value of any **disqualified assets** transferred to the requesting spouse by the nonrequesting spouse [I.R.C. §6015(c)(4)(A)]. Disqualified assets are assets transferred if the principal purpose was the avoidance of tax or payment of tax. There is a rebuttable presumption that assets transferred during the 12-month period before the mailing of the 30-day letter proposing a deficiency are disqualified assets. But this presumption does not apply if the asset was transferred pursuant to a divorce decree or decree of separate maintenance. Additionally, the election is invalid if IRS establishes that assets were transferred between the spouses as part of a **fraudulent scheme** [I.R.C. §6015(c)(4)(B)].

Example 8. Donald and Judy Boyce are divorced. In May 1999, Judy transfers $10,000 to Donald, and in April 2000, Donald and Judy receive a 30-day letter proposing a $40,000 deficiency on their 1998 joint income tax return. The liability remains unpaid, and in October 2000, Donald elects to allocate the deficiency under this section. Donald proposes that the entire deficiency of $40,000 would be allocated to Judy, to which IRS agrees. Donald submits a signed statement providing that the principal purpose of the transfer of $10,000 was not the avoidance of tax or payment of tax, but does not submit any documentation indicating the reason for the transfer. Donald has not overcome the presumption that the $10,000 was a disqualified asset. Therefore, Donald will be granted relief for $30,000, the possible relief available of $40,000 reduced by $10,000 in disqualified assets. Donald will remain liable for $10,000.

The knowledge standard under the election to allocate a deficiency differs from the knowledge standard under the innocent spouse provision, where the taxpayer bears the burden of proving no actual or constructive knowledge. Under the election to allocate a deficiency, the **IRS has the burden of proving actual knowledge,** which is a much higher standard. However, a requesting spouse's actual knowledge of the tax consequences of an item is not relevant. The IRS only has to show actual knowledge of the item giving rise to the deficiency. Since enactment of I.R.C. §6015(c), the knowledge standard has received and continues to receive quite a bit of attention from the courts.

Practitioner Note. The knowledge standard under I.R.C. §6015(c) has been considered in several recent court cases, one of which is under appeal to the Fifth Circuit. See *Cheshire v. Commissioner*, 115 T.C. No. 15 (August 30, 2000).

Note that it is **not** a requirement to show it is inequitable to hold the taxpayer liable under the election to allocate a deficiency, unlike the requirement under the innocent spouse provisions under I.R.C. §6015(b).

If a spouse makes this election, erroneous items are generally allocated between the spouses as if they had filed separate returns. It is not a complete recomputation of the entire tax return, but an **allocation of the deficiency** based on the proportion of erroneous items allocable to each spouse. It is the taxpayer's burden to establish the proper allocation.

Erroneous income items are generally allocated to the spouse who earned the income or owned the investment or business producing the income. Erroneous business or investment deductions are likewise allocated. Personal deductions are generally allocated equally to both spouses, unless evidence shows a different allocation is appropriate. There are exceptions to the general allocation of an item to the nonrequesting spouse if the requesting spouse received a tax benefit from it on the joint return or if there is fraud involved. Also, any portion of the deficiency that is attributable to an item allocable solely to one spouse that results from the disallowance of a credit, or to an increase in tax or addition to tax, is allocated separately to that spouse. (It is called a "separate treatment item.")

Example 9. David and Patty Wiley filed a joint return that was examined by IRS, resulting in a $54,000 tax deficiency that was not paid. David and Patty divorce and Patty elects to allocate the liability. Five erroneous items gave rise to the deficiency:

- $40,000 charitable deduction attributable to Patty
- $40,000 interest deduction attributable to Patty
- $15,000 business deduction attributable to David
- $20,000 unreported income attributable to David
- $5,000 deduction for education expenses attributable to David

In total, there are $120,000 in erroneous items, of which $80,000 are attributable to Patty and $40,000 are attributable to David. In other words, 67% ($80,000/$120,000) of the items are attributable to Patty, and 33% ($40,000/$120,000) of the items are attributable to David.

Patty may be relieved of the deficiency solely attributable to David of $18,000 (33% × $54,000). However, Patty remains jointly and severally liable for $36,000 (67% of $54,000).

The IRS may collect up to $36,000 from Patty and up to $54,000 from David. The total amount collected, however, will not exceed $54,000.

If David also made an election, $36,000 would be allocated to Patty and $18,000 to David.

EQUITABLE RELIEF PROVISION, I.R.C. §6015(f)

This new provision authorizes IRS to grant equitable relief to requesting spouses who do not qualify for relief under the other two provisions. It is the **only provision that allows relief for underpayments,** i.e., balances owing from original or amended returns. Refunds under this section are provided in very limited circumstances. IRS provided detailed guidance on the administration of this provision in Revenue Procedure 2000-15, 2000-5 I.R.B. 447.

A spouse must meet **seven** basic **threshold requirements** that include

1. Liability is unpaid (except for very limited exceptions)
2. Filing a joint return
3. Meeting the time limitations for filing a claim
4. Not qualifying for relief under the other two provisions
5. Not transferring assets as part of a fraudulent scheme
6. Not transferring disqualified assets
7. Not filing the joint return with fraudulent intent

Once these tests are met, IRS will **generally grant relief** for unpaid amounts if each of the following conditions is met:

- Seeking relief for an **underpayment** (an amount owed on an original or amended return, not a deficiency from an audit)
- Liability is attributable to the nonrequesting spouse
- Requesting spouse is no longer married to, is legally separated from, or has not been a member of the same household as the nonrequesting spouse during the 12-month period before relief was requested

- At the time the return was signed, the requesting spouse had no knowledge or reason to know that the tax would not be paid
- Requesting spouse will suffer economic hardship if relief is not granted

If a taxpayer passes the seven threshold requirements but cannot meet each of the tests just mentioned, relief **may still be granted if, based on all the facts and circumstances,** it is inequitable to hold him or her liable. This part of the equitable relief provision applies to liabilities from both deficiencies and underpayments. A non-inclusive list of positive and negative factors is given in the Revenue Procedure.

Factors weighing in **favor** of relief include

- Amounts due are attributable to the nonrequesting spouse
- Requesting spouse had no knowledge or reason to know in an understatement case and had a reasonable belief the tax would be paid in an underpayment case
- Marital status (divorced, separated, or not a member of same household for 12 months)
- Economic hardship
- Marital abuse
- Nonrequesting spouse's legal obligation to pay as reflected in written instruments incident to divorce or separate maintenance decrees

Factors weighing **against** relief include

- Amounts due are attributable to the requesting spouse
- Requesting spouse had knowledge or reason to know of the understatement
- Lack of economic hardship
- Requesting spouse's legal obligation to pay as reflected in written instruments incident to divorce or separate maintenance decrees
- Significant benefit (beyond normal support) from the unpaid liability or items giving rise to the liability
- Noncompliance with federal income tax laws

The decision to grant or deny relief is based on all of the facts and circumstances as a whole, with no one factor controlling.

Example 10. Julie filed a claim for equitable relief for unpaid taxes (underpayment) from the joint 2000 return she filed with Dean. She met the seven threshold requirements for equitable relief, however, she could not be granted relief under the provision where relief is "generally granted" for underpayments because she had just left Dean, and was not legally divorced or separated, nor had she lived apart from Dean for 12 months. However, Julie may still be granted equitable relief if, based on all the facts and circumstances including the factors weighing in favor of and against relief, it is inequitable to hold her liable.

APPEAL OF DENIED CLAIMS

The requesting spouse may protest IRS's full or partial denial of a claim and request an informal hearing in the Appeals Division of IRS. If Appeals denies the claim or if a hearing is not requested and a final determination letter is issued, the requesting spouse may petition the tax court within 90 days of the mailing of the determination letter denying relief. Additionally, the requesting spouse may petition the tax court if IRS does not make a determination within six months of the filing of a claim.

REFUNDS

All three provisions provide relief for unpaid taxes. However, only the innocent spouse provision and the equitable relief provision (the latter in very limited circumstances) allow refunds of amounts previously paid. Refunds are not allowable under the election to allocate a deficiency [I.R.C. §6015(g)(3)]. Also, remember that the allowance of refunds is limited by the normal refund statute of limitations, which is three years from the due date of the return or two years from the date of payment, whichever is later.

> **Practitioner Note.** Many taxpayers who file a claim are seeking a refund, not just relief from unpaid amounts. Taxpayers should be advised that although they may be granted relief under one of the innocent spouse provisions, they may not get a refund. Their relief may be limited to unpaid liabilities.

Example 11. On June 15, 2001, Kathy filed a claim for relief from a $15,000 audit assessment on a 1995 joint liability that still had a balance due of $10,000 plus accrued interest. She had made prior payments on the assessment as follows:

5/20/98	$2,000	Payment by check
7/20/00	$ 500	Payment from IRS levying W's bank account
9/12/00	$1,500	Payment by check
5/10/01	$1,000	IRS took W's tax year 2000 refund to pay the 1995 liability
	$5,000	Total payments by W

If Kathy is granted relief under the innocent spouse provisions of I.R.C. §6015(b), she would be entitled to a refund of amounts paid in the two years preceding her claim filed on June 15, 2001. This would include the $500 payment on July 20, 2000, the $1,500 paid on September 12, 2000 and the $1,000 refund from 2000 applied on May 10, 2001—a total of $3,000. Kathy would also receive relief for the unpaid balance of $10,000. She would not receive relief for the $2,000 paid on May 20, 1998 since it was paid more than two years before she filed her claim for relief.

If Kathy were granted relief under the allocation of deficiency provisions of I.R.C. §6015(c) or under the equitable relief provisions of I.R.C. §6015(f), she would be relieved of the unpaid liability of $10,000, but would not receive a refund.

RELIEF FROM JOINT AND SEVERAL LIABILITY AT A GLANCE

Factors	Innocent Spouse Relief §6015(b)	Allocation of Liability §6015(c)	Equitable Relief §6015(f)	Equitable Relief Community Property States §66(c)
Type of Return	Joint	Joint	Joint	Married filing separate
Type of Liability	Deficiency	Deficiency	Deficiency or underpayment	Deficiency or underpayment
Special Requirements			Relief under § 6015(b) and § 6015(c) not available Liability remains unpaid except for amounts meeting requirements for refunds listed here	Liability remains unpaid except for amounts meeting requirements for refunds listed here
Refunds (Normal Refund Statute (RSED) Controls)	Refunds available	No refunds	Refunds available for amounts paid between 7/22/98 and 4/15/99, and for amounts paid under an installment agreement (if not defaulted) after the later of 7/22/98 or date Form 8857 filed	
Marital Status	Marital status considered as an equitable factor	**Must** be divorced; widowed; legally separated; or not living together for at least 12 months prior to the election	Marital status considered as an equitable factor	
Knowledge	**Taxpayer must establish** had **no knowledge OR reason to know**	**IRS must establish** Taxpayer had **actual** knowledge of **deficiency items**	Knowledge considered as an equitable factor	
Equity	Inequitable to hold Taxpayer liable: consider all facts and circumstances		Inequitable to hold Taxpayer liable: consider all facts and circumstances	
Required Factors Tier I			Tier **I** Cases (Relief ordinarily granted if all 4 factors met) 1. Underpayment 2. No longer married, legally separated, OR not living together for 12 months prior to request 3. No knowledge or reason to know when return signed 4. Taxpayer will suffer economic hardship if relief not granted	
List of Partial Factors Tier II			Tier **II** Cases—**Underpayment and Deficiency** Factors Weighing in Favor of Relief 1. Marital status (same as §6015(c)) 2. Economic hardship (defined in Regs. §301.6343-1(b)(4)) 3. Abuse (but not duress) 4. No knowledge or reason to know (that liability would not be paid (for underpayment) or of item (for deficiency)) 5. Nonrequesting spouse's legal obligation (not positive factor if knowledge NRS would not pay at time decree/ agreement signed) 6. Liability solely attributable to nonrequesting spouse	

			Factors Weighing Against Relief 1. Attributable to requesting spouse 2. Knowledge or reason to know (extremely strong factor) 3. Significant benefit 4. Lack of economic hardship 5. Noncompliance with federal income tax laws 6. Requesting spouse's legal obligation	
Fraud	Fraud is a consideration in equity determination	Election invalid if IRS shows Taxpayer transferred assets as part of a fraudulent scheme	Relief not available if 1. Fraudulent return or 2. Assets transferred as part of fraudulent scheme	
Disqualified Assets Transferred for Avoidance of Tax or Payment of Tax	Transfer of disqualified assets is a consideration in equity determination	Amount of allocation is increased by value of disqualified assets	Relief not available to extent of value of any disqualified assets	
Time for Filing	2 years from first collection activity after 7/22/98	2 years from first collection activity after 7/22/98	2 years from first collection activity after 7/22/98	
Consideration in Courts	Tax Court; if full-paid, District Court or Court of Federal Claims	Tax Court	Tax Court review of IRS's possible abuse of discretion	Tax Court review if part of deficiency proceeding or under Collection Due Process proceedings

ABUSIVE TRUST SCHEMES

INTRODUCTION

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 typically 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 sub-promoters, who may charge anywhere from $5,000 to $70,000 for a package, often sponsor such schemes. The promoters provide trust documents that use foreign and domestic trustees, and foreign bank accounts and corporations. In some instances, tax return preparer services are also made available.

Investors of abusive trust schemes that improperly 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 prosecution. Civil fraud can include a penalty of up to 75% of the underpayment of tax attributable to the fraud, in addition to the taxes owed. Criminal convictions may result in fines and/or prison sentences.

BASIC TRUST TAXATION

A trust is a form of ownership that is controlled and managed by a designated independent trustee. The trust separates responsibility and control of the assets from the benefits of ownership. The IRS recognizes numerous types of legal trust arrangements, which are commonly used for estate planning, charitable 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 taxpayer who put assets into the trust unless specifically exempted by the Internal Revenue Code (I.R.C.).

Distributions. A legitimate trust is allowed to deduct distributions to beneficiaries from its taxable income, with a few modifications. Therefore, trusts can eliminate taxable 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. Generally, a domestic trust must file Form 1041, U.S. Income Tax Return for Estates and Trusts, for each taxable year. However, if the trust is classified as a Domestic Grantor Trust, it is not generally required to file a Form 1041, provided the individual taxpayer who created the trust 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.

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 with 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 trusts, 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 and reported on Form 1040.

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 Reports 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

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:

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.

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 a sole proprietorship, partnership, limited liability company, or corporation to a trust. The AMC is the trustee of the business trust. 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. In addition, the taxpayer may claim false administrative expenses on the trust's tax return as a means of fraudulently reducing taxable income.

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 fraudulently reduces its income by claiming deductions for payments to the equipment trust.

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 expenses of maintaining and operating the residence such as gardening, pool service, and utilities.

Charitable Trust. In many promotions, the last layer in the scheme 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 non-allowable expenses are deducted from the charitable trusts 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 distribution of 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.

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

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

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.

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. There are several methods these promoters then use to repatriate the taxpayer's funds to the U.S. The two most common include

1. Opening a foreign bank account in a tax haven country with either a credit or debit card associated with the account. The card is then used by the taxpayer for everyday purchases (i.e., food, gas, etc. . . .) and is difficult to trace to the taxpayer because the account is located in a tax haven country.
2. Fraudulent loans are set up through foreign accounts with the money being wired from a foreign entity to the taxpayer, who claims the purported loans to be nontaxable.

Promoters will claim 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 trusts. 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. 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.

Voluntary Disclosure. It is the practice of the IRS that a voluntary disclosure will be considered along with all other factors in the case in determining whether criminal prosecution will be recommended.

A voluntary disclosure will not of itself guarantee immunity from prosecution, yet a voluntary disclosure may result in no prosecution recommendation. However, since the IRS's application of the voluntary disclosure practice does not automatically result in immunity from criminal prosecution, **taxpayers should be advised that they cannot rely on the fact that others may not have been prosecuted.**

Voluntary disclosure occurs when the communication is truthful, **timely,** complete, and when the TP shows a willingness to cooperate (and in fact does) with the IRS in determining his or her correct tax liability.

A disclosure is timely if it is received before,

1. The IRS has initiated an inquiry that is likely to lead to the taxpayer and the taxpayer is reasonably thought to be aware of that investigative activity, or
2. An event (known by the taxpayer) that is likely to cause an audit into the taxpayer's liabilities.

Practitioners should contact the Special Agent in Charge of their local Criminal Investigation Division Field Office to discuss any voluntary disclosure situations.

FALSE CLAIMS USED BY PROMOTERS

Promoters falsely claim that establishing a trust will reduce or eliminate income taxes or self-employment taxes. In truth, taxes must be paid on the income or assets held in trusts including the income generated by property held in trust. The responsibility to pay taxes may fall to the trust, the beneficiary, or the transferor.

Promoters further claim that individuals will retain complete control over income and assets with the establishment of a trust. However, to be recognized for federal income tax purposes, 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.

Another false claim is that taxpayers may deduct personal expenses paid by the trust on their tax return, but, nondeductible personal living expenses cannot be transformed into deductible expenses by virtue of assigning assets and income to a trust.

A final false claim is that taxpayers can depreciate their personal residence and furnishings and take them as deductions on their tax return. 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.

CIVIL AND CRIMINAL PENALTIES

Investors of abusive trust schemes that improperly 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 prosecution. 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.

In addition, the law allows the courts to impose a penalty of up to $25,000 when they come to any of three conclusions:

- A taxpayer instituted a proceeding primarily for delay
- A position is frivolous or groundless
- A taxpayer unreasonably failed to pursue administrative remedies

RECENT CRIMINAL CONVICTIONS

HENDERSON CASE—PROMOTERS

On February 22, 2001, Dorothy and George Henderson were sentenced to lengthy prison terms in connection with a massive conspiracy to defraud the IRS.

The Hendersons, operating through an entity called "G&D Associates," sold packages of bogus trusts to their clients and advised the clients about generating false tax deductions. As part of the scheme, clients transferred their businesses, homes, and other assets into trusts, but did not relinquish control of the assets after the transfer. On federal income tax returns, clients claimed various personal expenses, such as home repairs, pool maintenance, lawn care, and house cleaning, as deductible expenses of the trusts. Clients also deducted mortgage payments, including principal, and depreciated the value of their residences and distributed these payments to their personal tax returns, often resulting in negative taxable income. In accordance with the scheme, some clients who made in excess of $150,000 per year claimed Earned Income Credit on their personal returns.

For higher income clients, the Hendersons operated another scheme to conceal additional income from the IRS by passing client income through a series of bank accounts in the U.S. and various tax haven countries in the Caribbean. The funds that flowed through these accounts were ultimately transferred back to clients less a 5% fee. On their tax returns, clients took deductions for the distribution to the offshore accounts, but did not report the return of the funds. The Hendersons earned over $1 million in fees from their clients during the course of marketing the scheme from 1994 through early 1998. The Hendersons filed no tax returns and paid no taxes during that period.

MODENA CASE—PROMOTER AND TAXPAYERS

John Modena was sentenced to 60 months imprisonment for conspiracy to commit income tax evasion for creating and promoting “sham” trusts in an attempt to insulate income and assets from the federal government.

During the course of the conspiracy, Modena assisted brothers Denver, Daniel, Jack, Orval, and Timothy Russell in evading income taxes in excess of $3 million over a four-year period. As part of the scheme, the Russells, who were involved in the metal die cast business, did not use personal bank accounts, relied on cash, rescinded social security numbers and birth certificates, and used business trusts to conduct personal business and make personal purchases. The Russells received sentences ranging from 33 months to 54 months imprisonment for their role in the scheme.

SATHER CASE—TAXPAYER

Ronald Sather was sentenced to 35 months imprisonment for corruptly interfering with the IRS, failing to file federal income tax returns, evading bank reporting requirements, bankruptcy fraud, and fraudulently using a social security number. Sather was convicted by a jury of these violations in connection to his “get out of the tax system” scheme. According to the indictment, Sather was a member of the Pilot Connection, an organization involved in promoting “untaxing packages.”

Sather formed several trusts including business and equipment trusts for his chiropractic practice. Sather established several bank accounts for his business in trust names and removed his name from several properties he owned, including his chiropractic practice, in a further attempt to conceal his activities from the IRS. Sather also instructed his office staff to destroy his business computer system with a “ZAP” program if the IRS attempted to look at his records.

During 1992–1994, Sather failed to file federal income tax returns that should have shown income in excess of $600,000. In addition to his imprisonment, Sather was ordered to pay restitution to the IRS in excess of $133,000.

ROIS AND REINKE CASE—PROMOTERS

Glenn L. Rois and Faye S. Reinke were sentenced to 46 months imprisonment and six months in a halfway house, respectively, for their involvement in marketing illegal trusts. A jury convicted them of conspiracy to defraud the IRS, and Rois was convicted of submitting false returns to the IRS.

Rois and Reinke marketed trusts to taxpayers by asserting that trusts were separate entities and therefore allowed taxpayers to claim that the trusts earned income, rather than the individuals or businesses. In addition, they claimed that taxpayers could deduct all their personal living expenses, including food, clothing, lodging, and vacations, because they were managing the trusts. Rois and Reinke typically charged over $1,500 for creating trust documents. Rois received in excess of $200,000 from trusts marketed with Reinke, and Rois failed to report this income on his federal income tax returns.

Witnesses testified that Rois and Reinke instructed them to lie to the IRS about who created the trusts, backdated certain trust documents, and switched other trust documents when they learned of impending audits. Rois denied that he sold trusts or prepared trust documents and in fact claimed that he was a consultant to farmers on the best crops to grow. Reinke also denied selling trusts and claimed that she accompanied Rois on his consulting work with farmers and advised people on health issues.

HOTCHKISS CASE—TAXPAYER

Lyle Hotchkiss was sentenced to 27 months of imprisonment for failing to file federal income tax returns and for tax evasion. Hotchkiss failed to report to the Internal Revenue Service over $1.5 million in taxable income.

Hotchkiss deposited receipts from his dental practice into fraudulent trusts. The judge in the case found that the trusts used by Hotchkiss were shams that were used for tax evasion and to funnel money out of the country. The judge found that Hotchkiss “parked” over $100,000 in a Bahamas bank account as part of his scheme to conceal the funds.

In addition to imprisonment, the judge fined Hotchkiss $10,000 and sentenced him to place a full one-page advertisement, at his own expense, in the *Grand Rapids Press.* The judge required Hotchkiss to explain that he had been sentenced to 27 months imprisonment for not paying his taxes, that other people should pay their taxes, and that previous statements he made in the paper supporting his scheme were wrong.

SANCTIONS IMPOSED BY COURTS

The courts' determination to use their sanctions authority to discourage the filing of frivolous tax suits is evident in several recent cases.

SIGERSETH CASE—TAXPAYERS

On June 21, 2001, the Tax Court penalized Charles and Francesca Sigerseth of El Macero, California, for trying to avoid taxes through the use of trusts. The Court said the couple met all three of the above criteria and fined them $15,000. The Court pointed out that the case was "a waste of limited judicial and administrative resources that could have been devoted to resolving bona fide claims of other taxpayers."

MATRIXINFOSYS TRUST CASE—TAXPAYER

On June 7, 2001, the Court found that Andy Hromiko of Roseville, California, not his trust, was the true earner of income. It noted that he had made "shopworn arguments characteristic of the tax-protester rhetoric that has been universally rejected by this and other courts," and fined him $12,500.

MADGE CASE—TAXPAYER

While at the Federal Prison Camp in Duluth, Minnesota, for tax evasion, Darlow Madge contended that he wasn't a taxpayer, that his income from selling hospital supplies wasn't taxable, and that only foreign income is taxable. The Tax Court on December 7, 2000, in response to his contentions, imposed the maximum $25,000 fine after having warned Madge that continuing with his frivolous arguments would likely result in a penalty.

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. Also, 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**—There is doubt that the assessed tax is correct.
- **Doubt as to collectibility**—There is doubt 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 any one of the following conditions is met:

1. In the taxpayer's judgment he or she does not owe the tax liability (**doubt as to liability**). There must be a bona fide dispute as to a question of fact or law with respect to the merits of the 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. RRA '98 created new innocent spouse provisions. A taxpayer may claim innocent spouse relief as part of the offer procedure. At that point the offer will be considered an offer with doubt as to liability, and the innocent spouse claim and the offer will be sent to the area examination function for investigation and processing.
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. Policy Statement P-5-100 states that the IRS will accept an offer in compromise if the amount offered reasonably reflects collection potential. An offer in compromise is recognized as a viable alternative to declaring a case currently not collectible or to a protracted installment agreement. This represents a significant change in the IRS's policy. Taxpayers are encouraged to submit an offer. IRS District Counsel will assist in the implementation of this program.

   Collectibility determinations by the area Collection function are based on the potential collection from a taxpayer's assets, including present as well as future income. Consideration is to be given to all the priorities granted to the Government by statutes. The offer should reflect the taxpayer's maximum capacity to pay based upon his or her equity in assets and future income potential. If an offer is based in whole or in part on doubt as to collectibility, then a complete financial statement must accompany the offer (Form 433A for individuals and Form 433B for business entities).

   Doubt as to collectibility is not a factor in the determination of a deficiency in a tax court case. However, once the liability is agreed upon in a tax court case, an offer in compromise may be proposed based upon collectibility. The amount of the liability should be stipulated and the decision document filed or held in escrow by IRS Area Counsel pending approval of the offer.

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 financial statement and 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. A 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.
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

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. 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. The Web site has an interactive Installment Agreement calculator as well as information on Offer In Compromise.

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:

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

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.**

NO INTEREST CHARGED

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.

If the taxpayer defaults on the Offer in Compromise agreement, the entire tax liability will be reinstated, along with interest and penalties, since the statutory requirement for interest accrual will remain in place. 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, or
- 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.

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. The offer process could take six months or longer.

Suspension of the Statute of Limitations. The collection statute of limitations is suspended for all tax periods included in 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, or
- 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 taxpayer agreed to pay under an accepted agreement remains unpaid, or
- 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)

IRS has centralized initial processing of Form 656 at two centers–Memphis and Brookhaven (Holtsville).

Where to File

IF YOU RESIDE IN

the states of Alaska, Alabama, Arizona, California, Colorado, Hawaii, Idaho, Kentucky, Louisiana, Mississippi, Montana, Nevada, New Mexico, Oregon, Tennessee, Texas, Utah, Washington, Wisconsin, or Wyoming,

AND	AND
You are a wage earner or a self-employed individual without employees,	You are **OTHER** than a wage earner or a self-employed individual without employees,
THEN MAIL	THEN MAIL
Form 656 and attachments to:	Form 656 and attachments to:
Memphis Internal Revenue Service Center COIC Unit **PO Box 30803, AMC** Memphis, TN 38130-0803	Memphis Internal Revenue Service Center COIC Unit **PO Box 30804, AMC** Memphis, TN 38130-0804

IF YOU RESIDE IN

Arkansas, Connecticut, Delaware, District of Columbia, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Vermont, Virginia, West Virginia, or have a foreign address,

AND	AND
You are a wage earner or a self-employed individual without employees,	You are **OTHER** than a wage earner or a self-employed individual without employees,
THEN MAIL	THEN MAIL
Form 656 and attachments to:	Form 656 and attachments to:
Brookhaven Internal Revenue Service Center COIC Unit **PO Box 9007** Holtsville, NY 11742-9007	Brookhaven Internal Revenue Service Center COIC Unit **PO Box 9008** Holtsville, NY 11742-9008

Form 656 Filing Centers

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.

Offers in Compromise may be rejected if the taxpayer is not current with all required tax filings or if the taxpayer is in bankruptcy. If the offer is rejected, an independent reviewer, located in the Special Procedures function, 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. RRA '98 amended I.R.C. §7222 to provide that the IRS shall not reject an offer from a low-income taxpayer "solely on the basis of the amount of the offer."

Once an Offer in Compromise is made, it is not accepted until the Commissioner or his delegate executes the appropriate acceptance form, i.e., Form 7249, Offer Acceptance Report, and acceptance letter and the proponent is notified in writing of the acceptance of the offer. An accepted offer constitutes a contract between the government and the proponent and is legally enforceable provided the consideration is deemed adequate, there is mutual assent, and other provisions of contract law are met.

Fraud will invalidate a compromise if all of the following conditions are met:

1. The representations were false as to a material fact, e.g., concealment of assets.
2. The proponent knew them to be false.
3. They were made to, and did, induce the other party to make the contract.
4. The other party relied on them to his injury.

Once the offer is accepted, the compromise is effective for the entire liability for taxes, including penalties and interest for the periods for which the offer was submitted. All questions of tax liability for those periods are finally settled and that tax year is closed. No refund or addition to tax for that period may thereafter arise.

COLLECTION DUE PROCESS HEARING

To qualify for a Collection Due Process (CDP) hearing, the taxpayer must receive either a Notice of Federal Tax Lien Filing and Your Right to a Hearing under I.R.C. §6320 or Notice of Intent to Levy and Your Right to a Hearing under I.R.C. §6330.

The issuance of a notice under I.R.C. §6320 or §6330 entitles the taxpayer to an opportunity for an independent review conducted by the Office of Appeals. Lien and levy actions for CDP cases are required by statute to be suspended. However, if the taxpayer's appeal involves a levy issue only, a notice of lien may still be filed. The taxpayer would then be issued a Notice of Federal Tax Lien and afforded an opportunity to file a CDP appeal based on I.R.C. §6320.

There are two exceptions to the pre-levy notice requirements of I.R.C. §6330.

1. When the collection of tax is in jeopardy under I.R.C. §6331(a)
2. When a levy is served on a state to collect a Federal tax liability from a state tax refund

In both of these situations, the taxpayer will be given the opportunity for a Collection Due Process hearing within a reasonable period of time after the levy.

HOW TO REQUEST A HEARING

Taxpayers are requested to use Form 12153, Request for Collection Due Process (CDP) Hearing, to request the appeal.

The taxpayer should include a copy of the CDP notice with the CDP hearing request and should file the request for the hearing with the employee or function initiating the action. CDP notices issued by the field revenue officer will have the assigned revenue officer's name and address listed on the CDP hearing notice.

A written request for a CDP hearing signed by the taxpayer or authorized representative may be submitted if Form 12153 is not used. The request must be in writing. If a Notice of Federal Tax Lien was issued, the taxpayer's request must be made within the 30 days beginning with the day after the five business day period of the lien filing. If a Notice of Intent to Levy was issued, the taxpayer's request must be made within 30 days of the date of the notice. The taxpayer(s) or the taxpayer(s) authorized representative must sign the request. In the event the taxpayer's Form 12153 is received **after** the requisite 30-day period, the postmark date will be used to show that it was a timely filed CDP hearing request. The use of the postmark date for cases received after the "30-day" date should ensure that taxpayers are not unfairly deprived of a CDP hearing.

STATUTE OF LIMITATIONS

A timely filed request suspends the collection statute of limitations. A timely filed request for a hearing suspends the statutory period of limitations on collection, criminal prosecutions, and other suits for the tax period that is being appealed. If the taxpayer commences the appeal process to the Tax Court or to a federal district court, the statute of limitations is suspended and the determination is not final until the taxpayer withdraws the CDP request or the determination becomes final, including any court appeals. If 90 days is not remaining on the statute of limitations when the determination becomes final, the statute of limitations is recomputed to allow for this 90-day period.

If the request for the hearing is received after the I.R.C. §6320 or §6330 notice period, the taxpayer is entitled to receive an equivalent hearing. The taxpayer is still afforded the opportunity for an independent review conducted by the Office of Appeals. Lien and levy actions are not required by statute to be suspended on equivalent hearings. However, as a general rule, even when not required by statute, levy action is suspended. In an equivalent hearing, the decision by Appeals is final. The taxpayer cannot appeal the decision to Tax Court or federal District Court, except as it relates to certain spousal defenses under I.R.C. §6015. The taxpayer is encouraged to work with the office that issued the CDP hearing notice in an effort to resolve the matter even after the taxpayer has requested a hearing with Appeals.

RESOLUTION BEFORE THE HEARING

If the taxpayer reaches a satisfactory resolution with Collection after filing a request for a CDP hearing, the taxpayer can withdraw his or her request for a CDP hearing. The taxpayer can use Form 12256, Withdrawal of Request for Collection Due Process Hearing, when the CDP hearing request is based on an appropriately issued CDP notice but the taxpayer has been able to satisfactorily resolve his or her case prior to the commencement of the CDP hearing with Appeals.

A taxpayer can also withdraw his or her request for a CDP hearing with Appeals, if the case is resolved prior to the commencement of the CDP hearing with Appeals but after the case has been forwarded to Appeals. The withdrawal form eliminates the right to judicial review. The decision to use Form 12256 belongs to the taxpayer. Upon receipt of the withdrawal request, Form 12256, the suspension of the statute of limitations on the period of collection under the provisions of I.R.C. §§6320 and 6330 is no longer in effect.

THE COLLECTION DUE PROCESS HEARING

The Office of Appeals holds the CDP hearing. An officer or employee who has had no prior involvement with respect to the unpaid tax conducts the hearing. However, the taxpayer may waive this requirement.

In every case, Appeals must consider and address the requirements of the law and administrative procedures, the relevant issues presented and the intrusiveness of collection action.

The taxpayer may raise any relevant issue at the conference, such as appropriate spousal defenses, appropriateness of collection actions, and collection alternatives, such as an installment agreement, offer in compromise, etc. The taxpayer may also challenge the existence of the underlying tax liability if he or she did not receive a notice of deficiency or did not have an opportunity to dispute the tax liability.

Taxpayers with liabilities not subject to the deficiency procedure such as Trust Fund Recovery Penalty (TFRP) are considered to have had an opportunity to dispute the liability if they were previously offered and declined a conference with Appeals.

The taxpayer may NOT raise an issue that was raised and considered at a previous CDP hearing or in any other previous administrative or judicial proceeding in which the taxpayer participated meaningfully.

DETERMINATION/DECISION LETTER

Appeals' hearing on a timely CDP request is concluded with the issuance of a determination letter. Letter 3193, Notice of Determination Concerning Collection Action(s) Under I.R.C. §6320 and/or I.R.C. §6330 (Tax Court) is issued to the taxpayer for cases where the Tax Court would appear to have jurisdiction. The Tax Court has jurisdiction of CDP cases where the underlying tax liability is the type of liability that is subject to the deficiency procedures (e.g., income, gift, and estate taxes). For these types of tax liabilities, the Tax Court is the appropriate court of jurisdiction, regardless of whether an actual deficiency is at issue. The determination letter advises the taxpayer that he or she may initiate an action for judicial review of the Appeals determination within 30 days of the date of the letter.

Letter 3194, Notice of Determination Concerning Collection Action(s) Under I.R.C. §6320 and/or I.R.C. §6330 (District Courts) is issued for cases where U.S. District Courts would appear to have jurisdiction. The U.S. District Courts have jurisdiction over CDP cases not within the jurisdiction of the Tax Court. For these types of tax liabilities, the District Court is the appropriate court of jurisdiction where the underlying tax liability is not the type of liability subject to the deficiency procedures (e.g., Trust Fund Recovery Penalty and excise taxes other than those under I.R.C. Chapters 41, 42, 43, and 44). The determination letter advises the taxpayer that he or she may initiate an action for judicial review of the Appeals determination within 30 days of the date of the letter.

The appeals hearing on an equivalent hearing is concluded with the issuance of a decision letter, except as it relates to certain spousal defenses under I.R.C. §6015. In both the Notice of Determination letter and decision letter, Appeals will provide clear information regarding any agreement reached with the taxpayer, any relief given, and any necessary actions required by Compliance.

If the tax liability is upheld or the enforcement action is valid, the letter will so state even if the appeals/settlement officer decides to provide the taxpayer a different collection alternative. The letter will also set forth specific ramifications should the taxpayer not comply with the terms of the agreement. Compliance will be responsible for implementing the agreement worked out in Appeals.

A taxpayer that reaches a satisfactory resolution with Appeals may sign Form 12257, Summary Notice of Determination, Waiver of Right to Judicial Review of a Collection Due Process Determination, and Waiver of Suspension of Levy Action. The waiver will provide clear information regarding any agreement reached with the taxpayer, any relief given, and any necessary actions required by Collection. The waiver eliminates the right to judicial review.

The Office of Appeals retains jurisdiction with respect to any Notice of Determination made under I.R.C. §6320 or I.R.C. §6330, including subsequent appeals requested by the taxpayer who requested the original CDP hearing. A retained jurisdiction hearing would be considered on the following issues:

- Collection actions taken or proposed with respect to such determination
- After the person has exhausted all administrative remedies, a change in the taxpayer's circumstances affects such determination

Taxpayers who request subsequent review of their case by Appeals under the changed circumstance provision under retained jurisdiction, must first exhaust all administrative remedies, such as having a conference with the manager.

SUBSEQUENT REVIEW

Taxpayers, who request subsequent review of their case by Appeals under the changed circumstance provision under retained jurisdiction, must first exhaust all administrative remedies, such as having a conference with the collection manager. If there has been a change in circumstances with respect to the taxpayer affecting the I.R.C. §6320 or §6330 determination, Appeals, under the retained jurisdiction provision, may consider issues that were raised and considered at the previous hearing. The statutory period for collection is not suspended during the retained jurisdiction proceeding.

QUESTIONABLE REFUND PROGRAM (QRP)

OVERVIEW

The Questionable Refund Program, administered by the Criminal Investigation (CI) Division, is a nationwide multifunctional program established in January of 1977. The QRP was designed to identify fraudulent returns, stop the payment of fraudulent refunds, and to refer identified fraudulent refund schemes to CI field offices. While the primary focus is on individual tax returns, business tax returns are also reviewed under the QRP.

Since its inception, the QRP has detected over $2.2 billion in fraudulent refunds and has stopped payment on 89 percent of these refunds. In addition, QRP has been responsible for the identification of substantial abuse in other programs that has resulted in the savings of hundreds of millions of dollars from fraudulent schemes in Abusive Tax Shelters and fraudulent claims for the Earned Income Tax Credit (EITC).

Questionable Refund Detection Teams (QRDT) are located in the CI Fraud Detection Centers (FDCs). The QRDT reviews questionable tax returns that have been identified by manual or computerized screening techniques. Schemes with criminal potential are referred to CI field offices for investigation. Many other returns are referred to other appropriate Operating Divisions as well as to the Adjustments Section for appropriate civil action. QRP schemes are also detected through communications from Electronic Return Originators (ERO), financial Institutions, return preparers, and concerned citizens.

The Electronic Fraud Detection System (EFDS) is a computer system located in the FDCs and many CI field offices. The EFDS automates the computer identification output for potentially fraudulent Electronically Filed (ELF) tax returns, increases data available for analysis, and assists in the development of information relating to paper and ELF schemes detected by the QRDTs.

The EFDS not only provides a means to review potentially fraudulent ELF tax returns "on-line" but also allows queries of various databases to identify other returns with similar characteristics. Queries can be performed on current-year ELF returns as well as many paper returns. The EFDS also contains tax account information and Employer Information Returns Processing (IRP) information for two preceding years.

The QRP area also attracts a relatively new type of crime, that of identity theft. On October 30, 1998, The Identity Theft and Assumption Deterrence Act of 1998, hereinafter referred to as the Act, went into effect. Section 3 of the Act amends Title 18 U.S.C. §1028 by, among other things, adding new subsection (a)(7). This subsection establishes an offense by anyone who:

> "Knowingly transfers or uses, without lawful authority, a means of identification of another person with the intent to commit, or to aid and abet, any unlawful activity that constitutes a violation of federal law, or that constitutes a felony under any applicable state or local law."

Title 18 U.S.C. §1028(d)(3) defines "means of identification" as any name or number that may be used, alone or in conjunction with any other information, to identify a specific individual. It covers several examples, such as name, social security number, and government-issued driver's licenses.

Criminal Investigation is now able to investigate and recommend prosecution under this statute in tandem with the investigation of substantive tax and money-laundering violations emanating from refund fraud and money laundering schemes. A violation of Title18 U.S.C. §1028 is most likely to occur when individual identities are stolen with the intent to file false tax returns claiming tax refunds.

RECENT CRIMINAL CONVICTIONS

BREEDLOVE—IDENTITY THEFT

On March 24, 2000, Rachel L. Breedlove was sentenced to serve 48 months imprisonment.

Breedlove pleaded guilty to filing tax returns which falsely claimed refunds using misappropriated identities and social security numbers. Breedlove directed the refund checks to be sent to an address over which she had control. She deposited the checks into bank accounts and spent most of the proceeds.

Breedlove was ordered to make restitution and forfeit an amount believed to be the unspent amount of the proceeds.

ALLI—FILING FALSE TAX RETURN

Julius Alli, 40, was convicted in federal court of five counts of conspiracy to file false income tax returns and four counts of filing false returns.

Alli used the names and social security numbers of unsuspecting adults and children to file fraudulent tax returns. Alli received the names and related information from county database lists obtained through his former wife, who at the time of the criminal conduct worked for the Los Angeles County Department of Children and Family Services.

Alli and his co-conspirators prepared multiple false tax returns. Alli and others rented private post office boxes, where they planned to receive refund checks from the IRS.

Alli faces up to 25 years in federal prison and a fine of $1.25 million. Several of his co-conspirators were also tried and convicted.

OPARA—IDENTITY THEFT

Chuck Nnamdi Opara was charged with identity theft and submitting false claims to a government agency.

Opara engaged in a multimillion-dollar fraud scheme which included the theft of the identities of 28 persons and submission of bogus federal income tax returns which sought an average refund of approximately $50,000 for each of the 28 claims. Some of the false tax refund claims were requested to be mailed to mail-drops acquired by Opara, while others were submitted electronically.

Opara pleaded guilty to two counts of false claims for refunds, and two counts of identity theft. Sentencing is scheduled at a future date.

INTERNAL REVENUE SERVICE FRAUD PROGRAM

The Internal Revenue Service (IRS) is actively engaged in the discovery, investigation, and prosecution of taxpayers and return preparers engaged in fraudulent activities. A new and unique approach to administering the IRS's resources in the battle against fraud was launched in September 2000.

In an effort to reinvigorate the fraud program in the Compliance function, a design team recommended the establishment of groups of "fraud referral specialists" strategically placed around the country. The specialists were selected from applicants from both examination and collection functions and are responsible for assisting field personnel in identifying and developing criminal referrals. They do not carry a case inventory of their own, and are assigned to specialist groups under the direction of a Fraud Referral Specialist Group Manager (FRS G/M). While the FRSs are assigned to a territory manager in SB/SE Compliance areas, they will serve personnel in all operating divisions.

The effort to specialize the fraud process will allow the IRS to focus its resources in areas that have traditionally been filled with fraudulent activity. Some of these areas include

- I.R.C. §7201 (Evasion)—the willful attempt to evade or defeat tax or payment thereof
- I.R.C. §7202 (Trust Fund Violation)—the willful failure to collect, truthfully account for, and pay over employment taxes
- I.R.C. §7206(1)—the willful filing of a return, statement, or other document made under penalties of perjury that is material and false, etc.

Most felonies and misdemeanors relating to tax matters and the reporting of information regarding tax matters exist within federal law under Title 26, Title 18, and Title 31.

The IRS has embarked on an aggressive campaign to train the specialists in revisions to the program, and reinforce vital skills. Additionally, a national fraud program manager has been selected to ensure integration and consistency of this revised fraud strategy across operating divisions. Taxpayers and return preparers can expect IRS employees to receive revised training in fraud areas, revisions to the Special Enforcement Program (SEP), and a renewed organizational commitment to the fraud program.

Tax fraud is often defined as an intentional wrongdoing on the part of a taxpayer, with the specific purpose of evading a tax known or believed to be owing. Tax fraud requires both an underpayment and fraudulent intent. In all criminal and civil fraud cases, the burden of proof is on the government. The major difference between civil fraud and criminal fraud is the degree of proof required for conviction.

In criminal cases, the government must present sufficient evidence to prove guilt beyond a reasonable doubt. In civil fraud cases, the government must prove fraud by clear and convincing evidence. Civil fraud cases are remedial actions taken by the government, such as assessing the correct tax and imposing civil penalties as an addition to tax, as well as retrieving transferred assets. Civil penalties are assessed and collected administratively as part of the tax.

Criminal fraud cases are punitive actions with penalties consisting of fines and/or imprisonment. Criminal penalties are enforced only by prosecution. Criminal penalties are provided to punish the taxpayer for wrongdoings and serve as a deterrent to other taxpayers. A single fraud offense may result in both civil and criminal penalties.

I.R.C. §6663(c), which controls the civil fraud penalty, indicates that the civil fraud penalty is assessed against individuals. Thus, in cases that involve a joint return, where the civil fraud penalty is attributable to only one spouse, the other spouse is not liable. The burden of proof to assess the civil fraud penalty rests with the IRS, not the taxpayer. The Internal Revenue Code indicates that civil fraud shall not apply to a spouse unless some or all of the underpayment is due to the fraud of that spouse. Unlike an innocent spouse election, a taxpayer does not have to request relief from the civil fraud penalty. Rather, it is the burden of the IRS to show that there is reasonable belief that the spouse participated in the fraudulent activities. If the burden of proof is not met, the spouse is not liable for the civil fraud penalty.

Lastly, there is a clear distinction between the avoidance of tax and the evasion of tax. Avoidance of tax is not a criminal offense. Taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means. One who avoids tax does not conceal or misrepresent, but shapes and preplans events to reduce or eliminate tax liability within the parameters of the law.

Evasion involves some affirmative acts to evade or defeat a tax or payment of tax. Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, attempts to color or obscure events, or make things seem other than they are. Common evasion schemes include understatement or omission of income, claiming fictitious or improper deductions, false allocation of income, and/or improper claims, credits, or exemptions.

HOME-BASED BUSINESS ISSUES

Home-based businesses have gained popularity over the last few years for a variety of reasons, including

- The ability to spend more time with family
- The deductibility of a portion of the home and certain business assets
- Aggressive marketing of multi-level marketing companies
- The desire of individuals to reduce the amount of taxes they pay

Many home-based businesses accurately report their income and expenses, while enjoying the benefits that a home-based company can offer. However, there are individuals who believe they can operate a business out of their home and claim personal expenses. Nondeductible personal living expenses cannot be transformed into deductible expenses regardless of how convincing the information in marketing materials may seem. I.R.C. §162 requires an expense to be ordinary and necessary in order to claim the deduction. The following are examples of items that are generally not deductible:

- Deducting the entire cost and operation of a personal residence. Placing a calendar or some other business-related item in each room does not increase the amount that can be deducted. Individuals may attempt to deduct a portion of the total house payment, which is not allowable. They should also be informed of depreciation recapture rules when assets are later sold
- Paying children an annual salary to answer the telephone
- Deducting education expenses for the children
- Deducting 100% of car and truck expenses when the asset has been used for both business and personal use
- Deducting personal furniture, home entertainment equipment, children's toys, etc.

Practitioner Note. Any investment scheme or promotion that claims to allow a person to deduct these types of expenses should be considered highly suspect. As always, a business must truly exist prior to claiming expenses.

The following IRS Web sites may provide additional information on this and related issues:

http://www.ustreas.gov/irs/ci/

http://www.irs.gov/prod/ind_info/abuse/index.html

METHODS OF ACCOUNTING

Revenue Procedure 2001-10 was published on January 8, 2001. The revenue procedure permits taxpayers, including those that provide merchandise, that have average annual gross receipts of $1 million or less to use the cash method of accounting and to be relieved of reporting inventories for tax purposes.

The revenue procedure was the direct result of multiple court decisions (Galedringe, Osteopathic, Turin, RACMP, and Smith) and concerns within the Internal Revenue Service (IRS) regarding the increased tax and record-keeping burden suffered by small businesses. There had been significant controversy over whether small businesses that provide goods in connection with their services should be required to use inventory accounts and an accrual method of accounting. In cases involving emulsified asphalt, concrete, and flooring contractors, and health care providers that administered chemotherapy drugs, the IRS argued that the taxpayers were in the business of providing merchandise and, therefore, had to use inventory accounts and an accrual method. The courts, however, disagreed and the IRS has listened. The IRS recognizes that it is a burden for small businesses to use inventory accounts and an accrual method and has taken several significant actions to reduce that burden.

The IRS hopes that the publication of Revenue Procedure 2001-10 will make a difference to many small businesses. The relief obtained with the option of choosing a cash method of accounting and opting out of recognizing inventories for tax purposes will allow small businesses to simplify their tax reporting and to save time and resources on extensive and complicated record keeping. The IRS has issued an action on decision (AOD 2000-05) on April 28, 2000, in response to the case that involved health care providers who administered chemotherapy drugs (Osteopathic Medical Oncology and Hematology PC, 113 T.C. No. 26). The AOD says that the IRS now agrees that prescription drugs or similar items administered by a health care provider are not merchandise that could prevent the provider from using the cash method of accounting. This AOD would also apply to veterinarians who do not market pet care or other products to their customers. The IRS believes that this decision is a relief for those in the health care community.

Pending the issuance of future guidance, the IRS has changed its policies in litigation and examination regarding use of the cash method of accounting. The IRS Chief Counsel issued a notice (CC-2001-010) that says the IRS will not assert that taxpayers that provide goods in connection with services are providing merchandise and, therefore, must use inventory accounts and an accrual method of accounting. For example, this would apply to taxpayers such as paving, painting, roofing, drywall, or landscaping contractors. This does not apply, however, to taxpayers that are resellers or manufacturers.

The Deputy Commissioner of the IRS has written a memorandum to the Commissioners for SB/SE, W&I, and LMSB (February 14, 2001). Similar to the Chief Counsel notice, the memorandum states that, pending further guidance, an examiner will not propose that a taxpayer must use inventory accounts and an accrual method in businesses such as paving, painting, roofing, drywall, or landscaping on the basis that the taxpayer is providing merchandise.

COMMODITY CREDIT CORPORATION LOANS

The Commodity Credit Corporation makes loans to farmers using their crops as collateral. The grain is valued at a certain dollar amount per bushel and the farmer can borrow up to a certain percentage of this dollar amount. The farmer can repay the loan to the CCC (Termed Redemption) and then sell the grain, feed the grain, or store it. The farmer can also turn the grain over to the CCC in satisfaction of the loan (Termed Forfeiture). If the loan is repaid, the farmer must pay interest but if the grain is forfeited to the CCC, no interest is charged.

Farmers usually report income from a crop in the year it is sold. However, if they pledge part or their entire crop to secure a CCC loan, they can elect to report loan proceeds as income in the year the loan is received (I.R.C. §77).

When a farmer receives the first loan from the CCC, there is a choice of reporting the loan proceeds under one of two methods:

1. Loan Method: The loan is treated as any other loan (no income is reported because the debt equals the amount received).
2. Income Method: The CCC loans are treated as income in the year they are received.

The I.R.C. §77 income election must be made **on a timely filed return**; it cannot be adopted on an amended return (Rev. Rul. 56-358). The income election is considered as an adoption of an accounting method and is binding on all future years. If a farmer has treated all previous CCC loans as loans, the election to treat subsequent loans as income can be made without the approval of the IRS.

The election is binding on all future CCC loans until permission to change the accounting method is granted. The election applies to all crops and to all subsequent years.

RECENT ISSUE IDENTIFICATION

Recent examination adjustments have been made relating to the CCC loans. The farmers were reporting CCC loans on the loan method. The farmer took the grain under CCC loan to the elevator and the elevator issued the check to the CCC for the repayment of the loan. The elevator also issued a check to the farmer for the net between the gross sale and the CCC repayment. The farmer correctly reported the net sale.

In one case, the farmer failed to report the CCC loan repayment in income since the amount was not deposited in the bank account. In other cases, the check that the elevator issued to the CCC overpaid the loan and the CCC issued a refund check to the farmer who failed to include this refund in income. In the latter cases it was determined that the refund amount should have been included in income since the taxpayer was using the CCC Loan amount as income and not the entire sale as income per the books and records. The farmer failed to report this refund amount in income since he thought it was the market gain. It was determined that this refund amount was caused by market fluctuations that occurred between the day the farmer received the loan payoff amount and the day the loan was actually paid off. It had nothing to due with the market gain reflected on the Form 1099G.

> **Practitioner Caution.** When these loans are being paid off by the elevator, ensure the correct amount of income is being reflected since many farmers report income using bank deposits. If these amounts are never deposited, they may be overlooked.

SCHEDULE K-1 MATCHING PROGRAM

Trust, partnership, and S corporation filings have been steadily growing from 1995 through 1999. These are referred to as flow-through returns as they pass their income through to beneficiaries, partners, and shareholders. Eight and one-half million flow-through returns are expected to be filed in 2001, passing through $700 billion to their beneficiaries, partners, and shareholders. The Service expects 35 million Schedules K-1 will be attached to these flow-through returns.

Matching means many different things. Several research efforts suggest that 8 to 15% of the Schedules K-1 attached to flow-through returns are currently being omitted from beneficiary, partner, and shareholder returns. The Matching Program will be used to support the Non-filer, Underreporter, and Abusive Trust Programs and to assist Compliance functions in the examination of tax returns and collection of tax due. Implementation and oversight teams are in place to review the program for accuracy and to ensure that information is appropriately used.

E-FILE MODIFICATIONS FOR THE 2002 FILING SEASON

Nearly 40 million individual taxpayers filed their tax return electronically in 2001, a 13% increase over the prior year. Almost 29 million of these returns were e-filed through an Authorized IRS e-file provider, an increase of almost 15%. Several changes are on tap for the 2002 filing season to make IRS e-file even more attractive to both taxpayers and practitioners.

NEW FORMS AND SCHEDULES

The IRS has continually added more forms and schedules to the e-file program to allow for greater participation. Twenty-three new forms and schedules were accepted electronically this year, and an additional 32 forms and schedules will be added to the program for the 2002 filing season. This means that by next year approximately 99% of all 1040 forms and schedules can be filed electronically. The IRS will also increase the occurrences or the number of certain schedules that can be filed electronically.

A complete list of the 32 additional forms for 2002 (including the number of occurrences allowed) may be found on the Internet at

- http://www.irs.gov/elec_svs/ets2.html
- http://www.irs.gov/elec_svs/bus-bus-xchg.html

ELECTRONIC SIGNATURES

Nearly 9 million individual taxpayers participated in the Self-Select Personal Identification Number (PIN) Program in 2001, enabling them to file paperless returns without having to submit a written signature jurat. Taxpayers self-selected their own five digit PIN code and provided the IRS with two pieces of information (Adjusted Gross Income (AGI) and total tax) from their prior year tax return. The Self-Select PIN Program will continue in 2002 with some modifications including only requiring AGI, not total tax, with the Self-Select PIN.

In addition, the IRS will also be offering an alternative PIN program for practitioners similar to what was offered in 1999 and 2000. The Practitioner PIN Program will include an IRS e-file Signature Worksheet that is signed to indicate the taxpayer's intent to use a PIN signature. The Worksheet will be retained by the preparers and will not require information from the prior year tax return.

DEBT INDICATOR

Based on the successful results of the Debt Indicator pilot conducted this year, the program will be continued next filing season. For 2002, the IRS plans to have the debt indicator shown on every acknowledgment report. The filer will enter a "Y" in the RAL Indicator filed on page 2 of the Form 1040 record to indicate that a Refund Anticipation Loan (RAL) is involved.

CHECKBOX DISCLOSURE AUTHORIZATION

The new Checkbox Disclosure Authorization, which allowed taxpayers to easily authorize their return preparers to discuss tax return issues with the IRS, was another great benefit for taxpayers and tax practitioners during the 2001 filing season. The program will be continued and expanded for 2002 to allow taxpayers to identify any individual (not just paid preparers) to serve as designee. The designee will be able to:

- Speak to an IRS Customer Service Representative (by phone or in person) in response to math error notices
- Correspond with IRS concerning math error notices
- Respond to IRS about information contained on the tax return, and
- Inquire and receive information about a refund or payment

ELECTRONIC PAYMENTS

For 2002, the IRS will also expand the electronic payment options available to individual taxpayers. Next year, taxpayers will be able to use their credit card to make installment agreements or delinquent tax account payments (notices, etc.). Taxpayers can already use credit cards or electronic funds withdrawal for balance due returns, payments with extensions, and estimated tax payments.

MODERNIZATION E-SERVICES

Also in 2002, the IRS will be releasing its initial series of Web-based services for practitioners. The first release will involve:

- Registering with the IRS to get a username and password for Web-based services
- Electronically filing applications to become an e-file service provider
- Updating the e-file service provider's profile online
- Searching and browsing e-file related content
- Subscribing to e-mailed newsletters for e-file partners
- Participating in monitored online discussions with other e-file partners and IRS staff

A second release later in the year will include:

- Requesting and receiving taxpayer transcripts online
- Submitting disclosure authorization requests electronically (POA and TIA)
- Verifying Taxpayer Identification Numbers (TINs)
- Getting personal assistance in resolving taxpayer problems