Chapter 2: IRS Issues

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

IRS COLLECTIONS

Not all taxpayers file their tax returns properly; some fail to file and others have additional tax assessed during an audit. The IRS considers all of these cases to be collection cases. In 2004, the IRS resolved over five million collection cases, collecting over $36.5 billion dollars. With six million cases remaining open at the end of 2004, taxpayers owed the IRS over $50 billion. Collections are obviously not a small matter to the IRS. The table at the end of this chapter shows statistics the IRS released in their *2004 IRS Data Book.* This information can be found on the IRS website at **www.irs.gov/pub/irs-soi/04db16co.xls.**

It is very important that taxpayers or their representatives respond to all IRS correspondence. Failure to respond results in the IRS taking action to collect any assessed tax. Actions taken may include:

- Filing a Notice of Federal Tax Lien,
- Serving a Notice of Levy, or
- Offsetting a refund.

Before taking any action, the IRS gives taxpayers a chance to voluntarily pay or explain why they disagree with the assessment.

The following discusses the collection process and the options taxpayers have in settling their claims with the IRS. This information can assist tax professionals when their clients contact them regarding a letter they received from the IRS.

IRS Pub. 594, *The IRS Collection Process,* contains the following flowchart which illustrates some of the options available to taxpayers who owe taxes.

What to Do When You Receive a Bill from the IRS

You receive a tax bill in the mail

If it is correct. . .

Pay the full amount now. . .

See page 5 Or. . .

If you are unable to pay in full. . .

Pay in monthly installments

By: Direct Debit
Payroll Deduction
Check or Money Order

See page 6 Or. . .

See page 6 for additional options

If it is not correct. . .

Gather copies of:
- ❐ the bill
- ❐ any records
- ❐ tax returns, and
- ❐ canceled checks

See page 4

Possible Payment Sources:

Available Funds (cash, stocks, bonds, or bank accounts)
Loan
Credit Card
401(k) Plan
Life Insurance Policy

Contact us right away. . .

Call the number on the bill you received

Visit your local IRS office

Write to us at the address on your bill

Check the phone book or call the toll-free number for the address.

You should understand the possible immmediate and long-term effects of not paying your taxes when they are due or defaulting on an installment agreement. . .. It can adversely affect your credit rating.
See page 5

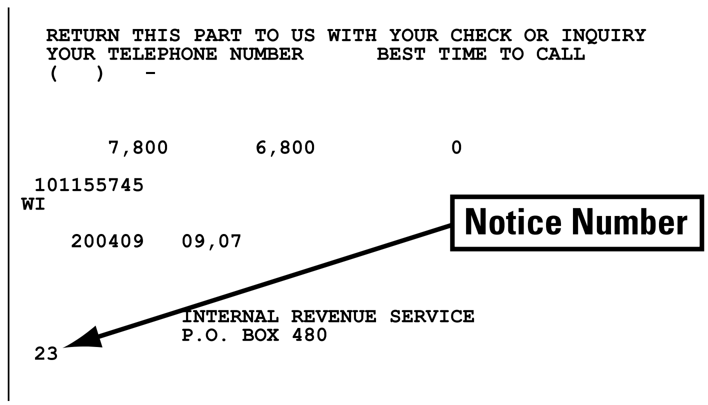
UNDERSTANDING THE IRS NOTICE

Before a tax preparer can advise a client regarding a notice, the preparer must understand the notice. In the past, this has been very difficult. As part of its restructuring program, the IRS placed a major emphasis on making these notices understandable. It accomplished this by publishing details of the codes listed on the notice on its website.

With information from the tear-off stub on the last page of the notice, the preparer can go to the IRS website to determine the following:

- Basic purpose of the notice
- Basic message
- Possible enclosures
- Other useful details

A sample of a tear-off stub follows:

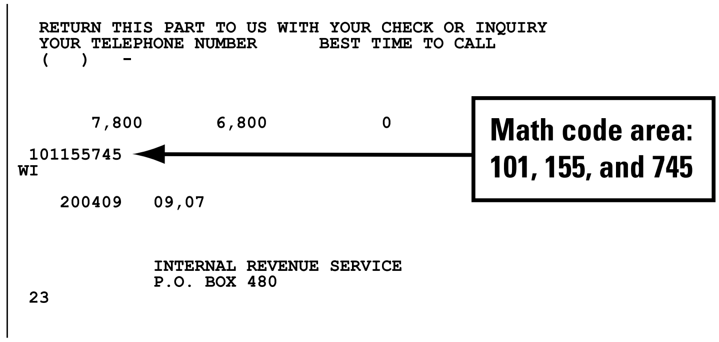


The **23** printed to the left and just below the IRS address on the tear-off stub identifies this sample as a CP 23, which is issued if there is an estimated tax discrepancy resulting in a balance due. This sample is for an individual return. For a business return, the notice number is positioned slightly higher on the page.

Tax preparers can access all of the CP codes for individual filer notices at **www.irs.gov/individuals/article/0,,id=125104,00.html** or **www.tinyurl.com/e2hnc**. A link from this site provides descriptions of the CP notice codes for business filers.

> **Note.** In order to simplify long URL addresses, a conversion website can be used which condenses a URL to a manageable size. Entering the short URL into the computer browser takes the user directly to the IRS site previously listed.

Determining the type of notice is important, but the preparer also needs to know why the IRS is proposing to change amounts on the return. These codes are available on the same tear-off sheet. The codes consist of three digits and a notice may contain multiple codes. The following sample illustrates these codes:



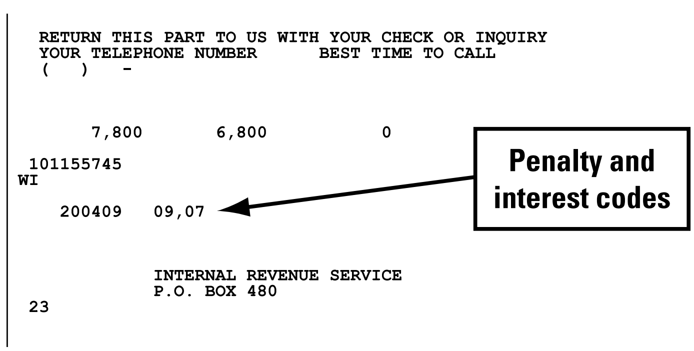
An explanation of these codes can be found on the IRS website (**www.irs.gov**) by going to the Tax Professionals section under "Understanding Your IRS Notice" and then clicking on "Individual Filer Notices" and following the links to the "Math Error Explanations" section for the applicable CP notice. In the above notice, the following codes are referenced:

- **Code 101** indicates the IRS changed the filing status to "single" based on information found on the return.
- **Code 155** indicates the IRS changed the amount claimed as tuition and fees deduction on line 27 of Form 1040 since the amount claimed was more than the maximum allowable amount based on filing status.
- **Code 745** indicates the IRS did not allow all or part of the amount claimed as earned income credit (EIC) on line 65a of Form 1040. The EIC was changed because the child or children listed on the form did not have valid social security numbers issued by the Social Security Administration. (Children issued individual taxpayer identification numbers by the IRS do not qualify for EIC.)

Since the entire code system contains almost 750 codes, the list is too long to include in this workbook. However, the codes are available at **www.irs.gov/individuals/article/0,,id=123493,00.html** (or **www.tinyurl.com/dnqpd**).

> **Note.** Practitioners should become familiar with these links as they provide substantial amounts of information.

If the IRS assessed a penalty or interest amount on the notice, these amounts are explained by additional codes. These codes are also listed on the tear-off sheet.



In this case, **code 09** indicates the IRS added interest because the tax liability was not paid on time. **Code 07** indicates a penalty was charged because of the late payment. The following web address links to an explanation of all of the penalty and interest codes: **www.irs.gov/individuals/article/0,,id=123532,00.html** (or **www.tinyurl.com/7q37p**).

> **Tip.** Selecting the link for **code 09** provides practitioners handy access to the interest percentage rates the IRS has applied to underpayments and overpayments since 1992.

INCORRECT BILLS

If the taxpayer believes the bill he received from the IRS is wrong, he needs to notify the IRS as soon as possible. He should either:

- Write the IRS office listed on the notice,
- Call the IRS office listed on the notice, or
- Visit the local IRS office.

In order to expedite correction of the erroneous bill, the taxpayer should gather a copy of the notice along with copies of any records, tax returns, and canceled checks that support the taxpayer's position.

If the taxpayer writes to the IRS, he should send **copies** of this information along with an explanation of why the notice is incorrect. If the IRS agrees with the taxpayer, it will send a corrected notice and adjust the taxpayer's account. **Original documents** should never be sent directly to the IRS.

TAXPAYER RIGHTS

When dealing with IRS collection matters, taxpayers have the right to:

1. Disagree with the notice,
2. Meet with an IRS manager if there is a disagreement with an IRS employee who handled the tax case,
3. Appeal most IRS collection actions,
4. Have their case transferred to a different IRS office if there is a valid reason (such as a move),
5. Be represented by someone, and
6. Receive a receipt for any payments made.

DISAGREEMENTS

Fast Track Mediation Process

In an attempt to expedite the collection process, the IRS established a Fast Track Mediation Process. To qualify for the process, a taxpayer must have a dispute arising from one of the following issues:

- Examinations (audits),
- Offers in compromise,
- Trust fund recovery penalties, or
- Other collections activities (for example, certain qualifying collection due process cases).

The advantage of the fast track process is that the case is assigned to a mediator who contacts the taxpayer within a week to schedule a meeting at a neutral location. While the mediator works within the law, he does not have the authority to require either party to accept the resolution. The process is started by the taxpayer's request for a mediation meeting. The IRS representative forwards the mediation request to the IRS Appeals Office. Both the IRS representative and the taxpayer must sign a form agreeing to participate in the mediation process.

Some cases **do not qualify** for the mediation process. These include:

- Issues for which there is no legal precedent
- Issues on which courts have rendered opposing or different decisions in different jurisdictions
- Industry Specialization Program issues
- An issue for which the taxpayer has filed a request for competent authority assistance
- Service Center penalty appeal cases
- Service Center Offer in Compromise cases
- Collection Appeals Program cases
- Automated Collection System cases
- Constitutional issues

To take advantage of the mediation process, the taxpayer must present all documentation in advance of the meeting. The taxpayer must be current with filing requirements and current with deposits.

Process. The mediator is an appeals officer trained in mediation. His goal is to help resolve the issues and to facilitate communications. He works with the taxpayer and the IRS to obtain information necessary to understand the nature of the dispute. This includes the issues involved and the positions of both parties.

The mediator may conduct separate or joint sessions with the parties. Hopefully, this will allow both parties to arrive at a mutually satisfactory resolution that is consistent with applicable law.

Representation. The taxpayer may represent himself at the meeting or he may have someone else represent him. However, to be successful, those who have the authority to make a decision must be present at the meeting. If this is someone other than the taxpayer, the taxpayer must file a signed Form 2848, *Power of Attorney and Declaration of Representative,* with the IRS.

Appeals. The taxpayer may withdraw from the mediation process at any time. If any issues remain unresolved, the taxpayer still has the usual appeal rights.

Collection Appeals Process

If a taxpayer disagrees with an IRS representative during the collection process, he may ask to speak to the representative's manager. The manager discusses the matter with the taxpayer on that day or calls the taxpayer the following work day. If the taxpayer does not agree with the manager, he can then file an appeal under the Collection Appeals Program. This program allows appeals on most collection actions, including liens filed, wages and bank accounts levied, and property seized. The taxpayer also has the right to request a collection due process (CDP) hearing with the Office of Appeals after the initial filing of a Notice of Federal Tax Lien. This process precedes the initial levy action, unless collection of the tax is in jeopardy or the levy is on the taxpayer's state tax refund.

INSTALLMENT AGREEMENTS

Assuming the taxpayer has exhausted his appeal rights and the IRS is proven to be correct, the taxpayer has some options for paying his tax debt. Obviously, the IRS's first preference is immediate full payment of the bill. Assuming the taxpayer does not have the money to make full payment, he can file a request to make partial payments under an installment agreement. If the amount due is less than $25,000 and the taxpayer agrees to pay the balance within five years, Form 9465, *Installment Agreement Request,* should be filed. If the amount due is over $25,000, Form 433-F, *A Collection Information Statement,* must be filed in addition to Form 9465.

Installment agreements generally require monthly payments. The amount of the payment is based on a combination of the amount owed and the taxpayer's ability to pay within the time frame available by law to the IRS. The taxpayer must be:

- Current in filing all tax returns before requesting an installment agreement,
- Current with estimated tax payments, if appropriate, and
- Current with his payroll tax deposits, if an employer.

The IRS charges a $43 fee to set up an installment agreement. The installment payment can be made with a direct debit from a checking account or a payroll deduction. These two payment methods are recommended to help prevent the taxpayer from defaulting on payments.

Form **9465**
(Rev. December 2004)
Department of the Treasury
Internal Revenue Service

Installment Agreement Request

▶ If you are filing this form with your tax return, attach it to the front of the return. Otherwise, see instructions.

OMB No. 1545-1350

Caution: *Do not file this form if you are currently making payments on an installment agreement. Instead, call 1-800-829-1040. If you are in bankruptcy or we have accepted your offer-in-compromise, see* ***Bankruptcy or offer-in-compromise*** *on page 2.*

1 Your first name and initial — Last name — **Your social security number**

If a joint return, spouse's first name and initial — Last name — **Spouse's social security number**

Your current address (number and street). If you have a P.O. box and no home delivery, enter your box number. — Apt. number

City, town or post office, state, and ZIP code. If a foreign address, enter city, province or state, and country. Follow the country's practice for entering the postal code.

2 If this address is new since you filed your last tax return, check here . . . . ▶ ☐

3 ( ) Your home phone number — Best time for us to call

4 ( ) Your work phone number — Ext. — Best time for us to call

5 Name of your bank or other financial institution:

Address

City, state, and ZIP code

6 Your employer's name:

Address

City, state, and ZIP code

7 Enter the tax return for which you are making this request (for example, Form 1040) . . . . . . ▶

8 Enter the tax year for which you are making this request (for example, 2004) . . . . ▶

9 Enter the total amount you owe as shown on your tax return **9**

10 Enter the amount of any payment you are making with your tax return (or notice). See instructions **10**

11 Enter the amount you can pay each month. **Make your payments as large as possible to limit interest and penalty charges.** The charges will continue until you pay in full **11**

12 Enter the date you want to make your payment each month. **Do not** enter a date later than the 28th ▶

13 If you want to make your payments by electronic funds withdrawal from your checking account, see the instructions and fill in lines 13a and 13b. This is the most convenient way to make your payments and it will ensure that they are made on time.

▶ **a** Routing number

▶ **b** Account number

I authorize the U.S. Treasury and its designated Financial Agent to initiate a monthly ACH electronic funds withdrawal entry to the financial institution account indicated for payments of my federal taxes owed, and the financial institution to debit the entry to this account. This authorization is to remain in full force and effect until I notify the U.S. Treasury Financial Agent to terminate the authorization. To revoke payment, I must contact the U.S. Treasury Financial Agent at **1-800-829-1040** no later than 7 business days prior to the payment (settlement) date. I also authorize the financial institutions involved in the processing of the electronic payments of taxes to receive confidential information necessary to answer inquiries and resolve issues related to the payments.

Your signature — Date — Spouse's signature. If a joint return, **both** must sign. — Date

The IRS **cannot refuse a request** for installment payments if:

- The taxpayer owes no more than $10,000;
- During the past three years, all tax returns were timely filed and taxes were paid without using an installment agreement;
- The IRS determines the taxpayer cannot pay the tax owed in full when it is due and the taxpayer furnished information to assist the IRS in its determination; and
- The taxpayer agrees to pay the full amount within three years and to comply with tax laws while the agreement is in place.

The IRS may file a Notice of Federal Tax Lien to protect its interest against the taxpayer's other creditors. However, it cannot levy against the taxpayer's property:

- While an installment payment request is being considered,
- While the agreement is in effect,
- For 30 days after the request for an agreement has been rejected, or
- For any period while an appeal of the rejection is being evaluated.

The IRS will consider changing an installment agreement if the taxpayer's financial situation changes. However, it may charge a $24 reinstatement fee. In order to determine the installment payment amount, the IRS may require that the taxpayer file Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals.* This form requires the taxpayer to provide the IRS with complete financial information, including details on employers, other sources of income, banking and investment account numbers and balances, sources of available credit such as credit cards and cash values in life insurance policies, wage garnishments, judgments, lawsuits, bankruptcies, asset transfers, and a listing of assets and liabilities on vehicles, personal items (jewelry, antiques, etc.), and business resources. The form also requires the taxpayer to detail monthly income sources and living expenses. All information is required to be documented by submitting proof with the form.

It is important that the taxpayer complete Form 433-A accurately. Once a payment amount is agreed upon, default may cause the IRS to file a Notice of Federal Tax Lien. In addition, default can be very damaging to the taxpayer's credit worthiness and cause financial difficulties. Business taxpayers file Form 433-B, *Collection Information Statement for Businesses.*

OFFER IN COMPROMISE

Some taxpayers find themselves in a situation in which they owe a tax liability they will never be able to pay. The IRS has a procedure for these taxpayers called "offer in compromise" (OIC). This process allows the IRS to forgive a portion of the tax liability. Obviously, there are very strict rules regarding the amount of tax liability that can be forgiven. The OIC includes interest, penalties, and taxes owed. There is a $150 user fee for submitting an offer.

QUALIFICATION

The IRS may legally compromise a tax liability for one of the three following reasons:

1. **Doubt as to liability**. This is a situation in which there is doubt that the assessed tax liability is correct.
2. **Doubt as to collectability.** This is a situation in which it is doubtful the taxpayer can ever pay the full amount of the assessed tax. The sum of the taxpayer's assets and future income must be less than the tax owed.
3. **Promote effective tax administration.** In this case the assessed tax is correct and there is no doubt the tax can be collected, but collection would impose economic hardship or other special circumstances which allows the IRS to collect less than the entire tax liability owed.

Example 1. Jeremy worked in a Las Vegas casino as a dealer for thirty years. In 2000, he was audited and the IRS assessed tax and penalties of $70,000 on unreported tips. Jeremy is unable to pay these taxes. He was recently diagnosed with lung cancer, the result of second-hand smoke. Jeremy's anticipated life expectancy is less than two years. Because Jeremy used all of his assets to pay medical bills and has no income other then a small disability check, he is a good candidate for the OIC program.

A taxpayer must submit a completed Form 656, *Offer in Compromise*, to be considered. If the taxpayer's claim is based on doubt as to collectibility or promotion of effective tax administration, he must also attach a completed Form 433-A or 433-B.

Note. The table at the end of this chapter shows that taxpayers were not very successful in having an offer in compromise accepted. In 2004, the IRS received 106,000 offers, but only accepted 20,000. Taxpayers should not file an offer in compromise unless they meet one of the three above reasons.

Note. The IRS recently said the number of offers has decreased and the quality of the offers has increased. With the advent of the $150 filing fee, the IRS no longer receives as many frivolous offers from taxpayers just trying to delay collection activity.

PARTIAL PAYMENT AGREEMENTS

Lower income taxpayers may have a problem utilizing the previously discussed IRS payment methods. It would be difficult for these taxpayers to make payments large enough to satisfy their tax full tax liabilities under the time restrictions imposed by installment agreements. They also may find it impossible to qualify for the offer in compromise because of the size of the lump sum payment required to settle the compromised liability.

The IRS implemented an additional payment option on January 17, 2005, known as the Partial Payment Installment Agreement (PPIA), for taxpayers who have outstanding federal tax liabilities. This new payment option became possible with the passage of the American Jobs Creation Act of 2004 signed into law on October 22, 2004. The new legislation includes language amending IRC §6159 to allow the IRS to enter into installment agreements that result in full or partial payment of the tax liability.

Taxpayers who request a PPIA must provide complete and accurate financial information that is reviewed and verified. Taxpayers are also required to address equity in assets that can be utilized to reduce or fully pay the amount of the outstanding liability.

In addition, taxpayers granted PPIAs are subject to a subsequent financial review every two years. As a result of this review, the amount of the installment payments could increase or the agreement could terminate if the taxpayer's financial condition improves.

The PPIA option provides a feasible payment plan for many taxpayers. Those who qualify for the PPIA are strongly encouraged to make their payments via the direct debit option.

PRIVATE COLLECTION AGENCIES

Another part of the American Jobs Creation Act of 2004 permits private collection agencies (PCA) to collect federal tax debts. The first phase of this 10-year project is an attempt to collect an additional $1.4 billion in outstanding taxes.

The IRS anticipates **three benefits** from the use of the private agencies.

1. The number of outstanding tax liabilities will be reduced.
2. Taxpayer confidence in the tax system may increase because the IRS is collecting delinquent accounts.
3. The IRS can devote its personnel to more difficult collection cases and issues.

The IRS developed a pilot program to test the use of private agencies in 1996. Although the results of this test were not as favorable as desired, a new program was designed to improve results. In the pilot project, agencies were assigned old tax debts with little chance for collection. PCAs are now assigned cases that are in the queue for less than one year, are over $100, and are not facing statutory issues.

Cases assigned to PCAs range from $100 to $25,000 and are cases in which taxpayers do not dispute their liabilities. The PCAs use skip tracing technology to locate taxpayers. During the first year, 40,000 cases will be assigned to these outside agencies. The IRS has developed procedures for PCAs to maintain the same high standards of customer service and protection of taxpayer rights as are required of IRS employees.

TEMPORARY DELAY OF THE COLLECTION PROCESS

The IRS can delay the collection process until a taxpayer's financial condition improves. However, interest and penalties continue to accrue during the delay while the IRS analyzes the taxpayer's ability to pay. The IRS may request additional information and it may also file a Notice of Federal Tax Lien to protect the government's interest in the taxpayer's assets.

LIENS

A lien gives the government a legal claim on a taxpayer's property. A lien arises when:

- A tax liability is assessed,
- Notice and Demand for Payment and a bill is sent to the taxpayer identifying the amount owed, and
- The taxpayer neglects or refuses to fully pay the liability within 10 days of notification.

The lien is a public record. Therefore, the taxpayer's creditors are notified of the government's claim against all property, including any property that may be acquired later. The lien attaches to the property and all rights the taxpayer may have in the property. Therefore, it covers not only the taxpayer's car, boat, and house, but also his wages, accounts receivable, and other property.

> **Note.** Once a lien is filed, the taxpayer's credit rating may be harmed. He may be unable to get a loan to buy a house or car, get a credit card, or lease a property.

RELEASING A LIEN

The IRS issues a Release of the Notice of Federal Tax Lien within 30 days after full payment of the tax liability, including penalties and interest, is made. It also releases the lien within 30 days after accepting a bond guaranteeing payment of the debt. The taxpayer must pay all fees assessed by the state or jurisdiction for filing and releasing liens.

After ten years, a lien is usually released automatically unless it is refiled. If the IRS negligently or willfully fails to release a lien, the taxpayer may sue the government, but not the IRS employee, for damages.

PAYOFF AMOUNT

The full amount of a lien appears as a public record, even though payments have been made on the tax liability. A taxpayer may request the lien amount be updated by contacting the IRS. This is done by either telephoning the IRS or going to a local office and requesting a letter with the current balance to be paid before the lien is released.

APPLYING FOR A DISCHARGE

If the taxpayer is relinquishing property ownership, such as selling his house, he may apply for a Certificate of Discharge. This releases the lien from a specific piece of property. Under certain conditions a third party may also request a Certificate of Discharge. Taxpayers selling their personal residence may be able to file for a relocation expense allowance.

OTHER LIEN ACTIONS

Some creditors refuse to extend credit unless the IRS lien is secondary, meaning the creditor is paid before the government. This process is called subordination and is discussed in IRS Pub. 784, *How to Prepare Application for Certificate of Subordination of Federal Tax Lien.*

At its discretion, the IRS may withdraw a lien. This could happen in four different situations:

1. The notice was filed too soon, or not according to IRS procedures,
2. The taxpayer entered into an installment agreement,
3. The withdrawal expedites the collection of the owed tax, or
4. Withdrawal is in the best interest of both the taxpayer and the federal government.

Liens may be appealed. The rules are similar as those discussed in the appeal section of this chapter.

LEVIES

While a lien only places a claim on the taxpayer's property, a levy can result in the seizure of the property. The IRS may seize and sell any type of personal or real property belonging to the taxpayer. For example, it could seize and sell the taxpayer's house, car, or boat. In addition, it can seize property for which the taxpayer has a right. This includes wages, accounts receivable, retirement accounts, bank accounts, cash value of life insurance, and other property rights.

Normally, the IRS only seizes property after the following **three requirements** are met:

1. Tax is assessed and a Notice and Demand for Payment is sent,
2. The taxpayer neglected or refused to pay the assessed tax, and
3. Thirty days prior to the levy, the IRS sent a Final Notice of Intent to Levy and Notice of Your Right to a Hearing. These notices can be sent by certified mail or hand delivered to the taxpayer's home or business.

As with the other collection activities, the taxpayer has the right to an appeal.

WAGES, RETIREMENT PAYMENTS, AND BANK ACCOUNTS

A levy ends when it is released, the tax debt is paid, or the time expires for legally collecting the tax. If a bank account is levied, the bank must hold the taxpayer's funds on deposit for 21 days. This period allows the taxpayer time to resolve any problems resulting from the levy. After 21 days, the bank sends the funds, up to the levied amount, to the IRS.

If the IRS made a mistake and as a result the taxpayer incurred bank charges, the taxpayer may be entitled to a reimbursement. The taxpayer must file a claim within one year after the bank charge on Form 8546, *Claim for Reimbursement of Bank Charges Incurred Due to Erroneous Service Levy or Misplaced Check.*

Form **8546**
(Rev. February 2001)

Department of the Treasury - Internal Revenue Service

Claim for Reimbursement of Bank Charges Incurred Due to Erroneous Service Levy or Misplaced Payment Check

Instructions

Prepare this form in ink or use a typewriter. Please carefully read the instructions on the back of this form and supply the information requested. Use additional sheet*(s)* if necessary. Submit this form to the address of the IRS office which served the levy or the address of the office that misplaced the payment.

1. Name and address of claimant *(Number, street, city, state, and ZIP code)*	2. Telephone number *(including area code)*	
	3. Best time to call	4. Amount of claim $
	5. Social security or employer identification number *(Disclosure is voluntary. Omission may delay your claim or prevent locating your records.)*	

Electronic Funds Transfer *(EFT)* Information
(See instructions on the back of this form.)

6. Name*(s)* on bank account	7. American Bankers Association *(ABA)* number
8. Bank name and address *(Number, street, city, state, ZIP code)*	9. Bank account number
	10. Type of account ☐ Checking ☐ Savings

11. Description of claim *(State the circumstances which resulted in the loss for which you are claiming reimbursement.)*

Certification	I certify that the amount of my claim covers only bank charges which resulted from either an erroneous I.R.S. levy or having to stop payment on a check which was lost or misplaced by the I.R.S. I agree to accept this amount in full satisfaction and final settlement of this incident.

12. Signature of claimant *(This signature should be used in all future correspondence.)*	13. Date of claim

Civil Penalty for Presenting Fraudulent Claim

The claimant shall be liable to the United States for the sum of $2,000 plus double the amount of damages sustained by the United States. *(See R S § 3490, 5438, 31 USC 3729.)*

Civil Penalty for Presenting Fraudulent Claim or Making False Statements

Fine of not more than $10,000 or imprisonment for not more than 5 years or both. *(See 62 Stat. 698, 749; 18 USC 287, 1001.)*

Catalog Number 63488O | www.irs.gov | Form **8546** (Rev. 2-2001)

RELEASING LEVIED PROPERTY

The IRS must release levied property if any of the following conditions occur:

- The tax liability, penalty, and interest are paid.
- The time for collection expires before the levy is filed.
- The taxpayer provides evidence that releasing the levy will help the IRS collect the tax.
- The taxpayer has an installment agreement (unless the agreement states the levy does not have to be released).
- The IRS determines the levy is creating a significant economic hardship.
- The fair market value of the property exceeds the liability for which the levy was made, and release can be made without hindering collection of the liability.

Before property is sold, the IRS may release the property if:

- The taxpayer pays the amount of the government's interest in the property.
- The taxpayer enters into an escrow agreement.
- Acceptable bond is furnished.
- An acceptable agreement for paying the tax is made.
- The expense of selling the property is greater than the government's interest in the property.

SELLING THE PROPERTY

The IRS will post a public notice of sale of property, usually in a local newspaper or flyer. The original notice is sent or delivered to the taxpayer by certified mail.

After placing the notice, the IRS must wait at least ten days before conducting the sale, unless the property is perishable and must be sold immediately.

Before the sale, the IRS computes a minimum bid price. This is normally 80% or more of the forced sale value of the property after subtracting any liens. If the taxpayer disagrees with the price, he can appeal it and ask for a new appraisal by the IRS or a private appraiser.

> **Example 2.** Marisa incurred over $100,000 in back payroll taxes, penalties, and interest when she operated a beauty shop. The IRS was not able to work out an acceptable payment plan and, due to Marisa's recent marriage to a Paris resident, the IRS anticipates she will leave the country. Consequently, the IRS seized the beauty shop property for future sale.
>
> The IRS valued the property at $60,000. Marisa did not agree this was a fair price. She believes that because the zoning has recently changed, the property is worth over $100,000. Therefore, she can ask for a private appraisal.

The taxpayer can also ask the IRS to sell the property within 60 days. The IRS can supply the taxpayer with information on this procedure.

REDEEMING REAL ESTATE

The taxpayer, or anyone with an interest in real property, can redeem real estate within 180 days after the sale. The taxpayer must pay the purchaser the amount paid for the property, plus interest computed at 20% annually.

> **Example 3.** The beauty shop in **Example 2** was sold at public auction for $70,000. Two months after the sale, Marisa inherits $250,000 from an uncle. Due to the zoning change, the property next to the shop recently sold for $150,000. Marisa can repurchase the property from the buyer for $70,000 plus $2,333 interest.

EXCEPTIONS

Certain property may not be seized or levied by the IRS. Property cannot be seized if the IRS does not expect there to be net proceeds which can be applied to the tax liability. Also, the IRS cannot seize property on the day the taxpayer attends a collection interview because of a summons. Other items which may not be levied include:

- School books and certain clothing.
- Fuel, provisions, furniture, and personal effects for a household totaling $7,200.[1]
- Books and tools used in the taxpayer's trade, business or profession totaling $3,600.[2]
- Unemployment benefits.
- Undelivered mail.
- Certain annuity and pension benefits.
- Certain service-connected disability benefits.
- Worker's compensation.
- Salary, wages, or income included in a judgment for court-ordered child support payments.
- Certain public assistance payments.
- A minimum weekly exemption for wages, salary, and other income.[3]

1. This amount is inflation adjusted annually.
2. Ibid
3. Amount may be determined using Publication 1494, *Table of Figuring Amount Exempt from Levy on Wages, Salary, and Other Income*

PAYMENT OPTIONS

The following chart lists the various payment options available to taxpayers who are not able to pay their entire liabilities when they file their tax returns.

Payment Options Comparison Chart

		Total of All Liabilities	Time Frame for Full Payment	Other Basic Requirements	Financial Information	Verification of Financial Information
98% of all IA taxpayers	Guaranteed Installment Agreement (IA)	Below $10,000	Within 36 months	Must stay current with all future taxes	Limited	No
	Streamlined IA	Below $25,000	Within 60 months	Must stay current with all future taxes	Limited	No
	Full Pay IA < 60 months*	No limit	Up to 60 months	Leverage equity in assets Must stay current with all future taxes Conditional expenses may be allowed	Complete	Yes
	Full Pay IA > 60 months*	No limit	61 months and up Prior to expiration of Collection Statute	Leverage equity in assets Must stay current with all future taxes Transition period for conditional expenses may be allowed for up to 12 months	Complete	Yes
	Partial Pay IA	No limit	Payments made until Collection Statute expires	Leverage equity in assets Must stay current with all future taxes No conditional expenses allowed No transition period	Complete	Yes
	Deferred Payment Offer In Compromise	No limit	Payments made until statute date or until accepted offer amount received	Net realizable equity must be accounted for in amount offered No conditional expenses allowed Must stay current with all future taxes	Complete	Yes

* Length of installment agreement determined by the financial analysis

INDIRECT METHODS FOR DETERMINING INCOME

Although practitioners are not required to perform audits of their clients' records before preparing their tax returns, they should understand how an IRS examiner might determine whether taxpayers have reported all of their income.

In addition to establishing income from accurate books and records, there are two other methods used for determining income: the **specific item method** and **the indirect method.**

The **specific item method** involves evaluating each questionable item of income and expense that affects the taxpayer's liability. The **indirect method** involves developing circumstantial proof of income by using various methods, such as source and application of funds, cash transactions, and net worth methods.

Every person subject to income tax is required to keep permanent records to verify the amount of gross income reported on his return. The IRS has the authority to reconstruct income by any reasonable method that clearly reflects the taxpayer's true income.

Under IRC §446, taxable income must be computed using the same method of accounting the taxpayer regularly uses for bookkeeping. If the method used does not accurately reflect income, a computation of taxable income may be made using a method determined by the IRS. However, the IRS method must clearly reflect the income.

The *Internal Revenue Manual* instructs IRS examiners to probe for unreported income on almost all returns examined. This probe includes questioning the taxpayer during the initial interview regarding sources of income, standard of living, purchase of assets, and cash hoards at the beginning and end of the tax year under exam. The purpose is to determine if the taxpayer's total expenses, deductible and nondeductible, exceed total reported income plus nontaxable income.

Minimum steps taken when examining gross income on the business return of a corporation or other business entity include:

- Preparing a balance sheet analysis,
- Reconciling Schedules M-1 and M-2,
- Evaluating the tax returns of significant shareholders or partners,
- Interviewing the taxpayer,
- Touring the business site,
- Evaluating internal controls, and
- Testing gross receipts or sales.

SUSPICION OF UNREPORTED INCOME

If an examination reveals an understatement of income in any given year, the case is discussed between the agent and his manager. The purpose of the discussion is to consider a possible expansion of the examination's scope or depth, audit techniques to be used, and the possibility of fraudulent activity by the taxpayer. This discussion is **mandatory** in any examination with an understatement of income greater than $10,000.

Where indicated, the examiner first looks for specific items of income that can be documented with direct evidence. This approach is appropriate when the taxpayer maintains adequate books and records.

The use of an indirect method to make the actual determination of correct taxable income is appropriate when the taxpayer's books and records are missing, incomplete, or irregularities are identified. It is also appropriate if an examiner's analysis indicates a material imbalance after consideration of specific adjustments.

> **Example 4.** When auditing Jan's T-Shirt Shoppe, the IRS examiner noticed the purchase of 30,000 unprinted T-shirts. However, sales of only 6,000 shirts were included in gross receipts. Jan's year-end inventory reported only 5,000 shirts. The IRS examiner also noticed that the business had rented tents at 40 outdoor festivals during the year.

When appropriate, third party contacts are made by the IRS examiner to corroborate oral testimony. Information is usually collected from the taxpayer; however, the IRS examiner may use external sources to corroborate a taxpayer's oral testimony and explanations.

> **Example 5.** Continuing from **Example 4**, the IRS examiner knew the state sales tax department went to all outdoor festivals and collected sales tax from the vendors. Therefore, he requested the sales tax information related to Jan's T-Shirt Shoppe.

SOURCE AND APPLICATION OF FUNDS METHOD

The Source and Application of Funds method is most often used when the taxpayer has many transactions involving assets and liabilities or does not have a checking account. This method is frequently used in the examination of "cash" businesses such as car washes.

This method of reconstructing income is used to determine the actual taxable income. It consists of analyzing the taxpayer's cash flow and comparing all known expenditures with all known receipts for the period. Net increases and decreases in assets and liabilities are considered along with nondeductible expenditures, including personal living expenses, and nontaxable income. When expenditures exceed the total of reported and nontaxable income, the difference is considered to be unreported taxable income. The use of this method has received Supreme Court approval.[4]

The Source and Application of Funds Method is usually used in the following situations:

- The review of a taxpayer's deductions and other expenditures appear out of proportion to the income reported.
- The taxpayer's cash does not all flow from a bank account which can be analyzed to determine its source and subsequent disposition.
- The taxpayer makes it a common business practice to use cash receipts to pay business expenses.

Sources of Funds

There are various ways the taxpayer may acquire money during the year. Examples of fund sources include:

- Decreases in assets, such as:
  - Cash on hand,
  - Bank account balances (including personal and business checking and savings accounts),
  - Inventory, and
  - Accounts receivable.
- Increases in liabilities, such as:
  - Accounts payable, and
  - Loan principal.
- Taxable and nontaxable income
- Deductions which do not require funds such as depreciation, carryovers and carrybacks, and adjusted basis of assets sold

Application of Funds

Application of funds describes ways a taxpayer uses or expends money during the year. Increases in assets, decreases in liabilities, and expenditures for personal living all require use of money, and therefore are applications of funds. Examples include:

- Increase in assets, such as:
  - Cash on hand
  - Bank account balances including personal and business checking and savings account,
  - Accounts receivable,
  - Business equipment purchased,
  - Real estate purchased, and
  - Personal assets purchased.

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4. *United States v. Johnson,* 319 U.S 503, June 7, 1943

- Decreases in liabilities, such as:
  - Accounts payable, or
  - Loan principal.
- Personal living expenses

Determining the beginning amount of cash on hand is extremely important. Cash on hand is a fundamental aspect of the examination of income. Therefore, the examiner establishes the amount and verifies the taxpayer's statements of cash accumulations during the initial interview. This is important for several reasons:

- Cash on hand can explain an examiner's analysis that appears to identify a potentially significant imbalance. This issue can be resolved quickly if it is addressed early in the examination.
- An examination can help determine whether a formal indirect method should be used and which method is most appropriate.
- An adjustment for unreported income can be challenged if the availability of cash on hand is not addressed at the beginning of the audit. The after-the-fact "cash in the mattress" defense is eliminated if the actual cash on hand was already established.

If a taxpayer indicates that he has what appears to be an inordinate amount of cash, the examiner makes further inquiries to establish:

- The amount of cash on hand at the end of each year under examination up to the present time,
- How cash was accumulated,
- Where cash was kept and in what denominations,
- Who had knowledge of the cash,
- Who counted the cash,
- When and where any of the cash was spent, and
- Why the taxpayer accumulated the cash on hand.

This information is necessary to establish the consistency of the taxpayer's statement. Usually no direct corroborating evidence is available, but statements made about the source and use of the funds can be verified. For example:

- The taxpayer may not have sufficient taxable or nontaxable income in prior years to accumulate cash.
- Claims of substantial cash on hand might be discredited by showing that the taxpayer lived frugally, borrowed money, made installment purchases, incurred large debts, was delinquent on accounts, had a poor credit rating, or filed for bankruptcy.
- Financial statements filed by the taxpayer at banks and other places can be reviewed to see if the taxpayer disclosed the cash on hand on these statements.

FINANCIAL STATUS AUDIT TECHNIQUES

Indirect examination methods and the techniques used to support income development are known as "financial status audit techniques." IRC §7602 states "the IRS shall not use financial status or economic reality techniques to determine the existence of unreported income unless they have a reasonable indication that there is a likelihood of such unreported income." "Examination techniques" include examining and testing the taxpayer's books and records, analytical tests, observing, and interviewing the taxpayer. None of these techniques are unique to the use of a formal indirect method and do not trigger §7602. However, the investigation of personal living expenses is an intrusive examination technique that is only used after making the decision to use a formal indirect method.

SOURCE AND APPLICATION FOR ACCRUAL TAXPAYERS

The following situation illustrates how unreported income might be found using a source and use of funds analysis.

Example 6.

Funds Applied		
Increase in cash on hand	$ 2,000	
Increase in cash in banks	1,500	
Increase in accounts receivable	10,000	
Increase in loans receivable	12,500	
Increase in inventory	11,100	
Increase in stocks and bonds	0	
Increase in furniture and fixtures	13,000	
Increase in real estate	145,000	
Increase in personal automobile	23,000	
Decrease in accounts payable	13,000	
Decrease in mortgage payable	0	
Personal living expenses	30,000	
Income taxes paid	6,000	
Nondeductible personal loss	4,000	
Gifts made	8,000	
Total Funds Applied	$279,100	$279,100
Source of Funds		
Decrease in cash on hand	$ 0	
Decrease in cash in banks	0	
Decrease in stocks and bonds	1,500	
Decrease in accounts receivable	0	
Decrease in loans receivable	0	
Decrease in inventory	0	
Increase in accounts payable	0	
Increase in notes payable	22,000	
Increase in mortgage payable	96,000	
Increase in accumulated depreciation	21,100	
Adj. basis of stocks and bonds sold	0	
Adj. basis of land and buildings sold	0	
Adj. basis of machinery and equipment sold	0	
Tax exempt interest	2,000	
Inheritances	40,000	
Nontaxable capital gains	0	
Other nontaxable income	0	
Total Source of Funds	$182,600	($182,600)
AGI as corrected		$ 96,500
AGI on return		(62,100)
Understatement of Income		$ 34,400

Observation. Assuming the tax return shows the only source of income to be Schedule C net profit, the $34,400 understatement of income is assumed attributable to Schedule C.

Adjustments for Accrual Basis Taxpayers

Adjustments for changes in accounts receivable and accounts payable must be made for accrual taxpayers. Since an increase in accounts receivable has been included previously in the taxpayer's income, it must be subtracted when testing for cash income. A similar adjustment must be made for any change in accounts payable. If the accounts payable decreases during the year, the amount of the change must be deducted from the cash analysis.

Example 7. Small Boats, Inc., reports accrual taxable income of $89,000 in 2004. If its accounts receivable increased from $35,000 to $55,000 during the year and its accounts payable decreased from $10,000 to $5,000 during the year, the following adjustments are required to determine the amount of cash income.

Accrual income reported	$89,000
Plus beginning accounts receivable	35,000
Minus ending accounts receivable	(55,000)
Minus beginning accounts payable	(10,000)
Plus ending accounts payable	5,000
Cash income	$64,000

CASH TRANSACTION METHOD

The cash transaction method is based upon the theory that if all cash sources and cash expenditures are known for a specific period of time, the sources should equal the expenditures. Thus, if an examination shows that a taxpayer had more cash expenditures than cash sources, there must be another source of funds. These funds may be either taxable or nontaxable. This cannot be determined without accounting for the difference.

The construction of the cash transaction statement begins during the initial interview with the revenue agent. The agent begins by making the following determinations:

- Were there any major purchases?
- Was all income reported during the year?
- Were any securities bought or sold?
- Were any loans received or repaid?
- Did the taxpayer have any cash accumulation other than amounts in the bank?

The concept that an agent examines "the taxpayer and not the tax return" is exemplified in the construction of the cash transaction method. An understanding of the taxpayer's entire financial situation is required to determine if the income and expenditures match.

A basic debit/credit worksheet is completed. This is commonly called a "T" account worksheet. All possible sources of funds, both taxable and nontaxable, are listed on the debit side of the worksheet. These include receipts such as cash on hand and in banks at the beginning of the year, wages, dividends, interest, gross rents, sales, loan proceeds, and inheritances. The credit side lists any deductible and nondeductible cash expenditures. This includes year-end cash balances, all cash expenses relating to any business, capital purchases, repayments of borrowed money, and personal living expenses.

The amounts of taxable income, which are shown on the debit side of the statement, are entered exactly as reported on the tax return. If an amount of income is understated on the tax return, the T account reveals the understatement of taxable income.

Once the two sides of the T account are complete and totaled, a comparison is made. If the credit side of the statement exceeds the debit side, an understatement of income exists. If the taxpayer is on the accrual method certain adjustments may be necessary.

> **Note.** IRS examiners are now required to prepare a preliminary cash transaction worksheet for nearly every exam.

Example 8. Jared and Megan McElroy were selected for an audit of the 2005 return. Megan is a full-time employee of Sluggers, Inc. and Jared owns and operates a travel agency, Cubs Win Travel Agency.

On the filed return, Jared reported a $30,000 loss from the travel agency. They also reported the following:

Wages paid to Megan	$41,638
Interest	1,000
Dividends	900
Capital gains	1,000
Net rental income	300

The following pages show Megan's Form W-2 and the forms and schedules they used to report their income from 2005.

The revenue agent prepared the cash transation (T) account analysis and determined that the McElroy's income was understated on the return by $64,900. The completed analysis is shown after the completed forms and schedules.

a Control number	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file. Visit the IRS website at **www.irs.gov**.
b Employer identification number **00-0000000**	1 Wages, tips, other compensation **41638.00**	2 Federal income tax withheld **2203.55**
c Employer's name, address, and ZIP code **Sluggers, Inc.** **420 N. Clark** **Chicago, IL 60610**	3 Social security wages **41638.00**	4 Social security tax withheld **2581.56**
	5 Medicare wages and tips **41638.00**	6 Medicare tax withheld **603.75**
	7 Social security tips	8 Allocated tips
d Employee's social security number **987-65-4321**	9 Advance EIC payment	10 Dependent care benefits
e Employee's first name and initial: **Megan** Last name: **McElroy** **520 Jackson Blvd.** **Oak Park, IL 60304-1402**	11 Nonqualified plans	12a See instructions for box 12
	13 Statutory employee ☐ Retirement plan ☒ Third-party sick pay ☐	12b
	14 Other	12c
f Employee's address and ZIP code		12d

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL		41638.00	1249.14			

Form **W-2** **Wage and Tax Statement** 2005 Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

For Example 8

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2005 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2005, or other tax year beginning , 2005, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type.
LABEL HERE

Your first name and initial: **Jared**	Last name: **McElroy**	**Your social security number**: 123 : 45 : 6789
If a joint return, spouse's first name and initial: **Megan**	Last name: **McElroy**	**Spouse's social security number**: 987 : 65 : 4321
Home address (number and street). If you have a P.O. box, see page 16.: **520 Jackson Blvd.**	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.: **Oak Park, IL 60304-1402**		Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 16) ▶ ☐ **You** ☐ **Spouse**

Filing Status
Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a . . . . — **Boxes checked on 6a and 6b**: 2
b ☒ **Spouse** . . . .
c **Dependents:**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 18)
				☐
				☐
				☐
				☐

If more than four dependents, see page 18.

No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 18)

Dependents on 6c not entered above

d Total number of exemptions claimed . . . . **Add numbers on lines above** ▶ 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	41,638
8a	**Taxable** interest. Attach Schedule B if required		8a	1,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	900
b	Qualified dividends (see page 20)	9b 650		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	(30,000)
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	1,000
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions 15a	b Taxable amount (see page 22)	15b	
16a	Pensions and annuities 16a	b Taxable amount (see page 22)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	300
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount (see page 24)	20b	
21	Other income. List type and amount (see page 24)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	14,838

Adjusted Gross Income

23	Educator expenses (see page 26)	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	One-half of self-employment tax. Attach Schedule SE	27			
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction (see page XX)	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction (see page XX)	32			
33	Student loan interest deduction (see page XX)	33			
34	Tuition and fees deduction (see page XX)	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 31a and 32 through 35			36	0
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	14,838

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75. Cat. No. 11320B Form **1040** (2005)

For Example 8

SCHEDULE C (Form 1040)
Department of the Treasury
Internal Revenue Service

Profit or Loss From Business
(Sole Proprietorship)
▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.
▶ Attach to Form 1040 or 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074
2005
Attachment Sequence No. **09**

Name of proprietor: **Jared McElroy**	Social security number (SSN): **123 : 45 : 6789**
A Principal business or profession, including product or service (see page C-2 of the instructions): **Travel Agency**	**B** Enter code from pages C-7, 8, & 9 ▶ **5 6 1 5 0 0**
C Business name. If no separate business name, leave blank. **Cubs Win Travel Company**	**D** Employer ID number (EIN), if any: **3 6 : 1 0 0 0 0 0 0**

E Business address (including suite or room no.) ▶ **1064 W. Addison St.**
City, town or post office, state, and ZIP code **Chicago, IL 60613**

F Accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2005? If "No," see page C-3 for limit on losses ☒ Yes ☐ No

H If you started or acquired this business during 2005, check here ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here ▶ ☐	1	470,000
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	470,000
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	470,000
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	470,000

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8	40,000	18	Office expense	18	38,000
9	Car and truck expenses (see page C-3)	9	10,000	19	Pension and profit-sharing plans	19	
				20	Rent or lease (see page C-5):		
10	Commissions and fees	10		a	Vehicles, machinery, and equipment	20a	
11	Contract labor (see page C-4)	11		b	Other business property	20b	105,000
12	Depletion	12		21	Repairs and maintenance	21	7,000
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)	13	15,000	22	Supplies (not included in Part III)	22	6,000
				23	Taxes and licenses	23	2,000
				24	Travel, meals, and entertainment:		
				a	Travel	24a	47,000
14	Employee benefit programs (other than on line 19)	14		b	Deductible meals and entertainment (see page C-5)	24b	10,000
15	Insurance (other than health)	15	15,000	25	Utilities	25	10,000
16	Interest:			26	Wages (less employment credits)	26	110,000
a	Mortgage (paid to banks, etc.)	16a	36,000	27	Other expenses (from line 48 on page 2)	27	24,000
b	Other	16b	20,000				
17	Legal and professional services	17	5,000				

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	500,000
29	Tentative profit (loss). Subtract line 28 from line 7	29	(30,000)
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you **must** go to line 32.	31	(30,000)

32 If you have a loss, check the box that describes your investment in this activity (see page C-6).
- If you checked 32a, enter the loss on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
- If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.

32a ☒ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11334P **Schedule C (Form 1040) 2005**

For Example 8

SCHEDULE D (Form 1040) Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074 2005 Attachment Sequence No. 12

Name(s) shown on Form 1040: Jared and Megan McElroy — Your social security number: 123 45 6789

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1					
2 Enter your short-term totals, if any, from Schedule D-1, line 2		2			
3 **Total short-term sales price amounts.** Add lines 1 and 2 in column (d)		3			

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** on page D-6 of the instructions	6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)	7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 100 Sh. Coca Cola	2/13/02	1/05/05	4,000	3,000	1,000
9 Enter your long-term totals, if any, from Schedule D-1, line 9		9			
10 **Total long-term sales price amounts.** Add lines 8 and 9 in column (d)		10	4,000		

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions. See page D-1 of the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** on page D-6 of the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back	15	1,000

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2005**

For Example 8

SCHEDULE E (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074
2005
Attachment Sequence No. 13

Name(s) shown on return: Jared and Megan McElroy
Your social security number: 123 45 6789

Part I Income or Loss From Rental Real Estate and Royalties **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see page E-3). Report farm rental income or loss from **Form 4835** on page 2, line 40.

1	List the type and location of each **rental real estate property**:	2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: • 14 days **or** • 10% of the total days rented at fair rental value? (See page E-3.)		Yes	No
A	20 acres of pasture McLean County, IL		A		X
B			B		
C			C		

Income:	Line	Properties A	B	C	Line	Totals (Add columns A, B, and C.)
3 Rents received	3	1,100			3	1,100
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-4)	6	340				
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9					
10 Legal and other professional fees	10					
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-4)	12	200			12	200
13 Other interest	13					
14 Repairs	14					
15 Supplies	15					
16 Taxes	16	260				
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19	800			19	800
20 Depreciation expense or depletion (see page E-4)	20				20	
21 Total expenses. Add lines 19 and 20	21	800				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-4 to find out if you must file **Form 6198**	22	300				
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-4 to find out if you must file **Form 8582.** Real estate professionals must complete line 43 on page 2	23	( )	( )	( )		
24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses					24	300
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here					25	( )
26 **Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 41 on page 2					26	300

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L **Schedule E (Form 1040) 2005**

For Example 8

Jared and Megan McElroy
2004
CASH TRANSACTION (T) ACCOUNT

Debits		**Credits**	
Cash on hand 12/31/03:		Cash on hand 01/01/05:	
Business		Business	
Personal		Personal	
Checking accounts 12/31/03:		Checking accounts 01/01/05:	
1,200		3,000	
13,000	14,200	12,000	15,000
Savings/Investments 12/31/03:		Savings/Investments 01/01/05:	
Schedule D – gross sales	4,000	Sch D – expense of sales	
Loan proceeds OR	32,000	Loan repayments OR	17,300
Increase in loans payable		Decrease in loans payable	
Wages (net after withholding)	35,000	Schedule C:	
Interest	1,000	Purchases	
Dividends	900	Expenses (less depreciation)	485,000
Gross rental income	1,100	Schedule F:	
Tax refunds		Expenses (less depreciation)	
Other sources:		Rental Schedule:	
Inheritance	6,000	Expenses (less depreciation)	800
		Expenses as employee	
		(less depreciation)	
Schedule C receipts	470,000	Capital assets acquired:	56,000
Schedule F receipts		Gifts	10,000
SUBTOTAL:	$564,200	Other capital expenditures:	7,000
		Personal expenses:	35,000
Understatement	61,900	Other outlays:	
TOTAL	$626,100	TOTAL	$626,100

ACCRUAL METHOD OF ACCOUNTING:

$ 61,900	Understatement from above		
	Add:	Increase in Accounts Receivable	$ 10,000
		Decrease in Accounts Payable	
	Less:	Decrease in Accounts Receivable	
		Increase in Accounts Payable	(7,000)
3,000			
$ 64,900	**Adjusted Understatement**		

Note. The taxpayers reported their Schedule C gross receipts using the accrual method of accounting.

NET WORTH METHOD

The net worth method was originally applied to taxpayers whose principal source of income was from an illegal activity. It is now used in fraud cases, especially when significant changes in net worth have occurred and other methods of proof are insufficient. In addition to being used as a primary means of proving taxable income, the net worth method is used to corroborate other methods of proof and test the accuracy of reported taxable income.

The net worth method for determining the actual tax liability is based upon the theory that increases in a taxpayer's net worth during a taxable year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income. This method requires a complete reconstruction of the taxpayer's financial history since the government must discover all assets, liabilities, nondeductible expenditures, and nontaxable sources of funds during the relevant period.

The net worth method theory is based upon the fact that for any given year, a taxpayer's income is applied or expended on items which are either deductible or nondeductible, including increases to the taxpayer's net worth through the purchase of assets and/or reduction of liabilities.

The taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year. The difference between these two amounts is the increase or decrease in net worth. The taxable portion of the income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible items, and subtracting that portion of income which is partially or wholly nontaxable. The purpose of the net worth method is to determine, through a change in net worth, whether the taxpayer is purchasing assets, reducing liabilities, or making expenditures with funds not reported as taxable income.

The government must meet the following requirements when using the net worth method:

- Establish an opening net worth with reasonable certainty,
- Negate reasonable explanations by the taxpayer inconsistent with guilt,
- Establish that the net worth increases are attributable to currently taxable income,
- Justify inferences of taxpayer's willfulness (where there are no books and records, willfulness may be inferred with proof of an understatement of income; where books and records appear correct, an inference of willfulness from net worth increases alone might not be justified),
- Prove every element beyond a reasonable doubt, though not to a mathematical certainty.

The net worth method is generally used in the following situations:

- Two or more years are under examination;
- Numerous changes to assets and liabilities are made during the period; and
- Books and records are:
  - Not maintained,
  - Inadequate or unavailable, or
  - Withheld by the taxpayer.

The same accounting method used by the taxpayer on the tax return must be used in computing net worth.

It has been stated that the source and application of funds method is a variation of the net worth method. Comparing the two methods reveals that they differ only in format. The source and application of funds method entails the use of only those assets and liabilities that change during the year, whereas the net worth method requires the use of all assets and liabilities. The same result is obtained using either method.

The formula for computing income using the net worth method is illustrated in the following worksheet:

Total assets	$1,000,000
Less: total liabilities	(600,000)
Net worth, end of year	$ 400,000
Less: net worth, beginning of year	(300,000)
Increase or decrease in net worth	$ 100,000
Add: nondeductible expenditures	5,000
Subtotal	$ 105,000
Less: nontaxable income	(2,000)
Adjusted gross income*	$ 103,000

* This amount is called net income or taxable income in the case of corporations or partnerships.

IRS MODERNIZATION AND RESTRUCTURING

Since 1998, the IRS has continually updated its operating structure. While the modernization was designed to increase efficiency and reduce costs, it has made it more difficult for some practitioners to deal with the IRS in the same manner as in the past. Taxpayers can no longer call a local IRS examiner or collection officer and receive immediate help with a question or problem. The following discussion deals with the reorganization and is designed to help practitioners understand the changes.

In 1952, the IRS was comprised of districts and service centers. There were 33 districts and 10 service centers. Each of the 43 units administered the entire tax law for every kind of taxpayer in a defined geographical area. Consequently, every taxpayer was serviced by both a service center and a district. Within each unit, work was accomplished by functional disciplines such as examination, appeals, collection, criminal investigation, submission processing, and customer service. Customer service was actually an amalgam of collections, examinations, general law, and account information services provided by mail, telephone, and personal contact. All client records were maintained on a master file, whose programming origins date back to some of the original programming code.

This organizational structure was largely successful, with minimal criminal cases and a successful track record of encouraging voluntary tax compliance. However, over the last 50 years the volume and complexity of IRS operations has expanded tremendously. The number of returns filed has more than doubled; the number of pages in the tax code has grown from 812 to approximately 3,500; and about 9,500 changes have been made to the Tax Code.

As successful as the IRS has been, it has not escaped criticism. Several studies have identified a wide range of problems. Major problems include inadequate technology and failure of technological modernization programs, poor service to taxpayers, violations of taxpayers' rights, failure to follow established procedures, lack of adequate training and resources for IRS employees, and inappropriate use of enforcement statistics.

IRS RESTRUCTURING AND REFORM ACT OF 1998

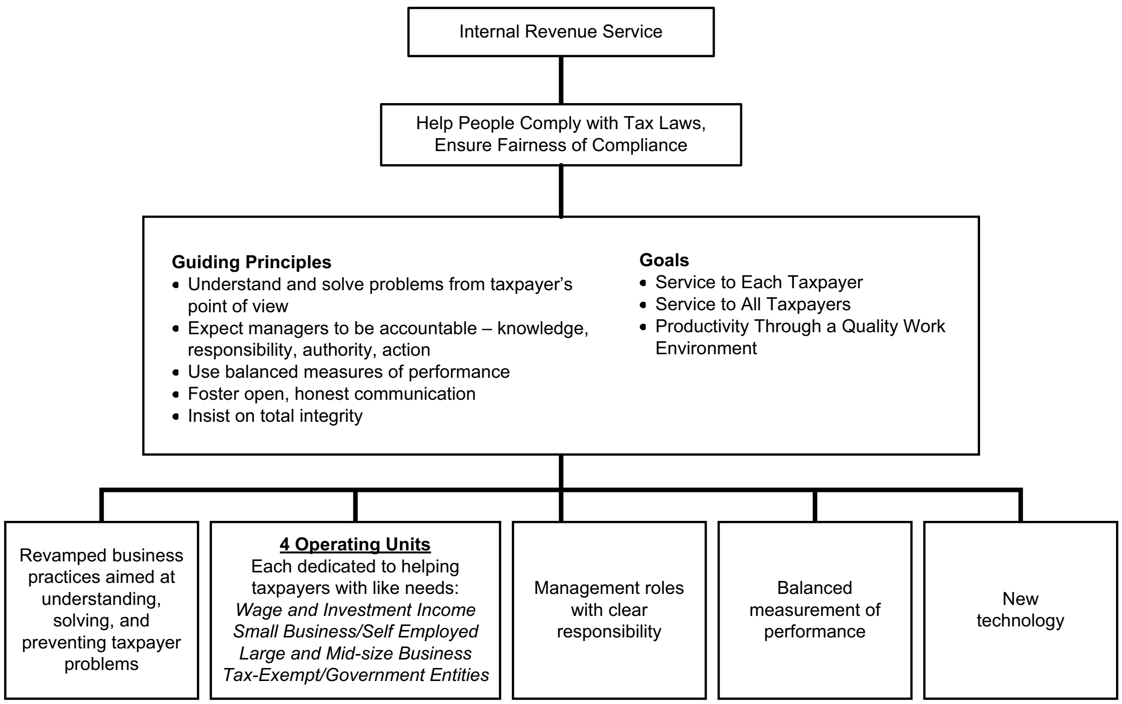
With strong bipartisan support, Congress addressed criticisms against the IRS with the passage of the IRS Restructuring and Reform Act of 1998 (RRA '98). This act mandated that the IRS rise to a higher level of performance by modernizing to meet taxpayers' needs and improve the efficiency of revenue collections. Since the act's passage, the IRS has made significant changes in five fundamental areas:

1. Redefinition of business practices
2. Organizational restructuring
3. Establishment of management roles with clear responsibility
4. Creation of a balanced set of performance measures
5. Technological advancements to support these changes

This process of modernization is ongoing. There have been some serious delays and setbacks caused by a variety of factors. For example, the technological revamping suffered from budget reductions. The IRS privatized the overhaul of its computer systems by outsourcing much of the job, which may not have worked well within the IRS bureaucracy and/or proved to be too overwhelming and complex of a task. Also, turnover of four chief information officers in the last five years contributed to the delay in modernization efforts. Although there is generally no timetable for modernization, target dates were established. One target was for 80% of all tax returns to be filed electronically by 2007.

The areas of change are so intertwined that discussing improvements in one area requires discussing changes in all areas. This section focuses only on item two of the five areas.

Modernizing America's Tax Agency

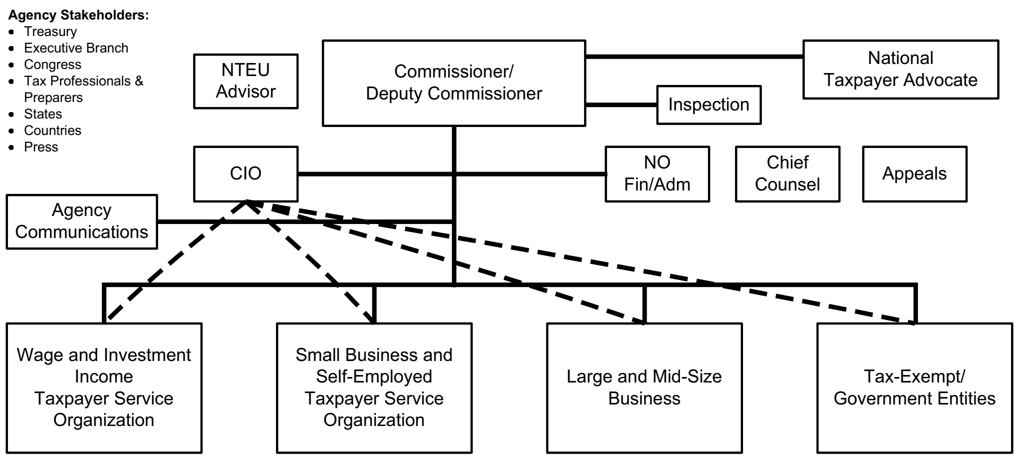


The RRA directive to the IRS is clear: The IRS must do a better job meeting the needs of taxpayers. As required by the act, this direction is expressed in the new IRS mission statement:

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

This mission statement emphasizes a change in focus for the IRS to customer satisfaction. The IRS realigned its structure by establishing customer-focused operating divisions. The new structure is similar to one widely used in the private sector, where businesses are organized around customers' needs. Just as many financial institutions have different divisions that serve retail customers, small to medium businesses, and large multinational businesses, the taxpayer base falls naturally into similar groups. These units replaced the four regional offices and a substantial part of the chief compliance and chief taxpayer service areas in the national office. This organization allows the national office to better fulfill its responsibilities of oversight and board policy rather than operations.

New IRS Structure



The key operational units are four operating divisions, each charged with full end-to-end responsibility for serving a set of taxpayers with similar needs. These operating divisions are supported by two service organizations: Information Systems and Agency Wide Services, providing common services such as facilities and procurement.

Division Characteristics

	Wage and Investment	Small Business and Self-Employed	Large and Mid-Sized Business	Tax-Exempt and Government Entities
Number of filers	122 million	45 million	210,000	2.4 million
Total tax liability (billions)	$380	$790	$466	$103
Average tax liability per filer	$4,310	$20,231	$2,231,274	$42,698

WAGE AND INVESTMENT DIVISION

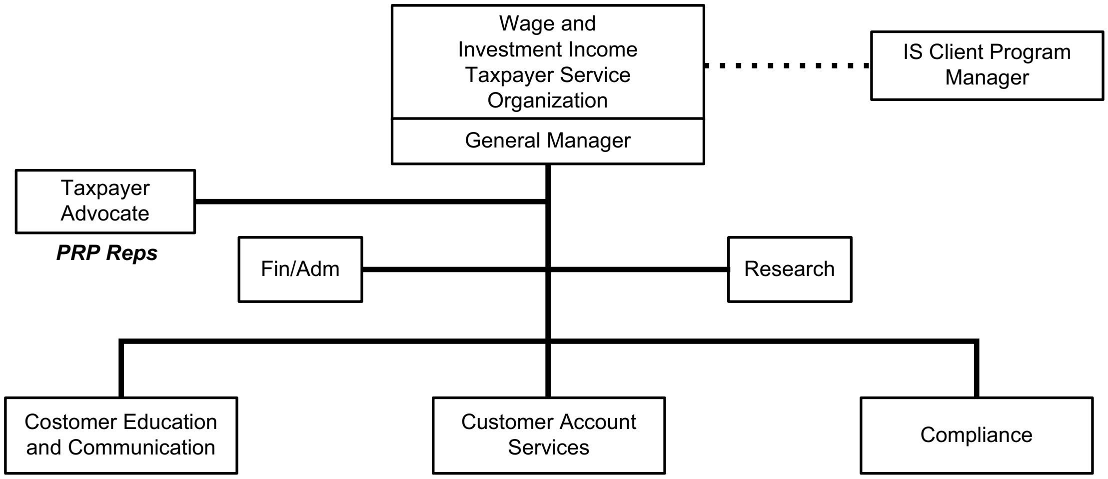
The first of the four operating divisions, Wage and Investment (W&I), serves approximately 122 million taxpayers. This group represents individual taxpayers. It includes those who file jointly with wage and investment income only, almost all of whom are paid by third parties. These are taxpayers filing Form 1040 with no accompanying Schedules C, E, F, or Form 2106, and no international activity. The majority of W&I taxpayers earn under $50,000 per year. Most of these taxpayers interact with the IRS only when filing their returns and most receive refunds. Collection problems are limited since the taxpayers directly pay only $46 billion of tax to the IRS. The balance of their liabilities is paid by their employers through withholding. Compliance issues are focused on a relatively limited range of issues and are concentrated on questionable exemptions, credits, filing status, and deductions.

The W&I division is designed to enable IRS employees to focus on educating and assisting taxpayers in all phases of interactions with the IRS through the following three organization offices:

1. **Customer Assistance, Relationships, and Education (CARE)** provides customers with the information, support, and assistance they need to understand and fulfill their tax obligations. CARE focuses on better service to customers through development of plain language notices, forms, and publications and development of educational materials.

2. **Customer Account Services (CAS),** located at eight service centers (Andover, Atlanta, Austin, Fresno, Kansas City, Philadelphia, Memphis, and Brookhaven), is responsible for taxpayer relationships through filing. This includes processing submissions and payments, providing taxpayers with information on the status of their returns, and resolving the majority of problems and inconsistencies.

3. **Compliance** is focused on a relatively limited range of issues, concentrating on dependant exemptions, credits, filing status and deductions. It also manages relationships with taxpayers who have a high risk of not paying or whose returns have a high risk of noncompliance.



The W&I division is headquartered in Atlanta, Georgia, and its employees are located in service centers and customer service sites throughout the United States. The National Office provides overall strategic and operational direction to the operating units.

SMALL BUSINESS/SELF-EMPLOYED DIVISION

The second group, Small Business/Self-Employed (SB/SE), includes fully or partially self-employed individuals, individuals filing schedules C, E, F, or Form 2106, and all other businesses (Forms 1120S, 1065) with assets under $10 million. This division also serves filers of estate and gift tax returns, fiduciary returns, employment tax returns, and all taxpayers with international tax returns. This includes 45 million filers, who have more complex dealings with the IRS than wage and investment taxpayers. Members of this group typically have between four to 60 interactions with the IRS per year and directly pay the IRS $915 billion in taxes. This represents 45% of the total tax collected by the IRS, including personal and corporate income taxes, employment taxes, excise taxes, and withholdings for employees. Since business income and a wide range of taxes are involved, each with difficult filing and technical requirements, compliance issues are complex. The probability for errors is the greatest in this group because of lack of withholding or information reporting and the large amount of tax paid. The result is more frequent dealings with the IRS.

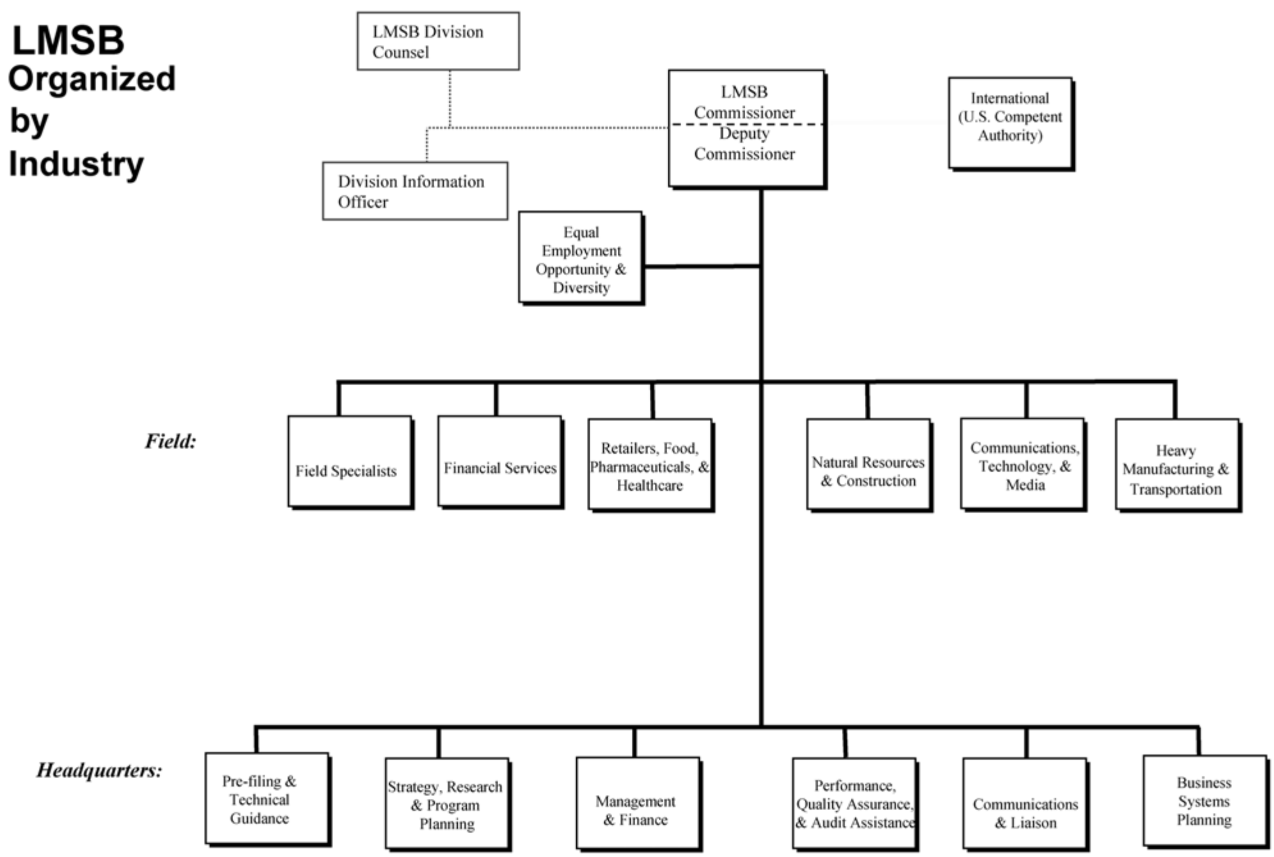
The SB/SE division serves the taxpayer segment through five organizations:

Organization	Mission
Collection	To collect delinquent taxes and secure delinquent tax returns
Compliance Services Campus Operations	To oversee operations of the Brookhaven, Philadelphia, Cincinnati, Memphis, and Ogden campuses
Examination	To make checks of returns filed and select returns for audit
Specialty Taxes	To collect specialty taxes; divided into four market divisions with responsibility for employment tax, excise tax, estate and gift tax, and international tax issues
Communications, Liaison, and Disclosure	To support the IRS mission and business objectives using strategic relationships, communication tools and processes, resolution of issues of mutual concern, product development, and information sharing

The SB/SE division is headquartered in Lanham, Maryland, and provides strategic leadership to all components of the SB/SE organization.

LARGE AND MID-SIZE BUSINESS DIVISION

The Large and Mid-Size Business (LMSB) division is comprised of approximately 210,000 of the largest filers who pay the IRS $712 billion in tax. This operating division is organized into industry segments to best address the needs of unique groups of large businesses. LMSB deals with corporations and partnerships with assets over $10 million. These businesses generally have large employee bases and "in-house" tax and accounting organizations. They also have access to large legal and accounting organizations for the most complex issues. While collection issues are rare, many complex issues such as tax law interpretation, accounting and regulation, and international operations frequently arise. At least 20% of these taxpayers interact with the IRS compliance functions annually, and the largest taxpayers deal with the IRS continuously. LMSB is predominately a field organization that is structured into five industry groups: Communications, Technology, and Media (headquartered in Oakland, CA); Financial Services (headquartered in Manhattan, NY); Heavy Manufacturing and Transportation (headquartered in Metuchen, NJ); Natural Resources and Construction (headquartered in Houston, TX); and Retailers, Food, Pharmaceuticals, and Health Care (headquartered in Chicago, IL). This alignment by industry, versus geography, allows the LMSB to develop staff with deep technical expertise, able to respond proactively to industry trends and needs.



The LMSB division is headquartered in Washington, DC, and maintains field offices throughout the nation. This allows the IRS to meet on-site with taxpayers.

An extensive listing of important contact telephone numbers for the LMSB division can be found at **www.irs.gov/businesses/article/0,,id=134521,00.html** or **www.tinyurl.com/9t5eb**.

TAX-EXEMPT AND GOVERNMENT ENTITIES DIVISION

The Tax-Exempt and Government Entities (TE/GE) division was established in late 1999. This division replaced the former Assistant Commissioner (Employee Plans and Exempt Organizations) function, which was established as a result of the Employee Retirement Income Security Act (ERISA) of 1974.

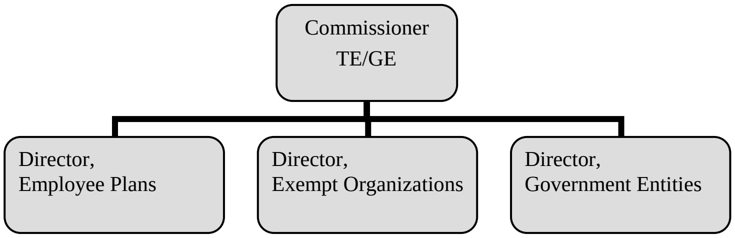
TE/GE is designed to serve the needs of three very distinct customer segments: employee plans, exempt organizations, and government entities. The customers range from small local community organizations and municipalities to major universities, huge pension funds, state governments, Indian tribal governments, and participants of complex tax-exempt bond transactions. These organizations represent a large economic sector with unique needs. Although generally paying no income tax, this sector does pay over $220 billion in employment taxes and income tax withholding, and controls approximately $8.2 trillion in assets. Governed by complex, highly specialized provisions of the tax law, this sector is not designed to generate revenue but rather to ensure that the entities fulfill the policy goals that their tax exempt status was designed to achieve.

The TE/GE division was created to address four key customer needs: education and communication, rulings and agreements, examination, and customer account services. Education and communication efforts focus on helping customers understand their tax responsibilities with outreach programs and activities tailored to their specific needs. Rulings and agreements efforts provide a strong emphasis on up-front compliance programs, such as determination, voluntary compliance, and private letter ruling programs. Examination initiatives identify and address noncompliance through customized activities within each customer segment, and Customer Account Services assists taxpayers with efficient tax filings, as well as provides accurate and timely responses to questions and requests for information.

The commissioner of TE/GE is responsible for the uniform interpretation and application of the federal tax laws on matters pertaining to the division's customer base. In addition, the commissioner provides advice and assistance throughout the IRS, to the Department of the Treasury, and to other governmental agencies including state governments and congressional committees. The commissioner also maintains a close connection with the Department of Labor and the Pension Guaranty Corporation.

TE/GE is comprised of three distinct business divisions:

1. Employee Plans
2. Exempt Organizations
3. Government Entities



The TE/GE division is headquartered in Washington, DC.

PRACTITIONER PROBLEMS

The organizational structure changes should be very beneficial to the IRS and should improve taxpayer service. However, until fully implemented, a practitioner still has a challenge when dealing with a problem. If the problem relates to a client notice and telephone contact is needed, the number shown on the notice should be used. Unless the notice is taken to one of the assistance centers, calling a local office will probably result in the preparer being directed to call the notice number.

If the problem relates to a tax law question, IRS personnel are told to refer both taxpayers and practitioners to the toll free number, where IRS employees have direct responsibility for answering tax questions.

Local telephone numbers for IRS offices can be found on the IRS website at **www.irs.gov/localcontacts/**.

IRS TOLL FREE NUMBERS

Individual problems	1-800-829-1040
Small Business Self-Employed problems	1-800-829-4933
Recorded tax topics	1-800-829-4477
Tax forms	1-800-829-3676

Table 16: Delinquent Collection Activities, Fiscal Years 2001–2004*

Activity	2001	2002	2003	2004
	(1)	(2)	(3)	(4)
Returns filed with additional tax due:				
Total amount collected (thousand dollars) [1]	32,186,839	32,557,571	35,507,826	36,659,487
From first notice of balance due	12,473,959	13,429,083	14,012,871	13,322,399
From subsequent notices of balance due [2]	11,683,382	10,505,694	11,521,248	12,567,170
From taxpayer delinquent accounts and additional actions [3]	8,029,499	8,622,794	9,973,708	10,769,919
Taxpayer delinquent accounts (thousands):				
Number in opening inventory	5,861	5,419	5,687	6,170
Number of issuances or receipts	4,319	4,849	5,379	5,179
Number of dispositions	4,761	4,581	4,896	5,368
Closing inventory:				
Number	5,419	5,687	6,170	5,981
Balance of assessed tax, penalties, and interest (thousand dollars) [4]	40,380,883	44,823,141	46,738,194	50,680,546
Returns not filed timely:				
Delinquent return activity (thousand dollars):				
Net amount assessed [5]	10,175,160	11,578,471	15,117,175	15,635,584
Amount collected with delinquent returns	1,447,864	1,684,382	3,334,442	2,976,681
Taxpayer delinquency investigations (thousands) [6]:				
Number in opening inventory	3,350	2,126	2,138	2,964
Number of issuances or receipts	1,310	1,422	2,490	2,051
Number of dispositions	2,534	1,410	1,664	1,993
Number in closing inventory	2,126	2,138	2,964	3,022
Offers in compromise (thousands) [7]:				
Number of offers received	125	124	128	106
Number of offers accepted	39	29	22	20
Amount of offers accepted (thousand dollars)	340,778	300,296	243,942	275,331
Enforcement activity (actual numbers):				
Number of notices of Federal tax liens filed	426,166	482,509	[r] 544,316	534,392
Number of notices of levy served upon third parties	674,080	1,283,742	1,680,844	2,029,613
Number of seizures	234	296	399	440

[r] - Revised.

[1] Includes previously unpaid taxes on returns filed plus penalties and interest.

[2] Includes payments on installment agreements.

[3] A taxpayer delinquent account is an unpaid balance of assessment plus accruals, where a taxpayer has not paid the balance due in full on a return or an additional assessment. Includes deferred accounts and non-Master File accounts (which include, for example, innocent spouse and transferee assessments).

[4] Includes “assessed” penalties and interest but excludes any “accrued” penalties and interest. Assessed penalties and interest are those that are usually assessed at the same time as the unpaid balance of tax. They are computed on the unpaid balance of tax from the due date of the return to the date of assessment. Accrued penalties and interest are the portion of the total penalties and interest that is not part of the original assessed amounts. They are the difference between the total penalties and interest less the assessed penalties and interest.

[5] Net assessment of tax, penalty, and interest amounts less prepaid credits (withholding and estimated tax payments) of delinquent tax returns secured by Collection activity.

[6] Investigation actions opened subsequent to nonresponse to notice activity for tax returns that have not been filed timely.

[7] An offer in compromise is an agreement, binding both the taxpayer and the Service, which resolves the taxpayer's tax liability where it has been determined that there is doubt as to the taxpayer's liability, doubt as to the Service's ability to collect the balance due, taxpayer does not have the financial ability to full pay the liability within the collection statute expiration date plus 5 years, or there is a serious economic hardship or other exceptional circumstance which warrants acceptance of less than full payment of the taxes owed.

NOTE: Detail may not add to totals because of rounding. All amounts are in current dollars.

SOURCE: IRS Data Book, FY 2004, Publication 55b. Also, Small Business/Self-Employed, Compliance, Compliance Policy, Centralized Workload Selection and Delivery, Collection Management Information Systems and Automation SE:S:C:CP:CW:CMIS

* From IRS Pub. 55B, *Data Book 2004*