

## Chapter 3: IRS Update

IRS Strategic Plan .....	69	Modernized e-File.....	93
Form 990 .....	70	Economic Hardship and the IRS .....	94
Correspondence Audits and Proposed Preparer Penalties .....	78	Trust Fund Recovery Penalty.....	98
2009 Audit Issues .....	80	Foreign Bank Accounts.....	102
Automated Underreporter Issues .....	92	IRS Focuses on S Corporations .....	106

Corrections were made to this workbook through January of 2010. No subsequent modifications were made.

### IRS STRATEGIC PLAN

On April 27, 2009, the IRS published its strategic plan for 2009–2013.<sup>1</sup> Commissioner Douglas Shulman emphasized the IRS mission statement:

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

Shulman listed six trends affecting the IRS in the coming years:

1. Increasing complexity of tax administration;
2. Growing human capital challenges;
3. Explosion in electronic data, online interactions, and related security risks;
4. Accelerating globalization;
5. Expanding role of tax practitioners and other third parties in the tax system; and
6. Accelerating change in business models.

The strategic plan lists the following two goals and objectives.

#### Goal 1. Improve service to make voluntary compliance easier:

- a. Incorporate taxpayer perspectives to improve all service interactions;
- b. Expedite and improve issue resolution across all interactions with taxpayers, making it easier to navigate the IRS;
- c. Provide taxpayers with targeted, timely guidance and outreach; and
- d. Strengthen partnerships with tax practitioners, tax preparers, and other third parties in order to ensure effective tax administration.

<sup>1</sup>. IRS Pub. 3744, *IRS Strategic Plan* (April 2009).

**Goal 2.** Enforce the law to ensure everyone meets their obligations to pay taxes:

- a. Proactively enforce the law in a timely manner while respecting taxpayers' rights and minimizing taxpayer burden;
- b. Expand enforcement approaches and tools;
- c. Meet the challenges of international tax administration;
- d. Allocate compliance resources using a data-driven approach to target existing and emerging high-risk areas;
- e. Continue focused oversight of the tax-exempt sector; and
- f. Ensure that all tax practitioners, tax preparers, and other third parties in the tax system adhere to professional standards and follow the law.

While these are lofty goals and objectives, the IRS is already implementing some of them.

## FORM 990

In August 2008, the IRS released the redesigned Form 990, *Return of Organization Exempt from Income Tax*. The new Form 990 includes a core form that must be completed by most tax-exempt organizations. It also includes schedules that are completed depending on the organization's type and related activities.

The IRS has a 3-year phase-in requirement in order to allow smaller organizations time to adapt to the new form. These organizations can file Form 990-EZ, *Short Form Return of Organization Exempt from Income Tax*. The Form 990-EZ was unchanged, although specific schedules created for the 2008 Form 990 replace certain attachments required by the 2007 Form 990-EZ. The new 2008 Form 990 consists of an 11-page, 11-part core form that is **required** to be completed by all tax-exempt organizations in addition to specific schedules that must be completed by particular organizations. The 2009 Form 990 consists of 12 pages and the same 11-part core.

Form 990 is the primary tax-compliance tool used by the IRS for tax-exempt organizations. In addition, most states rely on Form 990 to perform charitable and other regulatory oversight in addition to satisfying state income tax filing requirements for organizations claiming exemption from state income tax. The Form 990 is a public document which can be obtained from filing organizations, the IRS, and others. It is the key transparency tool relied on by the public, state regulators, media, researchers, and policymakers to obtain information about the tax-exempt sector and individual organizations. Each year, over 500,000 organizations file a Form 990 or Form 990-EZ with the IRS.<sup>2</sup>

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<sup>2</sup> Background Paper, *Summary of Form 990 Redesign Process* (Aug. 19, 2008).

Form **990**Department of the Treasury  
Internal Revenue Service**Return of Organization Exempt From Income Tax**

Under section 501(c), 527, or 4947(a)(1) of the Internal Revenue Code (except black lung benefit trust or private foundation)

▶ The organization may have to use a copy of this return to satisfy state reporting requirements.

OMB No. 1545-0047

**2009****Open to Public Inspection**

<b>A</b> For the 2009 calendar year, or tax year beginning , 2009, and ending , 20									
<b>B</b> Check if applicable: <input type="checkbox"/> Address change <input type="checkbox"/> Name change <input type="checkbox"/> Initial return <input type="checkbox"/> Terminated <input type="checkbox"/> Amended return <input type="checkbox"/> Application pending	<table border="1" style="width:100%; border-collapse: collapse;"> <tr> <td style="width:10%; vertical-align: top;"> <b>C</b> Name of organization            Doing Business As             Number and street (or P.O. box if mail is not delivered to street address) Room/suite             City or town, state or country, and ZIP + 4         </td> <td style="width:10%; vertical-align: top;"> <b>D</b> Employer identification number             :            :            :         </td> <td style="width:10%; vertical-align: top;"> <b>E</b> Telephone number             ( ) :            :         </td> <td style="width:10%; vertical-align: top;"> <b>G</b> Gross receipts \$         </td> </tr> <tr> <td colspan="4"> <b>F</b> Name and address of principal officer:         </td> </tr> </table>	<b>C</b> Name of organization Doing Business As  Number and street (or P.O. box if mail is not delivered to street address) Room/suite  City or town, state or country, and ZIP + 4	<b>D</b> Employer identification number  : : :	<b>E</b> Telephone number  ( ) : :	<b>G</b> Gross receipts \$	<b>F</b> Name and address of principal officer:			
<b>C</b> Name of organization Doing Business As  Number and street (or P.O. box if mail is not delivered to street address) Room/suite  City or town, state or country, and ZIP + 4	<b>D</b> Employer identification number  : : :	<b>E</b> Telephone number  ( ) : :	<b>G</b> Gross receipts \$						
<b>F</b> Name and address of principal officer:									
<b>I</b> Tax-exempt status: <input type="checkbox"/> 501(c) ( ) (insert no.) <input type="checkbox"/> 4947(a)(1) or <input type="checkbox"/> 527									
<b>J</b> Website: ▶									
<b>K</b> Form of organization: <input type="checkbox"/> Corporation <input type="checkbox"/> Trust <input type="checkbox"/> Association <input type="checkbox"/> Other ▶									
<b>L</b> Year of formation: <b>M</b> State of legal domicile:									

<b>Part I Summary</b>			
<b>1</b>	Briefly describe the organization's mission or most significant activities: .....		
<b>2</b>	Check this box <input type="checkbox"/> if the organization discontinued its operations or disposed of more than 25% of its net assets.		
<b>3</b>	Number of voting members of the governing body (Part VI, line 1a) . . . . .	<b>3</b>	
<b>4</b>	Number of independent voting members of the governing body (Part VI, line 1b) . . . . .	<b>4</b>	
<b>5</b>	Total number of employees (Part V, line 2a) . . . . .	<b>5</b>	
<b>6</b>	Total number of volunteers (estimate if necessary) . . . . .	<b>6</b>	
<b>7a</b>	Total gross unrelated business revenue from Part VIII, column (C), line 12 . . . . .	<b>7a</b>	
<b>7b</b>	Net unrelated business taxable income from Form 990-T, line 34. . . . .	<b>7b</b>	
<b>8</b>	Contributions and grants (Part VIII, line 1h) . . . . .	<b>8</b>	
<b>9</b>	Program service revenue (Part VIII, line 2g) . . . . .	<b>9</b>	
<b>10</b>	Investment income (Part VIII, column (A), lines 3, 4, and 7d) . . . . .	<b>10</b>	
<b>11</b>	Other revenue (Part VIII, column (A), lines 5, 6d, 8c, 9c, 10c, and 11e) . . . . .	<b>11</b>	
<b>12</b>	Total revenue—add lines 8 through 11 (must equal Part VIII, column (A), line 12) . . . . .	<b>12</b>	
<b>13</b>	Grants and similar amounts paid (Part IX, column (A), lines 1–3) . . . . .	<b>13</b>	
<b>14</b>	Benefits paid to or for members (Part IX, column (A), line 4) . . . . .	<b>14</b>	
<b>15</b>	Salaries, other compensation, employee benefits (Part IX, column (A), lines 5–10) . . . . .	<b>15</b>	
<b>16a</b>	Professional fundraising fees (Part IX, column (A), line 11e) . . . . .	<b>16a</b>	
<b>16b</b>	Total fundraising expenses (Part IX, column (D), line 25) ▶ . . . . .	<b>16b</b>	
<b>17</b>	Other expenses (Part IX, column (A), lines 11a–11d, 11f–24f) . . . . .	<b>17</b>	
<b>18</b>	Total expenses. Add lines 13–17 (must equal Part IX, column (A), line 25). . . . .	<b>18</b>	
<b>19</b>	Revenue less expenses. Subtract line 18 from line 12 . . . . .	<b>19</b>	
<b>20</b>	Total assets (Part X, line 16) . . . . .	<b>20</b>	
<b>21</b>	Total liabilities (Part X, line 26) . . . . .	<b>21</b>	
<b>22</b>	Net assets or fund balances. Subtract line 21 from line 20. . . . .	<b>22</b>	

<b>Part II Signature Block</b>			
Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than officer) is based on all information of which preparer has any knowledge.			
<b>Sign Here</b>	Signature of officer _____ Date _____		
	Type or print name and title _____		
<b>Paid Preparer's Use Only</b>	Preparer's signature ▶ _____ Firm's name (or yours if self-employed), address, and ZIP + 4 ▶ _____	Date _____ Check if self-employed <input type="checkbox"/>	Preparer's identifying number (see instructions) _____ EIN ▶ _____ Phone no. ▶ ( ) _____
May the IRS discuss this return with the preparer shown above? (see instructions) <input type="checkbox"/> Yes <input type="checkbox"/> No			

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11282Y

Form **990** (2009)

## REASONS FOR REDESIGN

The last significant revision of Form 990 occurred in 1979. Consequently, the form needed a major overhaul. The old form failed to reflect changes in the law and the increasing size, diversity, and complexity of the tax-exempt sector. The old form no longer adequately served the IRS's tax-compliance interests or met the transparency and accountability needs of the states, the public, and communities served by the organizations.

The IRS extensively revised the form's format and content based on three guiding principles: enhancing transparency, promoting tax compliance, and minimizing burden on the filing organization. Some of the major revisions include the following:

- A new summary page
- A new governance section
- Enhanced reporting of executive compensation and the organization's relationships with insiders and other organizations
- New reporting for noncash contributions, foreign activities, tax-exempt bonds, and hospitals

## NEW SUMMARY PAGE

The new summary page provides a snapshot of financial, governance, and operational information, including a 2-year comparison of key financial data.

**Part I Summary**

**1** Briefly describe the organization's mission or most significant activities: \_\_\_\_\_

**2** Check this box ☐ if the organization discontinued its operations or disposed of more than 25% of its net assets.

**3** Number of voting members of the governing body (Part VI, line 1a) . . . . . **3**

**4** Number of independent voting members of the governing body (Part VI, line 1b) . . . . . **4**

**5** Total number of employees (Part V, line 2a) . . . . . **5**

**6** Total number of volunteers (estimate if necessary) . . . . . **6**

**7a** Total gross unrelated business revenue from Part VIII, column (C), line 12 . . . . . **7a**

**7b** Net unrelated business taxable income from Form 990-T, line 34. . . . . **7b**

		Prior Year	Current Year
<b>Revenue</b>	<b>8</b> Contributions and grants (Part VIII, line 1h) . . . . .		
	<b>9</b> Program service revenue (Part VIII, line 2g) . . . . .		
	<b>10</b> Investment income (Part VIII, column (A), lines 3, 4, and 7d) . . . . .		
	<b>11</b> Other revenue (Part VIII, column (A), lines 5, 6d, 8c, 9c, 10c, and 11e) . . . . .		
	<b>12</b> Total revenue—add lines 8 through 11 (must equal Part VIII, column (A), line 12) . . . . .		
<b>Expenses</b>	<b>13</b> Grants and similar amounts paid (Part IX, column (A), lines 1–3) . . . . .		
	<b>14</b> Benefits paid to or for members (Part IX, column (A), line 4) . . . . .		
	<b>15</b> Salaries, other compensation, employee benefits (Part IX, column (A), lines 5–10) . . . . .		
	<b>16a</b> Professional fundraising fees (Part IX, column (A), line 11e) . . . . .		
	<b>b</b> Total fundraising expenses (Part IX, column (D), line 25) ▶ . . . . .		
	<b>17</b> Other expenses (Part IX, column (A), lines 11a–11d, 11f–24f) . . . . .		
	<b>18</b> Total expenses. Add lines 13–17 (must equal Part IX, column (A), line 25) . . . . .		
<b>Net Assets or Fund Balances</b>	<b>19</b> Revenue less expenses. Subtract line 18 from line 12 . . . . .		
	<b>20</b> Total assets (Part X, line 16) . . . . .	Beginning of Current Year	End of Year
	<b>21</b> Total liabilities (Part X, line 26) . . . . .		
	<b>22</b> Net assets or fund balances. Subtract line 21 from line 20. . . . .		

**Signature Block**

## NEW GOVERNANCE SECTION

The new Form 990 includes a section on governance, which consists of three parts:

1. Composition of the organization's governing body
2. The organization's governance and management policies
3. Disclosure practices

The governance section requests information about policies and practices that are not required by federal tax law. The instructions also explain that an organization should consider its own facts and circumstances, including its size, type, and culture, when deciding whether to adopt or revise its policies and practices.

Form 990 (2009) Page **6**

**Part VI Governance, Management, and Disclosure** For each "Yes" response to lines 2 through 7b below, and for a "No" response to line 8a, 8b, or 10b below, describe the circumstances, processes, or changes in Schedule O. See instructions.

**Section A. Governing Body and Management**

	Yes	No
<b>1a</b> Enter the number of voting members of the governing body . . . . .		
<b>b</b> Enter the number of voting members that are independent . . . . .		
<b>2</b> Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee? . . . . .		
<b>3</b> Did the organization delegate control over management duties customarily performed by or under the direct supervision of officers, directors or trustees, or key employees to a management company or other person? . . . . .		
<b>4</b> Did the organization make any significant changes to its organizational documents since the prior Form 990 was filed? . . . . .		
<b>5</b> Did the organization become aware during the year of a material diversion of the organization's assets? . . . . .		
<b>6</b> Does the organization have members or stockholders? . . . . .		
<b>7a</b> Does the organization have members, stockholders, or other persons who may elect one or more members of the governing body? . . . . .		
<b>7b</b> Do the actions of the governing body subject to approval by members, stockholders, or other persons? . . . . .		

## REVISED REPORTING OF COMPENSATION AND INSIDER TRANSACTIONS

Form 990 significantly revises the reporting of executive compensation and transactions with interested persons. In part VII, all organizations must list their officers, directors, trustees, and key employees, regardless of whether they were compensated, and report compensation paid by the organization and related organizations to such persons. The instructions provide new definitions of these terms. Therefore, the reporting of particular persons may differ from earlier years. Furthermore, the form extends the reporting of compensation paid to the organization's five highest-compensated individuals, and five highest-paid independent contractors, beyond charities (as was previously the case) to all filing organizations. The reporting threshold for the top five highest-compensated employees and highest-paid independent contractors was raised from \$50,000 to \$100,000. All organizations must report basic compensation information for such persons on the core form.

Compensation reporting for most organizations was simplified by requiring compensation to be reported based on the amounts reported on Form W-2 or Form 1099-MISC. Certain compensation not reported on Form W-2, such as retirement plan, health benefits, and deferred compensation, must also be reported on Form 990. In general, organizations that pay compensation greater than \$150,000 to a person who is required to be listed in the core form must provide additional compensation detail and information in Schedule J, *Compensation Information*.

Form 990 revises the reporting of transactions between the organization and certain interested persons. This information must be described in the new Schedule L, *Transactions with Interested Persons*. This schedule requires reporting of excess benefit transactions, loans, grants, and other financial assistance, as well as business transactions involving interested persons.



## MORE SCHEDULES, FEWER ATTACHMENTS

Form 990 has schedules which are completed only by organizations that engage in activities for which reporting is required. Many of these schedules replace “unstructured attachments,” which were required by the old form. Some of these schedules replace parts of the 2007 Schedule A, *Organization Exempt under Section 501(c)(3)*, which was streamlined to focus exclusively on an organization’s public charity status and public support. Organizations that previously filed Schedule A should review the filing requirements for new Schedules A, C, E, and R to determine whether they must complete any of these schedules.

Other new schedules include Schedule C, *Political Campaign and Lobbying Activities*; Schedule F, *Statement of Activities Outside the United States*; Schedule H, *Hospitals*; Schedule K, *Supplemental Information on Tax-Exempt Bonds*; Schedule M, *Noncash Contributions*; and Schedule R, *Related Organizations and Unrelated Partnerships*.

## MINIMIZE REPORTING BURDEN

Form 990 eliminated or revised reporting of many items, thus reducing the reporting burden for many organizations. This is accomplished through the use of reporting thresholds and exceptions, reporting by type rather than by transaction in some cases, and eliminating attachments or schedules in others. The various tools contained in the new instructions, such as the glossary and sequencing list, also should help minimize the reporting burden.

## LISTING OF 2008 CORE FORM PARTS I THROUGH XI

The Form 990 core form is required to be completed by all tax-exempt organizations. Parts I, IV, VI, and XI are new. Part VII is significantly revised from 2007. Parts II, III, V, and VIII through X generally request information required by the 2007 form.

Form 990 consists of the following parts:

- Part I. Summary** contains certain important information regarding the organization’s mission, activities, and current and prior years’ financial results.
- Part II. Signature Block** requires the signature of an organization’s officer and, if applicable, paid preparer.
- Part III. Statement of Program Service Accomplishments** requires reporting of the organization’s new, ongoing and discontinued exempt-purpose achievements and related revenue and expenses.
- Part IV. Checklist of Required Schedules** determines which schedules the organization must complete and file with the IRS as part of the Form 990.
- Part V. Statements Regarding Other IRS Filings and Tax Compliance** reports the organization’s compliance with other federal tax reporting and substantiation requirements.
- Part VI. Governance, Management, and Disclosure** requires information regarding the organization’s governing body and management, policies, and disclosure practices.
- Part VII. Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors** reports compensation paid and reported on Forms W-2 and 1099-MISC, and certain other compensation.
- Part VIII. Statement of Revenue**
- Part IX. Statement of Functional Expenses**
- Part X. Balance Sheet**
- Part XI. Financial Statements and Reporting** reports information regarding the organization’s accounting methods and its compiled, reviewed, or audited financial statements.

Parts VIII, IX, and X comprise the financial statements of the organization for federal tax reporting purposes.

## LISTING OF FORM 990 SCHEDULES

Form 990 now contains schedules that may need to be completed by an organization. The following is a list and brief description of the new form's schedules:

- **Schedule A, *Public Charity Status and Public Support***, is completed by organizations described in sections 501(c)(3) and 4947(a)(1) to provide information relevant to their status as public charities, including satisfaction of applicable public support tests on an ongoing basis.
- **Schedule B, *Schedule of Contributors***, provides information regarding contributions the organization reports as revenues.
- **Schedule C, *Political Campaign and Lobbying Activities***, is completed by organizations that conduct political campaign activities, organizations described in sections 501(c)(3) and 4947(a)(1) that conduct lobbying activities, and organizations subject to section 6033(e) notice and reporting requirements and potential proxy tax on certain membership dues, assessments, and similar amounts.
- **Schedule D, *Supplemental Financial Statements***, is completed by organizations to supplement certain balance sheet information, as well as conservation organizations, museums and other organizations maintaining collections, credit counseling organizations and others holding funds in escrow or custodial arrangements, and organizations maintaining endowments, donor advised funds, or other similar funds or accounts.
- **Schedule E, *Schools***, is the private school questionnaire previously contained in the former Schedule A.
- **Schedule F, *Statement of Activities Outside the United States***, reports the organization's activities conducted outside the United States.
- **Schedule G, *Supplemental Information Regarding Fundraising or Gaming Activities***, requires reporting by organizations that reported certain amounts of professional fundraising expenses, revenue from fundraising events and gaming activities.
- **Schedule H, *Hospitals***, is completed by organizations that operate one or more facilities licensed, registered, or similarly recognized as a hospital under state law.
- **Schedule I, *Grants and Other Assistance to Organizations, Governments and Individuals in the U.S.***, reports grants and other assistance provided by the organization to others within the United States.
- **Schedule J, *Compensation Information***, is completed by organizations to provide more detailed compensation information for certain officers, directors, trustees, key employees, and highest-compensated employees listed in Part VII of the core form, and reports certain information regarding the organization's compensation practices and arrangements.
- **Schedule K, *Supplemental Information on Tax-Exempt Bonds***, is completed by organizations with outstanding tax-exempt bond liabilities.
- **Schedule L, *Transactions with Interested Persons***, is completed by organizations that engage in certain types of relationships or transactions with interested persons, including excess benefit transactions, loans, grants or other financial assistance, and other financial or business transactions or arrangements.
- **Schedule M, *Noncash Contributions***, reports contributions other than cash received by the organization.
- **Schedule N, *Liquidation, Termination, Dissolution or Major Disposition of Assets***, reports major dispositions of assets by the organization.
- **Schedule O, *Supplemental Information to Form 990***, is used by organizations to provide supplemental information to describe or explain the organization's responses to questions contained in the core form or schedules.
- **Schedule R, *Related Organizations and Unrelated Partnerships***, provides information regarding the organization's relationships with other exempt and taxable organizations.

# 2009 Workbook

Many of the schedules or parts of schedules contain reporting exceptions or thresholds that may exempt an organization from having to complete that schedule or part of a schedule. Organizations should complete Part IV, *Checklist of Required Schedules*, to determine which of these schedules they must file as part of the Form 990. Schedules P and Q are reserved for future use.

**Note.** Additional details on the changes made to Form 990 are located at [www.irs.gov](http://www.irs.gov).

## INCREASED FORM 990-EZ FILING AMOUNTS

To address the sector's transition concerns, Form 990 will be phased in over three years. This will be accomplished by allowing significant numbers of small organizations to file the Form 990-EZ, rather than the new Form 990 for 2008 and 2009. Beginning with the 2008 tax year, an organization may file a Form 990-EZ if it satisfies both the gross receipts and assets tests as shown below:

	Gross Receipts	Assets
2008 tax year (filed in 2009)	>\$25,000 and <\$1 million	<\$2.5 million
2009 tax year (filed in 2010)	>\$25,000 and <\$500,000	<\$1.25 million
2010 and later tax years	>\$50,000 and <\$200,000	<\$500,000

These adjustments to the Form 990-EZ filing amounts will increase the percentage of organizations eligible to file a Form 990-EZ from 41% for the 2007 tax year to approximately 76% for the 2008 tax year. The IRS estimates the number of additional organizations eligible to file Form 990-EZ will be approximately 185,000 and 140,000 for 2008 and 2009, respectively.

## TRANSITION RELIEF FOR SCHEDULES FOR HOSPITALS AND TAX-EXEMPT BONDS

Schedule H, *Hospitals*, and Schedule K, *Supplemental Information on Tax-Exempt Bonds*, require significantly more reporting. Organizations required to complete either of these schedules for 2008 are only required to complete one part for each schedule: Part V, *Facility Information*, for Schedule H, and Part I, *Bond Issues*, for Schedule K. The other parts of these schedules are optional for 2008. However, they are required beginning with the 2009 tax year.

## SMALL TAX-EXEMPT ORGANIZATIONS

There are new annual electronic filing requirements for small tax-exempt organizations. Most small tax-exempt organizations (those normally with annual gross receipts up to \$25,000) now must file new Form 990-N, *Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ*. More information can be found on the IRS website at [www.irs.gov](http://www.irs.gov), under the Charities & Non-Profits tab.



## NEW ONLINE COURSES AT STAYEXEMPT.ORG

**StayExempt.org**, the web-based version of the popular IRS Exempt Organization (EO) workshops, has added new mini-courses on the redesigned IRS Form 990. The site now has the original five virtual workshop sessions, five mini-courses that cover topics important to tax-exempt organizations, and five mini-courses discussing aspects of the redesigned annual return (Form 990) for exempt organizations.

The new mini-courses for Form 990 include:

- **Preparing to File the New Form 990:** An overview of the changes in the form and tips for getting ready to file it
- **The Redesign Form 990 — Part I:** General instructions for completing the form and a walk-through of the heading and financial sections
- **The Redesign Form 990 — Part II:** A walk-through of the accomplishments, compliance, and compensation sections
- **The Redesign Form 990 — Part III:** A walk-through of the governance, management, disclosure, and summary sections; the checklist of required schedules; and Schedule A
- **The Redesign Form 990 — Part IV:** A walk-through of Schedules C, F, G, I, M, and R

The mini-courses on **StayExempt.org** are:

- **Navigating IRS EO Resources:** Explains how to use **www.irs.gov** and find workshops, outreach events, and publications
- **Political Campaigns and Charities:** Explains the ban on intervening in political campaign activities by tax-exempt and charitable organizations
- **Can I Deduct My Charitable Contributions?:** Explains what is deductible and what is not
- **The Wonderful World of Foundation Classification — Part I:** Covers two common types of classifications for 501(c)(3) organizations
- **Applying for Tax-Exempt Status:** Explains how to make the application process easier and quicker for new organizations

The five interactive virtual workshop sessions are:

- **Tax-Exempt Status:** How can you keep your 501(c)(3) exempt?
- **Unrelated Business Income:** Does your organization generate taxable income?
- **Employment Issues:** How should you treat your workers for tax purposes?
- **Form 990:** What records should your organization keep in order to file an accurate Form 990?
- **Required Disclosures:** What items are open to public inspection, and what disclosures are exempt organizations required to make?

Users can complete the modules in any order and repeat them as many times as needed. **StayExempt.org** does not require registration and visitors remain anonymous.

## IRS EXEMPT ORGANIZATIONS' NONFILER INITIATIVE<sup>3</sup>

### Gaming

In fiscal year 2007 and 2008, EO secured and researched 18 state databases to identify organizations that had filed information with the state, but failed to file a Form 990, 990-EZ, or 990-N with the IRS. They found organizations that were involved in gaming sometimes failed to file returns and/or failed to report gaming activity or withhold income tax, pay employment taxes, or report unrelated business income with the IRS or state tax agency. Analysis of the state database information identified 800 organizations that failed to file Form 990. The examinations uncovered numerous other delinquent filings including Forms 990-T, 940, 941, 945, 730, and 11C. The examinations are continuing in 2009.

### Employment Taxes

This initiative compares Form W-2 data reported to the Social Security Administration (SSA) with employer Form 941 data reported to the IRS. Using a matching program, the IRS seeks to obtain delinquent employment tax forms, resolve inconsistencies in forms on file, and correct inaccurate credit balances on employment tax modules.

### Form 990 Nonfilers

EO will continue to identify potential nonfilers in three categories:

1. Form 990 and 990-PF intermittent filers with reported high-dollar gross receipts;
2. Form 990-T filers showing substantial unrelated business income gross receipts without a corresponding Form 990 filing; and
3. Form 1098-C, *Contribution of Motor Vehicles, Boats, and Airplanes*, filers reporting high-dollar donations to their organizations without a corresponding Form 990.

## CORRESPONDENCE AUDITS AND PROPOSED PREPARER PENALTIES

In an effort to reduce the tax gap, the IRS allocated more resources to taxpayer audits, many of which will be conducted by correspondence. This causes increased concern for tax practitioners because their clients could be involved in an audit without the knowledge of the preparer. If the IRS makes changes to the return, they may assess an accuracy-related penalty under IRC §6662.

The two most common taxpayer penalties under §6662 are:

- Negligence or disregard of rules or regulations,<sup>4</sup> and
- Substantial understatement of income tax.<sup>5</sup>

“Substantial understatement” is defined as the greater of 10% of the tax required to be shown for the tax year or \$5,000.

A taxpayer may be able to avoid the §6662 penalty using a reasonable cause argument. Reliance on the advice of a tax professional is often considered cause for the IRS to abate the penalty.

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<sup>3</sup>. Letter from the Director, Tax Exempt and Government Entities (Nov. 2008).

<sup>4</sup>. IRC §6662(b)(1).

<sup>5</sup>. IRC §6662(b)(2).

**Example 1.** Unbeknownst to tax preparer Julie, her client is the subject of a correspondence audit. The IRS determines a certain deduction is not allowed. It increases the client's tax liability and assesses a §6662 penalty. The taxpayer argues against the assessment of the penalty because Julie told him the deduction was appropriate. He even sends a copy of a note given to him by Julie saying this was a valid deduction. The IRS decides to not assess the §6662 penalty.

This is not the end of the story. Next, the IRS decides to assess an IRC §6694 penalty against the tax preparer. This is the "sister" penalty of §6662. It is also assessed due to negligence or disregard of the rules or substantial understatement of the tax liability. The penalty is only assessed against the preparer if the IRS believes the understatement was due to a preparer's action or the preparer had knowledge that the return contained erroneous information.

The following table shows §6662 penalty statistics of IRS assessments based on fiscal year 2008. This data does not include penalties assessed against tax preparers. However, the IRS also determines whether a penalty should be assessed against the preparer.

Type of Tax and Type of Penalty	Civil Penalties Assessed <sup>a</sup>		Civil Penalties Abated <sup>a,b</sup>	
	Number	Amount	Number	Amount
Individual income tax (accuracy) <sup>c</sup>	391,621	\$904,206,000	48,326	\$216,870,000
Corporation income tax (accuracy)	3,355	572,514,000	138	183,068,000

<sup>a</sup> Penalties assessed and abatements of penalties included here were recorded in fiscal year 2008 regardless of the tax year to which the penalty may apply.

<sup>b</sup> An abatement is a reduction of assessed penalties. The IRS may approve an abatement of a penalty for IRS error, reasonable cause, administrative and collection costs not warranting collection of penalty, discharge of penalty in bankruptcy, and the IRS's acceptance of partial payment of assessed penalty.

<sup>c</sup> Includes penalties for negligence; substantial understatement of income tax; substantial valuation misstatement; substantial overstatement of pension liabilities; substantial estate or gift tax valuation understatement (under IRC §6662); and understatement of reportable transactions (under IRC §6662A). Also includes penalties related to negligence or disregard of rules and regulations (under IRC §6653(a)) assessed on returns due before January 1, 1990.

SOURCE: *Internal Revenue Service Data Book*, 2008

According to this data, the average accuracy penalty under §6662 is \$2,300 per individual. For corporate returns, the average penalty is \$170,645.

## 2009 AUDIT ISSUES

It is very difficult to obtain information about future audit issues from the IRS Small Business/Self Employed (SB/SE) division. However, one tax litigation consultant offers his opinion. The following material is reprinted with permission of the author.

### **IRS PROMISES TO GET MORE AGGRESSIVE IN 2009<sup>6</sup>**

#### ***Small businesses, self-employed are likely targets***

*The head of the Small Business/Self-Employed division of the Internal Revenue Service (IRS) has promised more audit activity in 2009.*

*Faris Fink, who runs the division focusing on the nation's small businesses and the millions of self-employed persons, outlined a broad approach to increasing audit coverage of a wide range of business forms, saying, "That is where we are seeing the most abuse."*

*The IRS intends to look closely at flow-through entities that issue K-1s but report no wages paid. Such entities file an information return, but the profit or loss flows through to the owners, who report the income or loss on their own tax returns. These include subchapter S corporations and partnerships.*

#### ***Questions Over Wages***

*In each case, the entity's tax return carries no tax liability; it simply reports income and expenses. The IRS intends to ferret out ignorance and abuse on the part of tax professionals and taxpayers alike over whether and to what extent self-employed owners of these businesses must pay themselves a salary.*

*The issue is important to the IRS because profits taken as distributions other than salary are not subject to social security taxes. By minimizing salary, a taxpayer can reduce his or her payroll tax hit.*

*However, the IRS, tax code, and courts declare such entities must pay their employees a salary commensurate with the fair market value of the services they render. That means self-employed owners must draw a salary and cannot take all their compensation in the form of distributions not taxable for social security.*

*The ignorance comes in when small business owners do not understand they must pay themselves a salary subject to social security taxes. The abuse comes in when they know it but simply do not obey. The IRS's audit program will focus on this issue.*

#### ***Expanding Audit Areas***

*Several other areas will attract IRS attention next year.*

*The IRS will increase the number of correspondence audits. The agency can audit many more people through the correspondence process than it can in a face-to-face environment. Hence, it will focus resources on the correspondence process for the vast majority of low- and middle-income citizens.*

*Even in the current National Research Program audit cycle, which is targeting 13,000 tax returns for audit, 5,000 of those will be done in whole or in part through the correspondence process.*

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<sup>6</sup> Dan Pilla (comments@taxhelponline.com) is a tax litigation consultant and author of numerous books on IRS abuse prevention and cure and problem-resolution issues. His newest book is *IRS, Taxes and the Beast*. He also publishes the *Pilla Talks Taxes* newsletter. This article appeared in the June/July 2008 issue of *Pilla Talks Taxes*. Used with permission. This was also published in *Budget and Tax News*, October 2008, by The Heartland Institute.

*The IRS will continue its use of “fraud specialists.” For some time the IRS has been working to increase the number of tax fraud prosecutions by (a) incorporating more-sophisticated fraud detection training for tax examiners and (b) planting “fraud technical advisors” directly into existing examination teams. The new head of the IRS’s Criminal Investigation (CI) function, Eileen Mayer, says the IRS will continue using these fraud specialists as consultants in ongoing examinations.*

*These advisors are senior examination agents or revenue officers specially trained and experienced in detecting tax fraud. They guide auditors in spotting potential fraud.*

*CI will continue to target “legal source income cases,” ones involving legitimate businesses, not drug dealers, organized crime figures, etc. The IRS will focus heavily on employment tax cases, including failure to pay employment taxes, failure to file employment tax returns, conspiracy to evade employment taxes, and filing false employment tax returns. IRS officials declare this area of criminal law enforcement is “not dormant anymore.”*

### **Increasing Audit Activity**

*The IRS will also target more medium-sized corporations. Corporations with income up to \$10 million will see more audit activity in the coming year. Though this is not said to be a major focus of IRS’s increased audit activity, the agency will strive to increase audits of these corporations.*

*Another new “major focus” will be on worker classification cases. These center on whether a worker is properly classified as an independent contractor or an employee. Many companies seek to save money by classifying workers as independent contractors, as it cuts employment taxes and compliance burdens. However, when those workers are misclassified, the IRS imposes substantial taxes and penalties.*

*John Tuzynski, the IRS’s chief of employment tax issues, promises “a nice increase” in the number of employment tax cases over the next year. This will be a major focus for the IRS, and the agency has entered into data-sharing agreements with a number of state tax departments.*

*The agency will provide employment tax training manuals to the states, train state tax examiners in these issues, and provide leads to states on noncompliant businesses and information on cash payments made by employers to their workers. Tuzynski promises the IRS is “extending this [agreement] out to all 50 states.”*

### **Going After Preparers**

*The IRS will also put the crosshairs on tax return preparers. For years, the IRS has been squeezing tax preparers and their representatives. I have stated many times that the combination of preparer penalties and intimidation by the IRS against representatives show the agency wants to make the tax professional community into nothing more than tax collectors paid by the private sector.*

*The IRS promises it will “aggressively pursue preparers” who “push the envelope” with their clients by systematically employing improper strategies for them. It is currently pursuing about 108 preparer examination cases, where the IRS selects for audit dozens of tax returns prepared by a given tax professional.*

*Preparer examination cases can lead to (a) preparer penalties, including the section 6701 penalty for advocating abusive tax schemes, (b) civil lawsuits by the Justice Department for injunctions, and (c) criminal prosecution in the most egregious cases.*

**Note.** The IRS announced they are hiring an additional 1,700 revenue agents and 1,100 revenue officers in 2009. There is continuing emphasis in this same area for 2010.



# 2009 Workbook

## AUDIT STATISTICS

The following statistics are from *Internal Revenue Service Data Book, 2008*. The entire book may be obtained from the IRS website ([www.irs.gov](http://www.irs.gov)). It is located under the heading “Tax Stats” on the home page.

### For Calendar Year 2007

Returns filed	183,052,945
Returns examined in fiscal year 2008	1,540,771
Percentage covered	0.8%
Field	430,560
Correspondence	1,110,211
Recommended additional tax	\$43,437,364,000
Field	36,729,140,000
Correspondence	6,708,224,000
Average recommended additional tax per return	
Field	\$85,306
Correspondence	6,042

The table on the following pages shows the percentage of the various types of returns audited.

Based on these numbers, it is obvious the IRS is dedicating the majority of its audit resources to corporation and high-income individual income tax returns.

# 2009 Workbook

## Returns Examined in Fiscal Year 2008<sup>a</sup>

	Percent	Number	
		Field	Correspondence
<b>United States, total</b>	0.8	430,560	1,110,211
<b>Taxable returns:</b>			
1. Individual income tax returns, total	1.0	310,429	1,081,152
a. Returns with total positive income under \$200,000: <sup>b</sup>			
(1) Nonbusiness returns without earned income tax credit:			
Without Schedules C, E, F, or Form 2106 <sup>c</sup>	0.4	36,433	306,525
With Schedule E or Form 2106 <sup>d</sup>	1.3	55,327	150,105
(2) Business returns without earned income tax credit:			
Nonfarm business returns by size of total gross receipts: <sup>e</sup>			
< \$25,000	1.2	47,146	75,175
\$25,000 < \$100,000	1.9	29,133	30,606
\$100,000 < \$200,000	3.8	23,582	12,549
\$200,000+	3.1	20,088	2,781
Farm returns	0.6	3,608	3,934
(3) Business and nonbusiness returns with earned income tax credit by size of total gross receipts: <sup>e,f</sup>			
< \$25,000	2.0	14,130	396,759
\$25,000+	3.5	27,248	24,120
b. Returns with total positive income of at least \$200,000 and under \$1,000,000: <sup>b</sup>			
Nonbusiness returns	2.6	19,046	52,960
Business returns	2.8	22,296	14,575
c. Returns with total positive income of \$1,000,000 or more <sup>b</sup>	5.6	12,233	9,641
d. International returns <sup>g</sup>	1.3	159	1,422
2. Corporation income tax returns, except Form 1120S, total <sup>h</sup>	1.3	28,373	2,044
a. Returns other than Form 1120-F: <sup>i</sup>			
(1) Small corporations <sup>j</sup>	1.0	18,783	1,797
No balance sheet returns	0.4	1,843	81
Balance sheet returns by size of total assets:			
< \$250,000	0.8	7,580	1,493
\$250,000 < \$1,000,000	1.4	4,924	106
\$1,000,000 < \$5,000,000	2.0	3,496	89
\$5,000,000 < \$10,000,000	3.1	940	28
(2) Large corporations <sup>k</sup>	15.3	9,205	201
Balance sheet returns by size of total assets:			
\$10,000,000 < \$50,000,000	11.7	3,778	55
\$50,000,000 < \$100,000,000	11.7	871	22
\$100,000,000 < \$250,000,000	12.8	1,006	20
\$250,000,000 < \$500,000,000	14.2	635	17
\$500,000,000 < \$1,000,000,000	18.6	606	18
\$1,000,000,000 < \$5,000,000,000	31.2	1,197	34
\$5,000,000,000 < \$20,000,000,000	64.2	652	26
\$20,000,000,000+	127.1 <sup>l</sup>	460	9
b. Form 1120-F returns <sup>i</sup>	1.6	385	46

See next page for footnotes.

3

# 2009 Workbook

## Returns Examined in Fiscal Year 2008<sup>a</sup> (Continued)

	Percent	Number	
		Field	Correspondence
3. Estate and trust income tax returns	0.1	993	3,589
4. Estate tax returns, total	8.1	m	m
Size of gross estate:			
< \$5,000,000	5.6	m	m
\$5,000,000+	19.4	1,670	0
5. Gift tax returns	0.4	m	m
6. Employment tax returns	0.2	43,726	16,620
7. Excise tax returns	1.8	13,477	2,657
8. Other taxable returns <sup>n</sup>	o	1,751	192
<b>Nontaxable returns:</b>			
1. Partnership returns	0.4	10,757	2,446
2. S corporation returns <sup>p</sup>	0.4	15,845	789
3. Estate and trust returns	o	288	720

<sup>a</sup> Excludes excise tax returns filed with the Customs Service and the Alcohol and Tobacco Tax and Trade Bureau, and returns of tax-exempt organizations, government entities, and employee plans.

<sup>b</sup> In general, total positive income is the sum of all positive amounts shown for the various sources of income reported on the individual income tax return and, thus, excludes losses. Examinations of individual income tax returns are shown in this table by total positive income of: under \$200,000; at least \$200,000 and under \$1,000,000; and \$1,000,000 or more.

<sup>c</sup> Includes Forms 1040 without a Schedule C (nonfarm sole proprietorship), Schedule E (supplemental income and loss), Schedule F (profit or loss from farming), or Form 2106 (employee business expenses).

<sup>d</sup> Includes Forms 1040 with a Schedule E (supplemental income and loss) or Form 2106 (employee business expenses). Excludes returns with a Schedule C (nonfarm sole proprietorship) or Schedule F (profit or loss from farming).

<sup>e</sup> "Total gross receipts" is the sum of gross receipts from farm and nonfarm businesses. It is calculated by adding the positive values of gross receipts and other income from Schedule C to the cost of purchased items and gross income (which can be positive or negative) from Schedule F. Schedule C is used to report profit or loss from nonfarm sole proprietorships. Schedule F is used to report profit or loss from farming. If a taxpayer reports both farm and nonfarm income, the return is classified by the larger source of income.

<sup>f</sup> Includes all Forms 1040, those with and without business income, reporting an earned income tax credit claim. These returns are classified by size of total gross receipts. Business returns have total gross receipts reported on Schedule C (nonfarm sole proprietorship) or Schedule F (profit or loss from farming). Nonbusiness returns, those with no Schedules C or F, are reported in the "Under \$25,000" classification.

<sup>g</sup> Includes Forms 1040PR (self-employment tax form for Puerto Rico) and 1040-SS (self-employment tax form for U.S. Virgin Islands, Guam, American Samoa, and the Northern Mariana Islands).

<sup>h</sup> Includes Forms 1120 ("long form"); 1120-A ("short form"); 1120-F (foreign corporation, except foreign life insurance company); 1120-H (homeowner association); 1120-L (life insurance company); 1120M (mutual insurance company); 1120-PC (property and casualty insurance company); 1120-POL (certain political association); 1120-REIT (real estate investment trust); 1120-RIC (regulated investment company); and 1120-SF (settlement fund). Excludes certain other types of corporations, which are included in "other taxable returns" described in footnote n.

<sup>i</sup> Form 1120-F is filed by a foreign corporation with U.S. income, other than a foreign life insurance company (Form 1120-L) or a foreign sales corporation (Form 1120-FSC).

<sup>j</sup> Includes returns with assets of less than \$10 million examined by either the Small Business/Self-Employed Operating Division or the Large and Mid-Size Business Operating Division.

<sup>k</sup> Includes returns with assets of \$10 million or more examined by either the Small Business/Self-Employed Operating Division or the Large and Mid-Size Business Operating Division.

<sup>l</sup> The percentage of returns examined may be greater than 100 percent of the returns filed in calendar year 2007 since examinations may be conducted on returns filed in prior calendar years.

<sup>m</sup> Not shown to avoid disclosure of information about specific taxpayers. However, the data are included in the appropriate totals.

<sup>n</sup> Includes Forms 1120S for an S corporation reporting a tax (see footnote p); 1120-FSC (foreign sales corporation); 8288 (withholding tax return for disposition by foreign persons of U.S. property interests); 990-C (farmers' cooperative association); and 8804 (partnership withholding).

<sup>o</sup> Not tabulated.

<sup>p</sup> Includes most Forms 1120S, which are filed by qualifying S corporations electing to be taxed through shareholders. Under certain conditions, S corporations are subject to tax and are included in "other taxable returns" in this table. See footnote n.

NOTE: Detail may not add to totals because of rounding.

SOURCE: Internal Revenue Service Data Book, 2008

## LARGE AND MID-SIZE BUSINESS DIVISION (LMSB)

LMSB classifies future audit issues in tiers.

### Tier I — High Strategic Importance

Tier I issues are those with high strategic importance and have significant impact on one or more industries. They could include areas involving a large number of taxpayers, significant dollar risks, substantial compliance risk, or high visibility. Tier I includes recognized abusive and listed transactions as well as other “high risk” transactions and issues that represent LMSB’s highest compliance priorities.

A fact sheet from April 3, 2009, lists the following Tier I issues:

- §118 abuse
- §199 domestic production deduction
- §936 exit strategies
- Foreign income repatriation
- Foreign tax credit generators
- International hybrid instrument transactions
- Mixed service costs
- Research credit claims
- Transfer of intangibles/offshore cost sharing
- U.S. withholding agents §1441 reporting and withholding on U.S. source FDAP income

### Tier II — Significant Compliance Risk

Tier II issues reflect areas of potential high noncompliance and/or significant compliance risk to LMSB or an industry. Tier II includes emerging issues in which the law is fairly well established but there is need for further development, clarification, direction, and guidance on LMSB’s position.

Following are the Tier II issues:

- Casualty loss: single identifiable property/capital vs. repairs
- Cost-sharing stock-based compensation
- §43 enhanced oil recovery credit
- Extraterritorial income exclusion effective date and transition rules
- Gift cards deferral of income
- Healthcare accounting issues: contractual allowance
- Interchange and merchant discount fees
- Nonperforming loans
- §172(f) specified liability losses
- Super completed contract method
- Upfront fees, milestone payments, and royalties in biotech and pharmaceutical industries

## Tier III — Industry Risks

These issues represent the highest compliance risk for a particular industry. The issues require unique treatment specific to the industry.

Following are the Tier III issues:

- Financial services
  - ♦ Premium deficiency reserves
  - ♦ REMICs
- Heavy manufacturing and transportation
  - ♦ Loyalty programs in service industries
  - ♦ Motor vehicle dealerships and §263A (uniform capitalization/UNICAP)
- Natural resources and construction
  - ♦ §198 expensing of environmental remediation costs (commonly referred to as the Federal Brownfield Tax Incentive)
  - ♦ Delay rentals
- Retailers, food, pharmaceuticals, and healthcare
  - ♦ Cost segregation studies
  - ♦ Vendor allowances

## IRS 2009 DIRTY DOZEN TAX SCAMS

The IRS released the 2009 “Dirty Dozen” on April 13, 2009.<sup>7</sup> They are:

### 1. Phishing

Phishing is a tactic used by Internet-based scam artists to trick unsuspecting victims into revealing personal or financial information. The criminals use the information to steal the victim’s identity, access bank accounts, make credit card purchases, or apply for loans in the victim’s name.

Phishing scams often take the form of an e-mail that appears to come from a legitimate source, including the IRS. The IRS never initiates unsolicited e-mail contact with taxpayers about their tax issues. Taxpayers who receive unsolicited e-mail messages that claim to be from the IRS can forward the message to [phishing@irs.gov](mailto:phishing@irs.gov). Further instructions are available at [www.irs.gov](http://www.irs.gov). To date, taxpayers have forwarded scam e-mail messages reflecting thousands of confirmed IRS phishing sites. Information is available at [www.irs.gov](http://www.irs.gov) for those who believe they have been the target of identity theft.

### 2. Hiding Income Offshore

The IRS aggressively pursues taxpayers and promoters involved in abusive offshore transactions. Taxpayers try to avoid or evade U.S. income tax by hiding income in offshore banks or brokerage accounts or through other entities. Recently, the IRS provided guidance to auditors on how to deal with those hiding income offshore in undisclosed accounts. The IRS draws a clear line between taxpayers with offshore accounts who voluntarily come forward and those who fail to come forward.

Taxpayers also evade taxes by using offshore debit cards, credit cards, wire transfers, foreign trusts, employee-leasing schemes, private annuities, or life insurance plans. The IRS has also identified abusive offshore schemes including those that involve use of electronic funds transfer and payment systems, offshore business merchant accounts, and private banking relationships.

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<sup>7</sup> IRS News Rel. IR-2009-41 (Apr. 13, 2009).



### 3. Filing False or Misleading Forms

Scam artists filing false or misleading returns to claim refunds that they are not entitled to is another area of IRS interest. Frivolous information returns, such as Form 1099-OID, *Original Issue Discount*, claiming false withholding credits are used to legitimize erroneous refund claims. The new scam has evolved from an earlier phony argument that a “strawman” bank account was created for each citizen. Under this scheme, taxpayers fabricate an information return, arguing they used their “strawman” account to pay for goods and services and falsely claim the corresponding amount as withholding in order to seek a tax refund.

### 4. Abuse of Charitable Organizations and Deductions

The IRS continues to observe the misuse of tax-exempt organizations. Abuse includes arrangements to improperly shield income or assets from taxation and attempts by donors to maintain control over donated assets or income from donated property. The IRS also continues to investigate various schemes involving the donation of noncash assets, including easements on property, closely-held corporate stock, and real property. Often, the donations are highly overvalued or the organization receiving the donation promises that the donor can purchase the items back at a later date at a price the donor sets. The Pension Protection Act of 2006 imposed increased penalties for inaccurate appraisals and new definitions of qualified appraisals and qualified appraisers for taxpayers claiming charitable contributions.

### 5. Return Preparer Fraud

Dishonest return preparers can cause many headaches for taxpayers who fall victim to their ploys. Such preparers derive financial gain by skimming a portion of their clients’ refunds and charging inflated fees for return-preparation services. They attract new clients by promising large refunds. Taxpayers should choose carefully when hiring a tax preparer. No matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. Since 2002, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others, which are pending in court.

### 6. Frivolous Arguments

Promoters of frivolous schemes encourage people to make unreasonable and unfounded claims to avoid paying the taxes they owe. The IRS provides a list of frivolous legal positions that taxpayers should avoid. Taxpayers who file a tax return or make a submission based on one of the positions on the list are subject to a \$5,000 penalty.

### 7. False Claims for Refund and Requests for Abatement

This scam involves a request for abatement of previously-assessed tax using Form 843, *Claim for Refund and Request for Abatement*. Many individuals who attempt this have not previously filed tax returns. The tax they are attempting to have abated was assessed by the IRS through the substitute for return program. The filer uses Form 843 to list reasons for the request. Often, one of the reasons given is “Failed to properly compute and/or calculate Section 83-Property Transferred in Connection with Performance of Service.”

### 8. Abusive Retirement Plans

The IRS continues to uncover abuses in retirement plan arrangements, including Roth individual retirement arrangements (IRA). The IRS looks for transactions that taxpayers use to avoid the limitations on contributions to IRAs as well as transactions that are not properly reported as early distributions. Taxpayers should be wary of advisers who encourage them to shift appreciated assets into IRAs or companies owned by their IRAs at less than fair market value to circumvent annual contribution limits. Other variations include the use of limited liability companies to engage in prohibited activity.

## 9. Disguised Corporate Ownership

Some taxpayers form corporations and other entities in certain states for the primary purpose of disguising the ownership of a business or financial activity. Such entities are used to facilitate underreporting of income, fictitious deductions, nonfiling of tax returns, participating in listed transactions, money laundering, financial crimes, and terrorist financing. The IRS works with state authorities to identify these entities and to bring their owners into compliance.

## 10. Zero Wages

Filing a phony wage- or income-related information return to replace a legitimate information return is used as an illegal method to lower the amount of taxes owed. Typically, a Form 4852, *Substitute for Form W-2, Wage and Tax Statement* or Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* or a “corrected” Form 1099 is used to improperly reduce taxable income to zero. The taxpayer also may submit a statement rebutting wages and taxes reported by a payer to the IRS. Sometimes fraudsters even include an explanation on their Form 4852 that cites statutory language on the definition of wages or may include some reference to a paying company that refuses to issue a corrected Form W-2 for fear of IRS retaliation. Taxpayers should resist any temptation to participate in any of the variations of this scheme.

## 11. Misuse of Trusts

For years, unscrupulous promoters have urged taxpayers to transfer assets into trusts. While there are many legitimate uses of trusts in tax and estate planning, some promoted transactions promise reduction of income subject to tax, deductions for personal expenses, and reduced estate or gift taxes. Such trusts rarely deliver the promised tax benefits and are used primarily as a means to avoid income tax liability and hide assets from creditors, including the IRS.

The IRS has recently seen an increase in the improper use of private annuity trusts and foreign trusts to divert income and deduct personal expenses. As with other arrangements, taxpayers should seek the advice of a trusted professional before entering into a trust arrangement.

## 12. Fuel Tax Credit Scams

The IRS receives claims for the fuel tax credit that are unreasonable. Some taxpayers, such as farmers who use fuel for off-highway business purposes, may be eligible for the fuel tax credit. But some individuals claim the tax credit for nontaxable uses of fuel when their occupation or income level makes the claim unreasonable. Fraud involving the fuel tax credit is considered a frivolous tax claim, potentially subjecting those who improperly claim the credit to a \$5,000 penalty.

## HOW TO REPORT SUSPECTED TAX FRAUD ACTIVITY

Suspected tax fraud can be reported to the IRS using Form 3949-A, *Information Referral*. Form 3949-A is available at [www.irs.gov](http://www.irs.gov). The completed form or a letter detailing the alleged fraudulent activity should be addressed to the Internal Revenue Service, Fresno, CA 93888. The person filing the report is not required to self-identify, although it is helpful to do so. The identity of the person filing the report can be kept confidential. The mailing should include specific information about:

1. Who is being reported,
2. The activity being reported,
3. How the activity became known,
4. When the alleged violation took place,
5. The amount of money involved, and
6. Any other information that might be helpful in an investigation.

Whistleblowers also may provide allegations of fraud to the IRS and may be eligible for a reward by filing Form 211, *Application for Award for Original Information*, and following the procedures outlined in Notice 2008-4, *Claims Submitted to the IRS Whistleblower Office under Section 7623*.

## AUDIT TECHNIQUE GUIDES

The IRS publishes training manuals used to train revenue agents in auditing specific industries and services. With all of the new IRS employees, it is likely the agent that examines your client's return will have recently studied one of these guides. Consequently, in preparing for the audit, the tax preparer should review the applicable audit technique guide (ATG) for the type of business being examined. These manuals are periodically updated and new manuals are continually added.

The listing of the ATGs currently available is located in the *Reference Materials* section at the end of this book. The guides can be downloaded at [www.irs.gov](http://www.irs.gov).

## FISCAL YEAR 2008 ENFORCEMENT RESULTS

The following tables show the IRS enforcement results from 1999 to 2008.<sup>8</sup>

	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
<b>Enforcement Revenue Collected<sup>a</sup> (Dollars in Billions)</b>										
Collection	\$21.3	\$22.1	\$24.3	\$24.4	\$24.8	\$25.7	\$26.6	\$28.2	\$31.8	\$31.1
Examination <sup>b</sup>	10.0	10.2	7.9	7.9	10.7	14.7	17.7	17.2	23.5	20.6
Document matching <sup>c</sup>	1.6	1.5	1.6	1.8	2.2	2.7	3.1	3.3	3.9	4.7
<b>Total</b>	<b>\$32.9</b>	<b>\$33.8</b>	<b>\$33.8</b>	<b>\$34.1</b>	<b>\$37.7</b>	<b>\$43.1</b>	<b>\$47.4</b>	<b>\$48.7</b>	<b>\$59.2</b>	<b>\$56.4</b>
<b>Staffing for Key Enforcement Occupations<sup>d</sup></b>										
Revenue officers	6,516	5,538	5,376	5,502	5,076	5,156	5,249	5,627	5,662	5,492
Revenue agents	13,085	12,542	12,092	11,743	11,780	11,811	12,192	12,778	12,816	12,599
Special agents	2,942	2,752	2,735	2,868	2,834	2,778	2,771	2,780	2,709	2,631
<b>Total</b>	<b>22,543</b>	<b>20,832</b>	<b>20,203</b>	<b>20,113</b>	<b>19,690</b>	<b>19,745</b>	<b>20,212</b>	<b>21,185</b>	<b>21,187</b>	<b>20,722</b>

<sup>a</sup> Enforcement revenue collected in a fiscal year includes tax, interest, and penalties from multiple tax years.

<sup>b</sup> Includes any revenue collection attributable to IRS Appeals activities.

<sup>c</sup> Includes the Information Reporter Program (IRP) and the Automated Under-Reporter (AUR) Program.

<sup>d</sup> Enforcement staffing levels presented in Full Time Equivalents (FTE).

<sup>8</sup>. [[www.irs.gov/pub/irs-news/2008\\_enforcement.pdf](http://www.irs.gov/pub/irs-news/2008_enforcement.pdf)].

## Examination — Individual Return Closures and Coverage Rates

	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
<b>Total Individual Returns</b>										
Field	384,484	251,108	202,515	205,134	206,457	197,388	247,235	302,785	311,339	310,429
Correspondence	715,789	366,657	529,241	538,747	642,839	810,486	968,073	981,165	1,073,224	1,081,152
Total examinations	1,100,273	617,765	731,756	743,881	849,296	1,007,874	1,215,308	1,283,950	1,384,563	1,391,581
Returns filed in prior CY	122,546,900	124,887,100	127,097,400	129,444,947	130,341,159	130,134,277	130,576,852	132,275,830	134,542,879	137,849,635
Coverage	0.90%	0.49%	0.58%	0.57%	0.65%	0.77%	0.93%	0.97%	1.03%	1.01%
<b>Income Under \$200,000</b>										
Field	n/a	n/a	n/a	n/a	n/a	n/a	n/a	266,726	267,699	256,854
Correspondence	n/a	n/a	n/a	n/a	n/a	n/a	n/a	929,666	1,003,759	1,003,976
Total examinations	n/a	n/a	n/a	n/a	n/a	n/a	n/a	1,196,392	1,271,458	1,260,830
Returns filed in prior CY	n/a	n/a	n/a	n/a	n/a	n/a	n/a	128,875,395	130,600,177	133,407,479
Coverage								0.93%	0.97%	0.95%
<b>Income \$200,000 and Higher</b>										
Field	n/a	n/a	n/a	n/a	n/a	n/a	n/a	36,059	43,640	53,575
Correspondence	n/a	n/a	n/a	n/a	n/a	n/a	n/a	51,499	69,465	77,176
Total examinations								87,558	113,105	130,751
Returns filed in prior CY								3,400,435	3,942,702	4,442,156
Coverage								2.57%	2.87%	2.94%
<b>Income \$1 Million and Higher</b>										
Field	n/a	n/a	n/a	n/a	n/a	5,857	7,166	9,459	12,259	12,233
Correspondence	n/a	n/a	n/a	n/a	n/a	3,719	5,669	4,728	10,941	9,641
Total examinations						9,576	12,835	14,187	23,200	21,874
Returns filed in prior CY						190,372	210,280	270,161	339,138	392,776
Coverage						5.03%	6.10%	5.25%	6.84%	5.57%

FY = fiscal year, CY = calendar year, n/a = not available

## Examination — Business Return Closures and Coverage Rates <sup>a</sup>

	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008
<b>Total Returns</b>										
Returns examined	67,965	49,574	40,557	40,287	38,299	29,445	47,593	52,149	59,516	59,823
Returns filed in prior CY	6,962,300	7,228,200	7,384,600	7,576,681	7,849,109	8,141,645	8,373,880	8,722,410	9,072,828	9,530,662
Coverage	0.98%	0.69%	0.55%	0.53%	0.49%	0.36%	0.57%	0.60%	0.66%	0.63%
<b>Small Corporation Returns (Assets Under \$10 Million)</b>										
Returns examined	28,268	18,623	14,332	14,655	13,608	7,294	17,858	17,849	20,020	20,580
Returns filed in prior CY	2,446,200	2,430,000	2,372,900	2,329,479	2,327,272	2,310,279	2,249,416	2,230,024	2,171,144	2,166,197
Coverage	1.16%	0.77%	0.60%	0.63%	0.58%	0.32%	0.79%	0.80%	0.92%	0.95%
<b>Large Corporation Returns (Assets \$10 Million and Higher)</b>										
Returns examined	10,537	9,212	8,718	8,443	7,125	9,523	10,829	10,578	9,644	9,406
Returns filed in prior CY	55,300	56,500	57,800	59,602	58,974	56,883	54,091	56,847	57,357	61,641
Coverage	19.1%	16.3%	15.1%	14.2%	12.1%	16.7%	20.0%	18.6%	16.8%	15.26%
<b>Subchapter S Returns (Form 1120-S)</b>										
Returns examined	21,169	15,200	12,437	11,646	9,695	6,402	10,417	13,970	17,657	16,634
Returns filed in prior CY	2,599,800	2,767,000	2,887,100	3,022,589	3,191,108	3,369,122	3,523,934	3,715,249	3,909,730	4,155,830
Coverage	0.81%	0.55%	0.43%	0.39%	0.30%	0.19%	0.30%	0.38%	0.45%	0.40%
<b>Partnership Returns (Form 1065)</b>										
Returns examined	7,991	6,539	5,070	5,543	7,871	6,226	8,489	9,752	12,195	13,203
Returns filed in prior CY	1,861,000	1,974,700	2,066,800	2,165,011	2,271,755	2,405,361	2,546,439	2,720,290	2,934,597	3,146,994
Coverage	0.43%	0.33%	0.25%	0.26%	0.35%	0.26%	0.33%	0.36%	0.42%	0.42%

FY = fiscal year, CY = calendar year.

<sup>a</sup> Business returns include small and large corporation returns and subchapter S and partnership pass-through returns.



## AUTOMATED UNDERREPORTER ISSUES

The IRS and Congress continue to search for ways to reduce the \$300 billion tax gap. Because of the limited budget, the IRS increased the use of correspondence audits. In 2007, nearly 3.5 million taxpayers received letters (CP2000 Notice) from the IRS proposing an additional tax liability. Other taxpayers simply received a notice that their returns were selected for audit. The IRS automated underreporter system (AUR) produces taxpayer underpayment notices. AUR is defined as a case in which income information associated with a tax return is less than what is reported by third parties such as banks and employers. The AUR system is used to select approximately 30% of the AUR inventory for a given tax year. The goal of the selection operation is to obtain those cases that satisfy the objectives established by the IRS. Approximately 16 million tax submissions annually are tagged as AUR cases. In 2008, the IRS collected \$4.7 billion from its document-matching program.

The system only uses information that is provided from other IRS systems. It does not collect any information directly from the taxpayer or other sources. Approximately 100 data elements make up the files that are used.

Frequently, a CP2000 Notice is issued, but the income tax return is correct. To avoid the CP2000 Notice, taxpayers should:

- **Not** group income amounts together. When a taxpayer receives several Forms 1099-INT, *Interest Income*, from the same bank, each amount should be listed separately on the tax return.
- **Not** net reportable income against deductible expenses. For example, a taxpayer receives a Form 1099-G, *Certain Government Payments*, reporting a \$5,000 reimbursement for expenses incurred for a government approved project. The taxpayer expended \$6,000 in completing the project. While the net effect is a \$1,000 deduction, the taxpayer should report both the \$5,000 reimbursement as income and the \$6,000 disbursement in the appropriate expense category.
- **Not** report income items on an incorrect line or schedule. For example, the taxpayer received a Form 1099-MISC, *Miscellaneous Income*, from her tenant. The rental income she received was reported in Box 7, *Nonemployee Compensation*, rather than Box 1, *Rents*. Because nonemployee compensation is subject to self-employment tax as well as income tax, the taxpayer is likely to receive a CP2000 Notice if she reports the amount on Schedule E, *Supplemental Income and Loss*. The taxpayer should request a corrected Form 1099-MISC from the tenant. If she cannot get a corrected Form 1099-MISC, she should attach an explanation to her return explaining why she reported the amount on Schedule E.
- Attach a statement if a Form 1099 amount is incorrect. If the Form 1099 is incorrect, the taxpayer should request a corrected Form 1099 by the issuer. In either case, the correct amount should be reported on the return. However, the statement should identify the incorrect Form 1099, explain why the amount is incorrect, and show the detail from the Form 1099 such as the payer information including the employer identification or social security number, name, and address. Frequently, a CP2000 Notice can still arise when both original and corrected Forms 1099 are received. Attaching an explanation to the filed return usually eliminates unnecessary correspondence from IRS.

The IRS understands that issuing a CP2000 Notice is not a perfect process. The taxpayer receiving the notice does not have the name of a specific person to contact. If multiple calls are needed, the taxpayer talks to a different person each time he calls. Often, the request for documents is incomplete or is not applicable to the matter being questioned. Consequently, the IRS is working on a more taxpayer-friendly process with the issuance of a CP2057 Notice (soft notice). The CP2057 Notice does not report an underpayment amount on the tax return. Rather, it suggests the taxpayer review a particular portion of the return to determine whether all income was reported. If the taxpayer determines income was not reported, he is requested to file an amended tax return. The CP2057 Notice was sent to approximately 31,000 taxpayers in the fall of 2008. The IRS believes the CP2057 Notice will encourage many taxpayers to voluntarily file an amended return without the IRS expending the amount of time and money required to pursue a CP2000 Notice.

Taxpayers should not ignore a CP2057 Notice. If an error was made and an amended return is not filed, the taxpayer may receive a CP2000 Notice and possibly trigger an audit.

## MODERNIZED e-FILE

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The IRS was very successful in its efforts to convince taxpayers and tax preparers to e-file income tax returns. Since 2001, the IRS increased the percentage of individual e-filed returns from 31% to 58%. In its attempt to further increase this percentage, the Modernized e-file Program (MeF) was created, and is planned for a phased-in implementation beginning in late 2009.

The IRS spent over three years on the design and development of the MeF system. A stakeholder group comprised of tax professionals and software vendors worked closely with the IRS during all phases of design, development, and implementation of MeF to ensure the needs of corporations were understood.

MeF is a web-based system that allows electronic filing of corporate, partnership, individual, exempt organization, and excise tax returns through the Internet. Benefits of MeF include:

- **More explicit error conditions.** New error code explanations pinpoint the location of the error in the return and provide complete information in the acknowledgement file.
- **Faster acknowledgements.** Transmissions are processed upon receipt and acknowledgments are returned in near real-time as opposed to waiting for once- or twice-daily system-processing cycles. The goal is to provide a response time of approximately five minutes to the transmitter in nonpeak periods. MeF returns are processed when received rather than being delayed in a batch system. This allows preparers to fix return issues in real-time.
- **Integrated payment option.** A taxpayer can e-file a balance due return and, at the same time, authorize an electronic funds withdrawal from his bank account. Payments are subject to limitations of the federal tax deposit rules.

The advantages of MeF for the tax practitioner are:

- **Specific explanation of errors.** Under the existing system, one error code could apply to multiple types of e-file errors. MeF error codes use specific wording to clarify each error that triggers a rejection.
- **Improved processing.** Form 1040 and any attachments are submitted electronically to MeF in XML (extensible markup language) format. This allows for more effective use of data. MeF also allows attachments in PDF to accommodate late-legislation and form changes.
- **Prior year returns.** Practitioners must determine from their transmitter which prior year returns will be accepted by MeF.

The 1040 MeF program is being phased in. The new platform processes 23 of the Form 1040 forms and schedules beginning November 2009, and is scheduled for release in January 2010. All other returns use the old platform in 2010.

Phase 2 will begin processing 2010 returns in 2011, and will accommodate prior year returns.

Phase 3 begins in 2012 for 2011 returns. At that time, all forms will be processed through the MeF platform.

## ECONOMIC HARDSHIP AND THE IRS

### HELP FOR PEOPLE WHO OWE TAXES

With many people facing financial difficulties, the IRS is taking several steps to help people who owe back taxes. “We need to ensure that we balance our responsibility to enforce the law with the economic realities facing many American citizens today,” IRS Commissioner, Doug Shulman said. “We want to go the extra mile to help taxpayers, especially those who’ve done the right thing in the past and are facing unusual hardships.”

On a wide range of situations, IRS employees have flexibility to work with struggling taxpayers to assist them with their situations. Depending on the circumstances, taxpayers in hardship situations may be able to adjust payments for back taxes, avoid defaulting on payment agreements, or possibly defer collection action.

The IRS reminds taxpayers who are behind on tax payments and who need assistance to be proactive by contacting the phone numbers listed on their IRS correspondence. There could be additional help available for taxpayers facing unusual hardship situations.

Following are descriptions of actions the IRS can take to provide assistance to those with financial hardships.

### Postponement of Collection Actions

IRS employees have greater authority to suspend collection actions in certain hardship cases in which taxpayers are unable to pay. This includes instances when the taxpayer recently lost a job, is relying solely on social security or welfare income, or is facing devastating illness or significant medical bills. If an individual recently encountered this type of financial problem, IRS employees may be able to suspend collection without documentation to minimize burden on the taxpayer.

### Added Flexibility for Missed Payments

The IRS allows more flexibility for previously compliant individuals who are currently under an installment agreement and who have difficulty making payments because of a job loss or other financial hardship. The IRS may allow a skipped payment or a reduced monthly payment amount without automatically suspending the installment agreement. Taxpayers in difficult financial situations should contact the IRS.

### Additional Review for Offers in Compromise on Home Values

An offer in compromise (OIC) is an agreement between a taxpayer and the IRS that settles the taxpayer’s tax debt for less than the full amount owed. It may be a viable option for taxpayers experiencing economic difficulties. However, the equity taxpayers have in real property can be a barrier to the acceptance of an OIC. With the uncertainty in the housing market, the IRS recognizes that the real estate valuations used to assess ability to pay may not be accurate. Therefore, in instances in which the accuracy of local real estate valuations is in question or other unusual hardships exist, the IRS created a new second review of the information to determine if accepting an offer is appropriate.

### Prevention of Offer in Compromise Defaults

Taxpayers who are unable to meet the periodic payment terms of an accepted OIC can contact the IRS office handling the offer for available options to help them avoid default.

### Expedited Levy Releases

The IRS hastens the delivery of levy releases by easing requirements on taxpayers who request expedited levy releases for hardship reasons. Taxpayers seeking expedited releases for levies to an employer or bank should contact the IRS number shown on the notice of levy to discuss available options. When calling, taxpayers requesting a levy release due to hardship must provide the IRS with the fax number of the bank or employer processing the levy.

Taxpayers with financial problems who discover they cannot pay when they file their 2008 tax returns also have options available. “What If” scenarios that deal with payment and other financial problems are available on the IRS website. These scenarios, in question-and-answer format, provide information on specific actions taxpayers can take. Taxpayers unable to pay in full can likewise contact the IRS to discuss additional options to pay.

## The “What Ifs” of an Economic Downturn

The IRS recognizes that many people may be experiencing difficult financial times. Events such as a job loss, debt forgiveness, or tapping a retirement fund can have tax consequences. If a taxpayer’s income decreased, he may be newly eligible for certain tax credits, such as the earned income credit (EIC).

Most importantly, if he believes he may not be able to pay his tax bill, he should immediately contact the IRS. There are steps the IRS can take to help ease the burden. A taxpayer also should file a tax return even if he is unable to pay in order to avoid additional penalties.

Following are “What if” scenarios and possible tax consequences for the taxpayer.<sup>9</sup>

### Question A. What if I lose my job?

**Answer A.** The loss of a job may create new tax issues. Severance pay and unemployment compensation are taxable income. Payments for any accumulated vacation or sick time also are taxable. The taxpayer should withhold enough taxes from these payments or make estimated tax payments to avoid a big tax liability on his tax return. Public assistance and food stamps are not taxable. The IRS updated a helpful publication that describes job-loss related tax issues. For more information, see IRS Pub. 4128, *Tax Impact of Job Loss*.

### Question B. What if I receive unemployment compensation?

**Answer B.** Unemployment compensation received under the unemployment compensation laws of the United States or of a state is considered taxable income. If the taxpayer received unemployment compensation, he will receive Form 1099-G showing the amount he was paid and any federal income tax withheld. For more information, see IRS Pub. 525, *Taxable and Nontaxable Income*.

**Note.** The American Recovery and Reinvestment Act temporarily changed the taxation of unemployment benefits for the 2009 tax year only. Under the new economic stimulus law, the first \$2,400 of unemployment benefits received in 2009 is not subject to federal taxes. The exclusion is reflected on tax returns filed in 2010.

### Question C. What if my income declines?

**Answer C.** Many tax credits are subject to income limitations. If the taxpayer has less income in 2008, he may be eligible for credits or deductions not usually available. For example, the earned income credit is available for working families and individuals. Eligibility is determined by income and family size. The taxpayer must file an income tax return in order to claim the EIC.

The IRS website has more information on these and other popular credits, such as the child tax credit and alternative fuel vehicle credit.

### Question D. What if I am searching for a job?

**Answer D.** The taxpayer may be able to deduct certain expenses he incurs while looking for a new job, even if he does not get hired. Expenses may include travel, resume production, and outplacement agency fees. For more information, see IRS Pub. 529, *Miscellaneous Deductions*. Moving costs for a new job that is at least 50 miles away from the taxpayer’s home may also be deductible.

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<sup>9</sup>. [[www.irs.gov/newsroom/article/0,,id=201853,00.html](http://www.irs.gov/newsroom/article/0,,id=201853,00.html)].

**Question E.** What if my employer goes out of business or into bankruptcy?

**Answer E.** An employer must provide a 2009 Form W-2 showing wages and withholdings by February 1, 2010. Taxpayers should keep up-to-date records or pay stubs until they receive their Forms W-2. If the employer or its representatives fail to provide a Form W-2, contact the IRS. They can help by providing a substitute Form W-2. Form 4852, *Substitute for Form W-2, Wage and Tax Statement*, or Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs Insurance Contracts, etc.* may be used if a Form W-2 is not issued by the employer. If the employer is liquidating the taxpayer's 401(k) plan, the taxpayer has 60 days to roll it over to another qualified retirement plan or IRA. For more information, see IRS Pub. 4128, *Tax Impact of Job Loss*.

**Question F.** What if I close my own business?

**Answer F.** If the business is no longer operating, the taxpayer is still responsible for filing all required tax returns for the business **by the due dates**. In addition, if the taxpayer had employees, he must file all required employment tax returns, including Forms 940, 941, 943 or 944. Both business and employment taxes should be paid when due. However, if the taxpayer is not able to pay in full, contact the IRS immediately to discuss options.

**Question G.** What if I withdraw money from my IRA?

**Answer G.** Generally, early withdrawal from an individual retirement account (IRA) prior to age 59½ is included in gross income and is subject to a 10% additional tax penalty. There are exceptions to the 10% penalty, such as using IRA funds to pay medical insurance premiums after a job loss. For more information, see IRS Pub. 590, *Individual Retirement Arrangements*.

**Question H.** What if my 401(k) drops in value?

**Answer H.** Generally, a taxpayer cannot claim a loss on retirement accounts that already receive favorable tax treatment. The only time a taxpayer would have a loss is when he receives a previously-taxed distribution. For more information, see IRS Pub. 575, *Pension and Annuity Income*.

**Question I.** What if I lose my home through foreclosure?

**Answer I.** Under the Mortgage Forgiveness Debt Relief Act of 2007, taxpayers generally can exclude income from the discharge of debt on their principal residence or mortgage restructuring. This exception does not apply to second homes or vacation homes. In some cases, the taxpayer may be able to file an amended tax return for previous tax years.

**Question J.** What if I sell my home for a loss?

**Answer J.** Losses from the sale of personal-use property, such as a home or car, are not deductible. The loss is not eligible for the capital gains loss of up to \$3,000 annually. For more information, see IRS Pub. 523, *Selling Your Home*.

**Question K.** What if my debt is forgiven?

**Answer K.** The tax impact of debt forgiveness or cancellation depends on the taxpayer's individual facts and circumstances. Generally, if the taxpayer borrows money from a commercial lender and the lender later cancels or forgives the debt, the taxpayer may have to include the canceled amount in income for tax purposes. The lender is usually required to report the amount of the canceled debt to the taxpayer and the IRS on a Form 1099-C, *Cancellation of Debt*.

There are several exceptions to the taxability of canceled debt, such as insolvency or bankruptcy.

More information can be found in IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*.



## **Question L.** What if I am insolvent?

**Answer L.** A taxpayer is insolvent when his total liabilities exceed his total assets. The forgiven debt may be excluded as income under the “insolvency” exclusion. Normally, a taxpayer is not required to include forgiven debts in income to the extent that the taxpayer is insolvent. The forgiven debt may also qualify for exclusion if the debt was discharged in a Title 11 bankruptcy proceeding or if the debt is qualified farm indebtedness or qualified real property business indebtedness. If the taxpayer believes he qualifies for any of these exceptions, see the instructions for Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*.

## **Question M.** What if I file for bankruptcy protection?

**Answer M.** Debts discharged through bankruptcy are not considered taxable income. If the taxpayer is an individual debtor who files for bankruptcy under Chapters 7 or 11 of the Bankruptcy Code, a separate “estate” is created consisting of property that belonged to the taxpayer before the filing date. This bankruptcy estate is a new taxable entity, completely separate from the taxpayer as an individual taxpayer. Please note, however, that some tax debts are not dischargeable in a bankruptcy action. For more information, see IRS Pub. 908, *Bankruptcy Tax Guide*.

## **Question N.** What if I cannot pay my installment agreement?

**Answer N.** The taxpayer has several options available if his ability to pay has changed and he is unable to make payments on his installment agreement or offer in compromise agreement with the IRS. Call the IRS immediately at 1-800-829-1040. Options could include reducing the monthly payment to reflect the taxpayer’s current financial condition. The taxpayer may be asked to provide proof of changes in his financial situation. Consequently, he should have this information available when he calls.

## **Question O.** What if there is a federal tax lien on my home?

**Answer O.** If there is a federal tax lien on the taxpayer’s home, he must satisfy the lien before he can sell or refinance the home. There are a number of options to satisfy the tax lien. Normally, if the taxpayer has equity in the property, the tax lien is paid (in part or in whole depending on the equity) out of the sales proceeds at the time of closing. If the home is being sold for less than the lien amount, the taxpayer can request the IRS discharge the lien to allow for the completion of the sale. Taxpayers or lenders also can ask that a federal tax lien be made secondary to the lending institution’s lien to allow for the refinancing or restructuring of a mortgage. The IRS currently is working to hasten requests for discharge or mortgage restructuring to assist taxpayers during this economic downturn.

## **Question P.** What if a levy on my wages is causing a hardship?

**Answer P.** The taxpayer should immediately contact the IRS at the telephone number on the levy notice or correspondence and explain his financial situation. The IRS is available from 8 a.m. to 8 p.m. local time, Monday through Friday. If the levy is creating an immediate economic hardship, the levy may be released. A levy release does not mean the taxpayer is exempt from paying the balance. The IRS works with the taxpayer to establish payment plans or take other steps to help him pay off the balance. To ensure quick action, the taxpayer should have the fax number available for the bank or employer office that is processing the levy.

## **Question Q.** What if I cannot resolve my tax problem with the IRS?

**Answer Q.** The Taxpayer Advocate Service (TAS) is available to help taxpayers resolve problems with the IRS. TAS is an independent organization within the IRS. Its employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.

The taxpayer can contact TAS by calling the TAS toll-free case-intake line at 1-877-777-4778 or TTY/TDD 1-800-829-4059 to determine whether he is eligible for assistance. He can also call or write his local taxpayer advocate, whose phone number and address is listed in the local telephone directory and in IRS Pub. 1546, *Taxpayer Advocate Service — Your Voice at the IRS*. A taxpayer can file Form 911, *Request For Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order)*, or ask an IRS employee to complete it on his behalf. More information is found at [www.irs.gov/advocate](http://www.irs.gov/advocate).



**Question R.** What if I need legal representation to help with my tax problem but can't afford it?

**Answer R.** Low Income Taxpayer Clinics (LITC) represent low-income taxpayers before the IRS, assist taxpayers in audits, appeals and collection disputes, and help taxpayers respond to IRS notices and to correct account problems. If the taxpayer is a low-income taxpayer who cannot afford professional tax assistance or if he speaks English as a second language (ESL) and needs help understanding a taxpayer's rights and responsibilities, he may qualify for help from the LITC. Assistance is available for free or for a nominal fee. Although LITCs receive partial funding from the IRS, LITCs, their employees, and their volunteers are completely independent of, and are not associated with, the federal government. Nonprofit organizations or academic institutions generally operate LITCs.

Each LITC independently decides if the taxpayer meets the income guidelines and other criteria before it agrees to represent the taxpayer. There is at least one LITC in each of the 50 states, the District of Columbia, and Puerto Rico. A taxpayer can find an LITC located in or near his area by using IRS Pub. 4134, *Low Income Taxpayer Clinic List*. This publication identifies all LITCs who represent low-income taxpayers before the IRS or provide ESL services and is available at [www.irs.gov/advocate](http://www.irs.gov/advocate) or at the local IRS office.

Low-income taxpayers also may be able to receive assistance from a referral system operated by state bar associations, state or local societies of accountants, and other nonprofit tax professional organizations.

## MAXIMIZING REFUNDS AND HASTENING REFUND DELIVERY

There are several steps taxpayers can take to maximize their refunds and hasten the delivery of money from the IRS.

Taxpayers should take advantage of the numerous available tax breaks and take every credit, deduction, and exclusion for which they qualify. People with less income in 2008 may qualify for credits that they previously were not qualified to use. In addition, there are several new benefits this year:

1. First-time homebuyer credit
2. The making work pay credit
3. Standard deduction for real estate taxes
4. Residential energy credits
5. Standard deduction for sales taxes on new vehicles

All these are described in more detail in Chapter 11, New Legislation.

## TRUST FUND RECOVERY PENALTY

Many companies are experiencing severe cash-flow problems. Taxpayers may not be able to make timely payroll tax payments to the IRS. The IRS takes a very harsh view of employers with unpaid payroll taxes. Because these are taxes withheld from employees and not forwarded to the IRS, the IRS considers it theft of the employee's money. To collect these unpaid taxes, Congress implemented the "Trust Fund Recovery Penalty."<sup>10</sup> This is commonly referred to as the "100% penalty."

The penalty is assessed against the responsible person. This is not necessarily the owner of the business. The "responsible person" is the person determined to have the authority over the payment of funds or the authority to direct payment to creditors. IRC §6672(a) applies to any person who:

- Is required to collect, truthfully account for, and pay over any tax imposed;
- Willfully fails to collect the tax, or truthfully account for and pay over the tax; or
- Willfully attempts in any manner to evade or defeat the tax or payment.

<sup>10</sup> IRC §6672, Failure to Collect and Pay Over Tax, or Attempt to Evade or Defeat Tax.

In addition to other penalties provided by law, the person is liable for a penalty equal to the total amount of the tax evaded, not collected, or not accounted for and paid over.

If multiple people are liable for the penalty, each person who paid the penalty is entitled to recover from other liable persons. The recoverable amount is equal to the excess of the amount paid by such person over such person's proportionate share of the penalty.<sup>11</sup> This means the IRS can take the "deep pockets" approach to collection. They attempt to collect from the person they believe is most likely to pay. That person then can bring suit against any other person that might be responsible for the underpayment.

**Example 2.** Bart and Homer are co-owners of Distressed Auto Sales, Inc. (Distressed). Both Bart and Homer participate in management decisions and sign checks. Sales during 2008 were minimal. Distressed could barely pay its rent and utility bills but knew it had to make the payroll each month or it would lose its employees. By the end of 2008, Distressed owed the IRS \$100,000 in unpaid withholding taxes. In January 2009, Distressed filed bankruptcy, and the bankruptcy court awarded all the proceeds from the liquidation of the assets to the bank. Because the payroll taxes were not paid, the IRS assessed the §6672 penalty against Bart and Homer.

The IRS quickly determined only Homer had the ability to pay the penalty and collected all unpaid taxes from Homer. It is now up to Homer to sue Bart if he wants to recover Bart's share of the penalty.

There is an exception for the §6672 penalty for voluntary board members of tax-exempt organizations. The exception applies if the board member:

- Is serving solely in an honorary capacity,
- Does not participate in the day-to-day or financial operations of the organization, and
- Does not have actual knowledge of the failure to pay the withheld taxes.

The exception applies if the IRS can find another person liable for the penalty.

The §6672 penalty only applies to third-party taxes. Therefore, only the portion of the payroll taxes withheld from the employee are included in the penalty. The employer's share of the taxes is not part of the penalty amount. This is not a "true" penalty, but is an assessment of the tax. Consequently, the §6672 amount is not dischargeable in bankruptcy.

Before the IRS can assess the §6672 penalty, it must establish the person is both responsible and willful. It is possible the penalty can be assessed for one quarter and not another depending on the facts and circumstances of the case.

## RESPONSIBLE PERSON

As mentioned previously, the penalty is assessed against the responsible person. The definition of "responsible person" has varied in different court cases.

In one case, the corporate officers were deemed the responsible persons. Although they had given up control of the company, they retained the authority to sign corporate checks. They also knew that payments were not being made to the IRS.<sup>12</sup>

In another case, a 50% shareholder was deemed the responsible person. This shareholder was also the vice president of the company. The court determined the shareholder was responsible because of his title, stock ownership, check-writing authority, and ability to control the business. It did not matter that the shareholder did not take part in the accounting of the business.<sup>13</sup>

<sup>11</sup> IRC §6672(d).

<sup>12</sup> *Danny L. Bowlen and Michael J. Bowlen v. U.S.*, 956 F.2d 723 (7th Cir. 1992) *aff'g* U.S. Dist. Ct., Southern Indiana, IP 88-1310-C (July 5, 1990).

<sup>13</sup> *William A. Kinnie v. U.S.*, 92-1690 (6th Cir. 1993) *aff'g* U.S. Dist. Ct., Eastern Michigan, Civ. 90-70728 (Aug. 6, 1991).

The IRM states that responsibility is a matter of status, duty, and authority. The determination of the responsible person depends on the facts and circumstances of the case.<sup>14</sup>

The following are potential responsible persons:

- Officer or employee of a corporation
- Partner or employee of a partnership
- Corporate director or shareholder
- Another corporation
- Employee of a sole proprietorship
- Surety lender
- Other person or entity outside the delinquent business organization

The responsible person must have:

- Duty to perform,
- Power to direct the act of collecting trust fund taxes,
- Accountability for and authority to pay trust fund taxes, and
- Authority to determine which creditors will or will not be paid.

In determining possible responsible persons, the IRS officer is directed to identify the individuals who:

- Are officers, directors, or shareholders of the corporation;
- Hire and fire employees;
- Exercise authority to determine which creditors to pay;
- Sign and file excise tax or employment tax returns, such as Form 941, *Employer's Quarterly Federal Tax Return*;
- Control payroll/disbursements;
- Control the corporation's voting stock; **or**
- Make federal tax deposits.

## Non-owner Employees

Individuals performing ministerial acts without exercising independent judgment are not deemed responsible persons. In general, non-owner employees who act solely under the dominion and control of others, and who are not in a position to make independent decisions on behalf of the business entity, are not assessed the trust fund recovery penalty. Non-owner employees are those who do not own any stock, interest, or other entrepreneurial stake in the company that employs them. Ministerial acts are performed under the supervision of someone else and do not require independent judgment or decision-making ability.<sup>15</sup>

A person is "responsible" for purposes of the §6672 penalty if that person has "significant control" over the company's finances. "Significant control" means more than having the mere mechanical duty of signing checks or preparing tax returns or having a title that appears to have authority. However, a responsible person need not have the final word in the company regarding the payment of creditors. Officers and higher-level employees of a company who are non-owners may still be required to sacrifice their jobs (i.e., quit) to avoid being responsible for the penalty, rather than obey the orders of an owner to pay other creditors but not pay current federal trust fund taxes as they become due.<sup>16</sup>

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<sup>14</sup> IRM 5.7.3.3.1.

<sup>15</sup> IRM 5.7.3.3.1.2.

<sup>16</sup> *Brounstein v. U.S.*, 979 F.2d 952, 956 (3rd Cir. 1992).

## Court Cases

The long-time controller of a company was never a shareholder, director, or officer of the company, but he was responsible for overseeing the finances of the company, including the preparation of the payroll and filing the company's federal employment tax returns. He had authority to sign checks in any amount and he dealt with the company's lender on a regular basis when the company experienced financial troubles, though he did not arrange or sign the lending agreement on the company's behalf. When the lender directed the company to pursue an orderly liquidation of its assets, the controller requested funds from the lender to make full payroll and pay the taxes due on the remaining employees. However, the lender forwarded only enough funds for the company to make net payrolls. The controller issued net payroll checks to the remaining employees and paid none of the taxes due, rather than prorate the funds available to the company between payroll and taxes. The controller could be a responsible person for the §6672 penalty.<sup>17</sup>

An experienced executive was never a shareholder, director, or officer of a new company, but he served as the general manager of the new company during a 7-month period. As general manager, he signed most of the company's checks to creditors, as well as signed net payroll checks to employees. There was no monetary limit placed on his check-signing authority. He told the bookkeeper which bills to pay. When the company experienced cash-flow problems, he spoke to one of the owners about the company's delinquent payroll taxes. The owner told the general manager that these unpaid taxes were none of the general manager's business and he should not worry about paying the company's net payroll and missing its tax payments. Both the general manager and the owner believed that the general manager could not be held liable for the §6672 penalty because he was not an owner or officer of the company; the general manager turned down an offer to become the company's president specifically because he was worried about the company's tax situation. The general manager could be a responsible person for the penalty.<sup>18</sup>

## Establishing Willfulness

"Willful" means intentional, deliberate, voluntary, reckless, or knowing, as opposed to accidental. No evil intent or bad motive is required.

To show willfulness, the government generally must prove that a responsible person was aware, or should have been aware, of the outstanding taxes and either intentionally disregarded the law or was plainly indifferent to its requirements. A responsible person's failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid satisfies the §6672 penalty "willfulness" element.<sup>19</sup>

It is difficult to establish "willfulness" in the types of assessments shown below.

If . . .	Then . . .
The assessment is a Combined Annual Wage Reporting (CAWR) assessment	It is normally difficult to establish willfulness to the degree necessary to assert the §6672 penalty.
An employment tax assessment is made under IRC §3509	It requires a determination of intentional disregard of the requirements to deduct and withhold taxes.
The assessment involves a volunteer director or trustee of a tax-exempt organization	The IRS may need to show the person's "actual knowledge" of the organization's failure to collect or pay over trust fund taxes, if the person was serving as a volunteer solely in an honorary capacity.

<sup>17</sup> *Hochstein v. U.S.*, 900 F.2d 543 (2nd Cir. 1990).

<sup>18</sup> *Gephardt v. U.S.*, 818 F.2d 469 (6th Cir. 1987).

<sup>19</sup> IRM 5.7.3.3.2.

## THIRD-PARTY LIABILITY PAYING OR PROVIDING FOR WAGES

A third party who is not the employer may pay wages directly to an employee or group of employees, or to an agent on behalf of the employee or employees. The third party is liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.<sup>20</sup>

**Example 3.** Dashboard, Inc., manufactures and supplies automobile dashboards to Car Maker, Inc. Dashboard is experiencing severe financial problems and notifies Car Maker it can no longer meet its payroll and will not be able to supply the dashboards. Car Maker agrees to pay Dashboard's employees for the next two months. Dashboard does not make the payroll deposits to the IRS.

Car Maker may be held liable for the \$6672 penalty on the undeposited tax.

## FOREIGN BANK ACCOUNTS

In June 2008, taxpayers became concerned about failing to report income from their foreign accounts when Bradley Birkenfield pleaded guilty to helping Forbes 400 member Igor M. Olenicoff hide \$200 million offshore. Birkenfield testified Swiss banking giant UBS held \$20 billion in "undeclared" accounts belonging to 20,000 U.S. investors.

On July 1, 2008, a federal judge in Miami authorized the IRS to serve a summons on UBS requiring them to divulge the names of its U.S. depositors. Knowing it does not have enough staff to audit all of these depositors, the IRS then issued news releases asking taxpayers to report their hidden income and avoid criminal charges through the voluntary disclosure program. Taxpayers have until September 23, 2009 to disclose their hidden income.

On August 18, 2009, U.S. prosecutors indicated in a filing with a federal court in Fort Lauderdale, Florida, that more than 150 American clients of Swiss bank UBS are facing criminal charges for tax evasion. Prosecutors indicated evidence provided by Mr. Birkenfield was critical to their investigation.<sup>21</sup> As of August 14, the IRS has successfully prosecuted four U.S. clients of UBS.

On August 19, 2009, the U.S. government entered into an agreement with the Swiss government related to the IRS receiving information about U.S. clients of UBS. It is expected that approximately 5,000 UBS records will be provided to the IRS.<sup>22</sup> Commissioner, Douglas Shulman, estimated the accounts were at one time valued at \$18 billion.

The publicity about the offshore accounts has caused many taxpayers to ask their tax preparers questions.

Form 1040, Schedule B, *Interest and Ordinary Dividends*, has a section in which taxpayers can divulge whether they possess a foreign account or trust. This must be completed if the taxpayer has over \$1,500 of taxable interest or ordinary dividends, had a foreign account or received a distribution from, or was a grantor of, or a transferor to, a foreign trust. Taxpayers that meet these conditions but fail to complete the required information have committed perjury once they sign the Form 1040.

**Part III Foreign Accounts and Trusts**  
(See instructions on back)

**7a** At any time during 2009, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See instructions on back for exceptions and filing requirements for Form TD F 90-22.1 . . . . .

**b** If "Yes," enter the name of the foreign country ▶

**8** During 2009, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back . . . . .

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 17146N Schedule B (Form 1040A or 1040) 2009

<sup>20</sup> IRC §3505.

<sup>21</sup> Brown, T. "U.S. says building criminal cases against UBS clients" *Reuters* (Aug. 18, 2009) [www.reuters.com/article/businessNews/idUSTRE57H49Z20090818]. Accessed on Aug. 18, 2009.

<sup>22</sup> IRS News Release IR-2009-75 (Aug. 19, 2009).

## FORM TD F 90-22.1

In addition, the IRS developed Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*. This is an 8-page form in which the taxpayer can divulge information relating to all his foreign accounts.

<b>TD F 90-22.1</b> <small>(Rev. October 2008)          Department of the Treasury          Do not use previous editions of this form after December 31, 2008</small>	<b>REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS</b>  Do NOT file with your Federal Tax Return	<small>OMB No. 1545-2038</small> <b>1</b> This Report is for Calendar Year Ended 12/31  Amended <input type="checkbox"/>
<b>Part I Filer Information</b>		
<b>2</b> Type of Filer a <input type="checkbox"/> Individual   b <input type="checkbox"/> Partnership   c <input type="checkbox"/> Corporation   d <input type="checkbox"/> Consolidated   e <input type="checkbox"/> Fiduciary or Other—Enter type _____		
<b>3</b> U.S. Taxpayer Identification Number  <small>If filer has no U.S. Identification Number complete Item 4.</small>	<b>4</b> Foreign identification (Complete only if item 3 is not applicable.) a Type: <input type="checkbox"/> Passport <input type="checkbox"/> Other _____ b Number _____   c Country of Issue _____	<b>5</b> Individual's Date of Birth MM/DD/YYYY
<b>6</b> Last Name or Organization Name	<b>7</b> First Name	<b>8</b> Middle Initial
<b>9</b> Address (Number, Street, and Apt. or Suite No.)		
<b>10</b> City	<b>11</b> State	<b>12</b> Zip/Postal Code
<b>13</b> Country		
<b>14</b> Does the filer have a financial interest in 25 or more financial accounts? <input type="checkbox"/> Yes   If "Yes" enter total number of accounts _____ <small>(If "Yes" is checked, do not complete Part II or Part III, but retain records of this information)</small> <input type="checkbox"/> No		
<b>Part II Information on Financial Account(s) Owned Separately</b>		
<b>15</b> Maximum value of account during calendar year reported	<b>16</b> Type of account   a <input type="checkbox"/> Bank   b <input type="checkbox"/> Securities   c <input type="checkbox"/> Other—Enter type below	
<b>17</b> Name of Financial Institution in which account is held		
<b>18</b> Account number or other designation	<b>19</b> Mailing Address (Number, Street, Suite Number) of financial institution in which account is held	
<b>20</b> City	<b>21</b> State, if known	<b>22</b> Zip/Postal Code, if known
<b>23</b> Country		
<b>Signature</b>		
<b>45</b> Filer Title, if not reporting a personal account		

## Filing Requirements

Form TD F90-22.1 must be filed by any U.S. person who has a financial interest in, or has signature or other authority over, any foreign financial accounts. This includes bank, securities, or other types of financial accounts in a foreign country, if the aggregate value of these financial accounts exceeds \$10,000 at any time during the calendar year. The taxpayer must report that relationship each calendar year by filing this form with the Department of the Treasury on or before **June 30** of the succeeding year. There is a filing exception for officers or employees of a bank as long as they do not have a personal financial interest in the account. There is also an exception for an officer or employee of a domestic corporation whose stock is listed on a U.S. stock exchange or has over \$10 million in assets and 500 or more shareholders.



## Foreign Country

A “foreign country” includes all geographical areas located outside the United States. The geographical location of the account, not the nationality of the account-holding financial entity, determines whether it is in an account in a foreign country. The taxpayer must report any financial account (except a military banking facility) that is located in a foreign country, even if it is held at an affiliate of a United States bank or other financial institution. Any account maintained with a branch, agency, or other office of a foreign bank or other institution that is located in the United States is not reported.

## Financial Interest

A financial interest in a bank, securities, or other financial account in a foreign country means an interest described in one of the following:

1. A U.S. person has a financial interest in each account for which such person is the owner of record or has legal title, whether the account is maintained for his benefit or for the benefit of others, including non-U.S. persons.
2. A U.S. person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is:
  - a. A person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person;
  - b. A corporation in which the U.S. person owns directly or indirectly more than 50% of the total value of shares of stock, or more than 50% of the voting power for all shares of stock;
  - c. A partnership in which the U.S. person owns an interest in more than 50% of the profits (distributive share of income, taking into account any special allocation agreement), or more than 50% of the capital of the partnership; or
  - d. A trust in which the U.S. person either has a present beneficial interest, either directly or indirectly, in more than 50% of the assets, or from which such person receives more than 50% of the current income.
3. A U.S. person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is a trust. This also applies to a person acting on behalf of a trust that was established by such U.S. person and for which a trust protector has been appointed. A trust protector is a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee.

## Signature or Other Authority over an Account

A person has signature authority over an account if he can control the disposition of money or other property in it by delivery of a document containing his signature (or his signature and that of one or more other persons) to the bank or other person with whom the account is maintained. Other authority exists in a person who can exercise comparable power over an account by communication with the bank or other person with whom the account is maintained, either directly or through an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person, either orally or by some other means.

## ACCOUNTANT-CLIENT CONFIDENTIALITY PRIVILEGE

Before discussing how to report a foreign bank account with a client, both the client and the accountant need to understand that the confidentiality privilege between a client and attorney is different than the privilege between an accountant and a client.

Communications regarding legal advice between an attorney and a client or a prospective client is protected by the common-law privilege of confidentiality. This privilege was granted in order to ensure fair representation of the client. The attorney must know all of the facts in order to fairly represent the client. Consequently, that communication cannot be disclosed without the consent of both parties.

Unfortunately, this same privilege is not extended to accountants and their clients. Prior to passage of IRC §7525 in 1998, there was no accountant-client privilege.<sup>23</sup> Tax practitioners were hesitant at times to ask clients certain questions for fear they might be required to testify against the client in court based on the client's answers. IRC §7525 offers only limited privilege. IRC §7525 gives the confidentiality privilege for "tax advice." Therefore, the privilege is much narrower than the privilege between an attorney and a client.

With respect to **tax advice**, the same common-law protections of confidentiality which apply to a communication between a taxpayer and an attorney also apply to communications between a taxpayer and any federally-authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.<sup>24</sup> The confidentiality privilege is limited to any noncriminal:

- Tax matter before the IRS, and
- Tax proceeding in federal court brought by or against the United States.

The privilege is only granted to a federally-authorized tax practitioner. These include the following:

- Attorneys
- CPAs
- Enrolled agents
- Enrolled actuaries

## Tax Advice

Tax advice means advice given by an individual about a matter that is within the scope of the individual's authority to practice. The confidentiality privilege does not apply to written communication regarding tax shelters if it is between a federally-authorized tax practitioner and:

- Any person,
- Any director, officer, employee, agent, or representative of the person, or
- Any other person holding a capital or profits interest in the person, and is in connection with the promotion of the direct or indirect participation of the person in any tax shelter.

## Nonprivileged Matters

In reality, the accountant-client privilege is very limited. The following is a list of items the privilege **does not cover**:

- Criminal tax matters
- Workpapers used in preparing a tax return, unless they only pertain to tax advice

**Note.** Tax advice possibly includes backup research or notes the accountant made reflecting his impressions.

- Anything relating to local or state tax jurisdictions
- Any tax jurisdictions outside of the United States
- Noncriminal tax matters in which the United States is not a party
- State court proceedings involving private litigants

<sup>23</sup> RRA '98.

<sup>24</sup> IRC §7525(a)(1).

## Possible Solution

If a situation arises and the tax preparer is concerned that she will receive client information that would damage the client if the IRS issued a summons for the information, the preparer should recommend the client hire a tax attorney. The attorney-client privilege applies to experts retained by an attorney as long as the expert is retained to assist in providing legal services to the attorney's client. The accountant's services must be necessary to allow the attorney to provide legal advice. This allows the tax preparer to work under the guidance of the attorney while sheltering any information from the IRS.

The IRS has issued summons to many tax practitioners requesting confidential information. Summons against the major accounting firms have gone to court. In some situations, the IRS has been victorious, and in the others, the accountants were the victors.

## IRS FOCUSES ON S CORPORATIONS

### NATIONAL RESEARCH PROGRAM (NRP) 2003/2004 S CORPORATION RESULTS

Tax practitioners have been waiting for results from the NRP audits on S corporations. The following information was reported by *Kiplinger Tax Letter*, July 24, 2009 from a presentation by Drew Johns from IRS Research, Analysis and Statistics at the 2009 Research Conference on July 8, 2009.

The last S corporation study was done in 1984. The number of S corporations increased 300% from 826,000 in 1986 to 3.5 million in 2004.

### Preliminary Findings

Preliminary findings of nearly 5,000 returns examined showed net misreported income amounts of \$50 billion and \$56 billion for 2003 and 2004, respectively, with an error rate of nearly 70% in each year. The findings found net misreported income at the entity level, which may not necessarily result in misreporting at the shareholder level.

In addition to misreported income, expenses were overstated. The error rate for expenses in various categories ranged from 23% to 42% over the 2-year period. The net misreported amount deducted in 2003 and 2004 was \$18 billion and \$16 billion, respectively. The expense categories with the highest number of errors were:

- Depreciation
- Car and truck expense
- Travel
- Meals and entertainment
- Tools and factory supplies
- Miscellaneous expenses

### Preliminary Conclusions

Underreported officers' compensation was over 20% as large as all other misreported items combined.

The error rate for closely-held smaller S corporations for 2003/2004 was similar to the error rate for sole proprietors in 2001.

## Shareholder Audits

In the study, shareholder returns were also audited. Items of interest were:

- Flow-through errors
- Limitations on losses (basis, passive activity, and at-risk)
- Taxable distributions:
  - ♦ In excess of basis
  - ♦ From accumulated earnings and profits

## WAGE COMPENSATION FOR S CORPORATION OFFICERS<sup>25</sup>

Corporate officers are specifically included within the definition of employee for FICA, FUTA and federal income tax withholding under the Code. When corporate officers perform services for the corporation, and receive or are entitled to receive payments, their compensation is generally considered wages. S corporations should treat payments for services to officers as wages and not as distributions of cash and property or loans to shareholders.

S corporations elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. S corporation shareholders report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates.

The Code establishes that any corporate officer, including an S corporation officer, is an employee of the corporation for federal employment tax purposes. S corporations should not attempt to avoid paying employment taxes by having their officers treat compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages.

## Who Is a Corporate Employee

Generally, a corporate officer is an employee of the corporation. The fact that an officer is also a shareholder does not change the requirement that payments to the corporate officer are wages. Courts have consistently held that S corporation officer/shareholders who provide more than minor services to their corporation and receive or are entitled to receive payment are employees whose compensation is subject to federal employment taxes.

The Treasury Regulations provide an exception for an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration. Such an officer would not be considered an employee.

## Reasonable Salary

The compensation amount never exceeds the amount received by the shareholder either directly or indirectly. However, if cash or property (or the right to receive cash and property) goes to the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate.

There are no specific guidelines for reasonable compensation in the Code or the Regulations. Various courts that ruled on this issue have based their determinations on the facts and circumstances of each case.

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<sup>25</sup> FS-2008-25, August 2008.

## Some factors considered by the courts in determining reasonable compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history
- Payments to nonshareholder employees
- Timing and manner of paying bonuses to key people
- The amount comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

## MEDICAL INSURANCE PREMIUMS TREATED AS WAGES

The health and accident insurance premiums paid on behalf of the greater-than-2% S corporation shareholder-employee are deductible by the S corporation as fringe benefits and are reportable as wages for income tax withholding purposes on the shareholder-employee's Form W-2. They are not subject to social security or Medicare (FICA), or unemployment (FUTA) taxes. Therefore, this additional compensation is included in Box 1 (Wages) of the Form W-2, *Wage and Tax Statement*, issued to the shareholder, but would not be included in Boxes 3 or 5 of Form W-2.

Payments of the health and accident insurance premiums on behalf of the shareholder may be further identified in Box 14 (Other) of the Form W-2.

Schedule K-1 (Form 1120S) and Form 1099 should not be used as an alternative to the Form W-2 to report this additional compensation.