Chapter 3: IRS Update

Disaster Assistance and Emergency Relief71
Federal Tax Procedure and Collection73
Installment Agreements
Offers in Compromise
Letter Rulings and Determination Letters

Taxpayer Rights9	0
Taxpayer Advocate Service9	4
Preparing for an Audit9	9
IRS Funding Update 10	6

Corrections were made to this material through January of 2012. No subsequent modifications were made.

DISASTER ASSISTANCE AND EMERGENCY RELIEF

The IRS has a disaster and emergency relief program. Its mission is to provide administrative filing and payment relief to taxpayers impacted by qualifying disasters and emergencies.

Relief is provided when the president declares a state disaster area by invoking the Robert T. Stafford Disaster and Emergency Assistance Act, **and** the Federal Emergency Management Agency (FEMA) identifies counties within the state as eligible for their individual assistance to households and families program. The IRS systemically applies a disaster freeze code to the master file accounts of taxpayers with addresses of record in the FEMA identified individual assistance counties.

When relief is granted, filing and payment deadlines are postponed for actions **originally due** during the relief period. Time sensitive actions listed in Rev. Proc. 2007-56 are also postponed.

The IRS issues a news release detailing the relief granted as well as the relevant time period. The news release is also posted by state in the "Around the Nation" category on **www.irs.gov**.

Note. Information on the deductibility of casualty losses can be found in IRS Pub. 547, *Casualties, Disasters, and Thefts.* Treas. Reg. §301.7508A-1 discusses disaster relief situations. IRS Pub. 2194, *Disaster Losses Kit for Individuals,* and IRS Pub. 2194B, *Disaster Losses Kit for Businesses,* provide information to assist in calculating and deducting losses. Additional disaster-related information can be found on **www.irs.gov** by entering the word "disaster" in the search box.

71

After a federally declared disaster, FEMA may open disaster recovery centers (DRCs) to help victims apply for assistance. The IRS has, at a minimum, disaster-related materials available at the centers. At times, IRS employees may be on-site to answer questions. The IRS entered in agreements with national professional organizations permitting chapter members to volunteer at the DRCs. These organizations are as follows.

- American Bar Association
- American Institute of Certified Public Accountants
- Association of Latino Professionals in Finance and Accounting
- National Association of Black Accountants
- National Association of Enrolled Agents
- National Association of Tax Professionals
- National Society of Accountants
- American Association of Attorney-Certified Public Accountants

PREPARING FOR A DISASTER¹

Planning what to do in the case of a disaster is an important part of being prepared. The IRS encourages taxpayers to safeguard their records. Simple steps can help taxpayers and businesses protect financial and tax records in the event of disasters.

Business and Individual Suggestions

• Utilize paperless recordkeeping for financial and tax records. Many people receive bank statements and documents via e-mail. This method is an outstanding way to secure financial records. Important tax records such as W-2s, tax returns, and other paper documents can be scanned and saved in an electronic format.

Backing up electronic files onto a CD or DVD and storing them in a safe place is crucial. Making duplicates of the backups and keeping them in a separate location is also a good business practice. When choosing a place to keep important records, convenience to the home or business should not be the primary concern. Remember, a disaster that strikes the home or business is also likely to affect other facilities nearby, making quick retrieval of records difficult and maybe even impossible. Utilizing "cloud" computing and backing up documents to be stored in the cloud is one way to safeguard records in the event of a disaster.

• **Document valuables and business equipment.** The IRS has disaster loss workbooks for individuals (IRS Pub. 584, *Casualty, Disaster, and Theft Loss Workbook*) and businesses (IRS Pub. 584-B, *Business Casualty, Disaster, and Theft Loss Workbook*) that can help taxpayers compile a room-by-room list of their belongings or business equipment. A list helps taxpayers recall and prove the market value of items for insurance and casualty loss claims.

One option is to photograph or videotape the contents of the home and/or business, especially items of greater value. These photos should be stored with a friend or family member who lives away from the geographic area at risk. Or, the photos could be scanned and stored electronically on a remote computer or in the cloud.

• Check on fiduciary bonds. Employers who use payroll service providers should ask the provider if they have a fiduciary bond in place. The bond could protect the employer in the event of default by the payroll service provider.

^{1.} [www.irs.gov/businesses/small/article/0,,id=180547,00.html] Accessed on Aug. 8, 2011.

Continuity of operations planning for businesses. How quickly the company can get back to business after a disaster often depends on planning done before a disaster strikes. The business creates a plan that improves the likelihood that the company will survive and recover.

There are many benefits to being prepared for disasters. The business only needs to plan once, and should be able to apply the plan to all types of hazards. The following preparedness strategies are common to all disasters.

- Become informed about hazards and emergencies and learn how to handle specific hazards.
- Develop an emergency plan.
- Identify places to seek shelter from all types of hazards.
- Back up all computer data systems regularly.
- Describe the procedure for communicating with employees, customers, and others.
- Use cell phones, walkie-talkies, or other devices that do not rely on electricity as a backup to the telecommunications system.
- Collect and assemble a disaster supplies kit. Include a portable generator.
- Identify the community warning systems and evacuation routes.
- Include required information from community and school plans.
- Conduct a practice disaster drill.
- **Update emergency plans.** Emergency plans should be reviewed annually. Personal and business situations change over time and so do preparedness needs. Individual taxpayers should make sure they are saving documents everybody should keep including such things as W-2s, home closing statements, and insurance records. When employers hire new employees or when a company or organization changes functions, plans should be updated accordingly and employees should be informed of the changes.

Taxpayers should ensure they have a means of receiving severe weather information. If the plan includes using a radio, it is important to decide how frequently to replace the radio's batteries. Some suggest replacing batteries each fall or spring when the time changes. Identify in the plan where to go and what to do when threatening weather approaches.

Note. See Chapter 8, Small Business Issues, for additional information about casualty losses and NOLs in federally declared disaster areas.

FEDERAL TAX PROCEDURE AND COLLECTION

Federal tax procedure largely involves the "rules of engagement" between the IRS and the taxpayer in the tax collection process. While the IRS is provided with powerful statutory collection tools, the same statutes provide the taxpayer with appropriate safeguards and rights throughout the collection process.

Before collection activity can begin, the IRS must generally:

- Complete an assessment of the tax liability, and
- Provide **notice** to the taxpayer of the liability.

73

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ASSESSMENT

Upon determining a tax deficiency, the IRS must first send a **notice of deficiency** to the taxpayer. This advises the taxpayer of the amount of tax the IRS believes the taxpayer owes. The IRS can take no further action for 90 days after issuing the notice of deficiency. This provides the taxpayer with time to file a petition with the Tax Court for a redetermination of the deficiency.² The IRS cannot assess the tax until:

- The 90-day period has expired,
- If the notice is addressed to a taxpayer outside the United States, 150 days have passed, or
- The Tax Court makes a final determination regarding the taxpayer's petition.

Note. Special rules apply for military personnel.³

Assessment refers to the process whereby an IRS official enters the taxpayer's tax liability into IRS records. This type of assessment is a **deficiency assessment** because it follows the determination of an underpayment of tax by the IRS.

An exception to the notice of deficiency and 90-day waiting period exists when an assessment is a **summary assessment.**⁴ A summary assessment takes place after the taxpayer files a typical income tax return showing a tax liability.⁵ By filing the return, the taxpayer acknowledges the tax liability. The IRS is not required to issue a notice of deficiency but can summarily assess and collect tax amounts reported on a return. The date the assessment officer signs the assessment record is the date of the assessment.⁶

COLLECTION

The IRS has a limitations period of 10 years after the date of assessment in which to collect the unpaid tax assessed.⁷ This 10-year limitations period begins on the day after the assessment date.⁸

The IRS has three powerful collection mechanisms.

- **1.** Administrative levy⁹
- **2.** Administrative seizure¹⁰
- **3.** Judicial collection action¹¹

- ^{4.} IRC §6201 enumerates the instances in which a summary assessment can take place.
- ^{5.} IRC §6201(a)(1).
- ^{6.} Treas. Reg. §301.6203-1.
- ^{7.} IRC §6502(a).
- ^{8.} U.S. v. J. Besase, 70-2 USTC ¶9626, 319 F.Supp 1064 (D.C. Ohio, 1970).
- ^{9.} IRC §6331(a).
- ^{10.} IRC §6331(b).
- ^{11.} IRC §7403(a).

^{2.} IRC §6213(a).

^{3.} IRS Pub. 3, Armed Forces' Tax Guide.

Within 60 days of either a deficiency or summary assessment, the IRS must forward **a notice and demand** for payment of the amount of tax owed.¹² To be effective, the IRS need only send it to the last known address of the taxpayer.¹³ There is no requirement that the taxpayer actually receive it.¹⁴ However, it is important for the IRS to send the notice and demand because it triggers statutory tax lien and administrative collection enforcement mechanisms.¹⁵ The notice and demand for payment indicates that the outstanding tax amount must be paid within 10 days of the notice date.

Note. Issuing the notice and demand gives the IRS the ability to use administrative levy and seizure. If no notice and demand is issued, the IRS is limited to judicial collection action.

STATUTORY LIEN

The IRS has a statutory lien on " \dots all property and rights to property, whether real or personal \dots " of the taxpayer when the taxpayer does not pay the amount of tax owed after receiving the notice and demand.¹⁶ This lien arises automatically by operation of the statute. This statutory lien represents an encumbrance on whatever ownership or other rights the taxpayer has in property.

All property of the taxpayer is encumbered by the lien and subject to administrative levy and seizure.

LEVY AND SEIZURE

The statute explains that **levy** includes "the power of distraint and seizure by any means . . ."¹⁷ Accordingly, under the statute, levy includes the concept of "seizure." This section uses the statutory meaning. However, as a practical matter, the two are distinguishable.

Levy occurs when the IRS serves a notice of levy on a third party that holds property of the taxpayer or who owes the taxpayer.

Example 1. Jacob has an outstanding debt of \$5,000. He owns commercial real estate that he leases to Isaac for \$1,500 per month. The IRS serves a notice of levy for \$5,000 on Isaac requiring him to remit the next month's rent directly to the IRS in partial satisfaction of Jacob's IRS debt. Isaac can pay any subsequent monthly rent to Jacob, unless he is served with an additional levy notice.

The levy may also be served on the taxpayer. The notice obligates the recipient to surrender directly to the IRS the property or money that belongs, or is owed, to the taxpayer. A levy is a seizure of property. However, **seizure** can refer to physically taking possession of particular property by the IRS. This act typically precedes a sale of that property with the proceeds being applied against the tax owed. The IRS has dual powers of levy and seizure. Under normal circumstances, before the IRS can levy or seize property, it must forward to the taxpayer:

- A notice of intent to levy,¹⁸ and
- A collection due process (CDP) notice.¹⁹

- ^{18.} IRC §6331(d).
- ^{19.} IRC §6330(a).

2011 Chapter 3: IRS Update

75

3

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^{12.} IRC §6303(a).

^{13.} Ibid.

^{14.} B.M. Gentry v. U.S., 91-2 USTC ¶50,374 (D.C. Tenn.), aff'd on other issues, CA-6, 92-1 USTC ¶50,225, 962 F.2d 555 (1992).

^{15.} IRC §6321 (federal tax lien) and IRC §6331(a) levy power are both predicated on the taxpayer failing to pay after "notice and demand."

^{16.} IRC §6321.

^{17.} IRC §6331(b).

Both notices must be sent at least 30 days before any actual levy is served. The CDP notice advises the taxpayer of a right to request a pre-levy hearing before an IRS office of appeals. This request must be made within 30 days after the date of the notice. During this 30-day waiting period, the IRS is prohibited from levying property.²⁰ When the taxpayer requests a hearing, levy action is precluded during the time the hearing is pending and for 90 days thereafter.²¹

Note. Both the notice and demand and the notice of intent to levy are required before any actual levy. The IRS can send both of these notifications at the same time.²²

The IRS is prohibited from levying property:

- During certain employment tax refund proceedings,²³
- While an **accepted offer in compromise** is in place,²⁴ and
- During the term of an **accepted installment agreement**.²⁵

The levy prohibition for an offer in compromise and an installment agreement includes the time during which the taxpayer request is pending. In addition, when the request is rejected, the prohibition extends 30 days after the date of rejection and any subsequent appeal period. During these periods of time when levy is prohibited, the 10-year statute of limitations is suspended.

Example 2. Norma received a tax assessment on December 31, 2000, in connection with her 1999 tax return. The appropriate notice and demand was received shortly thereafter for the 1999 tax Norma owed. Norma filed the forms and paperwork necessary to obtain an installment agreement for the 1999 taxes she owed. The IRS received her request on June 1, 2001. Her request was denied. She filed an appeal and the appeal was decided in favor of the IRS on October 31, 2001. The IRS sent Norma a notice of intent to levy and a CDP notice on June 13, 2011.

The usual 10-year limitations period for the collection of 2000 income tax is measured from the date after the assessment date. The assessment date is December 31, 2000. The 10-year limitations period runs from January 1, 2001, to December 31, 2010. However, this 10-year limitations period is suspended for the period of time it took to process the application and reject the request, and for the appeal period of the installment agreement that Norma attempted to obtain with the IRS. The limitations period is suspended:

- During the time the installment agreement request is pending,
- For 30 days after the rejection, and
- During the time the appeal is pending, if the rejection is appealed within 30 days.

In Norma's case, these periods spanned from June 1 through October 31, 2001 (a total of 153 days). This extends the 10-year collections limitation period by 153 days. Accordingly, rather than the collections limitation period ending on December 31, 2010, it ends 153 days later on June 2, 2011. The IRS notice of intent to levy, CDP notice, and any other collections activity related to the 1999 tax is past the limitations period. The final day for any IRS collection action, including judicial action or administrative action, is June 2, 2011.

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^{20.} Ibid.

^{21.} IRC §6330(e)(1).

^{22.} Treas. Reg. §301.6331-2(a)(1).

^{23.} IRC §6331(i).

^{24.} IRC §6331(k)(1).

^{25.} IRC §6331(k)(2).

LIEN PRIORITY RULES

Often, a federal tax lien (FTL) competes with other liens placed on the property of the taxpayer. These competing liens most often arise under state law. In order to determine whether state law liens have priority over an FTL, an understanding of both the basic rules and the several exceptions to those basic rules is necessary.

Federal law determines questions of priority of the FTL over liens created under state law. The federal rules are codified as IRC §6323. In addition, federal tax lien priority controversies are always addressed by federal courts.

However, state law is determinative of the particular property rights conferred to a lienholder. The federal lien priority law does not create property rights, rather, it only creates rights of priority in whatever property rights exist under applicable state law.

Basic Rules

The **first in time, first in right** principle applies to competing liens. In order for a prior state law lien to have priority over an FTL, it must be **choate** (complete and superior to subsequent liens). A prior lien is choate if all of the following apply.

- **1.** It has been **perfected** under state law.
- **2.** The identity of the lienholder is clear.
- **3.** The property subject to the lien is clearly established.
- 4. The amount of the lien is clear.

Perfection exists when the lienholder files the necessary financing statement with the appropriate state office to provide public notice of the lien.²⁶ The IRS perfects the FTL by filing a notice of federal tax lien (NFTL). The NFTL makes the tax lien against the taxpayer's property a matter of public record.

When the four factors are satisfied, the lien is choate and it prevails over an FTL. A lien is not choate until it attaches to specific, clearly identifiable property.

The FTL commences upon the filing of the NFTL.²⁷ Some courts hold that the lien must also be enforceable without judicial action (summarily enforceable) as an additional required element for choateness.²⁸

The FTL not only provides the IRS with a security interest in the taxpayer's property, but also in after-acquired property. An FTL and competing lien under state law attach to after-acquired property simultaneously. However, the FTL takes priority over state law liens in connection with after-acquired property.²⁹

^{26.} This is accomplished in connection with the state's version of Article 9 of the Uniform Commercial Code.

^{27.} U.S. v. McDermott, 507 U.S. 447 (1993); U.S. v. Pioneer American Ins. Co., 374 U.S. 84 (1963).

^{28.} Monica Fuel Inc. v. IRS, 56 F.3d 508 (3rd Cir. 1995) holds that choateness includes summary enforceability. Cf. Burrus v. Oklahoma Tax Comm'n, 59 F.3d 147 (10th Cir. 1995) rejecting summary enforceability as a fifth element of choateness.

^{29.} U.S. v. McDermott, 507 U.S. 447 (1993).

Unperfected Tax Lien. The statutory tax lien provided for under IRC §6321 arises at the time of assessment. Without the IRS filing an NFTL to perfect this lien, it only generally prevails against other later unperfected liens on the taxpayer's property. The following parties prevail against an unperfected FTL.

- **Purchasers** who paid adequate and full consideration to acquire a property interest, other than a lien or security interest, that is valid against subsequent purchasers under state law³⁰
- Holders of security interests that existed before an NFTL filing and that have been perfected under local law³¹
- Holders of a mechanic's lien that existed before an NFTL filing (A mechanic's lien arises as soon as it becomes valid against subsequent purchasers who have no notice of the lien. The earliest date this can occur is the date the lienholder began furnishing the services, labor, or materials to the taxpayer.)³²
- Holders of a judgment lien that is perfected and choate before any NFTL filing

Perfected Tax Lien. Even when the IRS files an NFTL to perfect its interest, lienholders involved in the following areas prevail over the perfected tax lien by federal statute.

Securities. Securities include stocks, bonds, debentures, negotiable instruments, voting trusts, and money.³³ The following lienholders prevail over a perfected tax lien.

- The purchaser of a security who has no knowledge or actual notice of the tax lien at the time of purchase³⁴
- The holder of a security interest in a security who has no knowledge or actual notice of the tax lien at the time the security interest arises³⁵
- The transferee of a protected purchaser or security interest holder as outlined previously³⁶

Motor Vehicles. A purchaser of a motor vehicle from the taxpayer prevails against a perfected FTL if the purchaser:

- Has no actual knowledge of the tax lien, and
- Takes possession of the vehicle and does not relinquish possession back to the taxpayer or any agent of the taxpayer.³⁷

Retail Transactions. A purchaser who makes a retail purchase prevails over a perfected tax lien if the purchaser did not intend for the purchase to subvert the collection of taxes.

A **retail purchase** is a sale made in the ordinary course of business. A retail purchase does not include bulk sales and certain auction transactions.

Example 3. Becky needs a new lawn mower. The local dealer has an outstanding IRS lien on its entire inventory. Becky can purchase the mower without fear of the IRS repossessing her mower in satisfaction of the dealer's tax lien.

Note. The retail purchaser prevails even with knowledge or notice of the federal tax lien.

- ^{32.} IRC §6323(h)(2).
- ^{33.} IRC §6323(h)(4) provides a full definition of the types of items that qualify as a "security" under this provision.
- ^{34.} IRC §6323(b)(1)(A).
- ^{35.} IRC §6323(b)(1)(B).
- ^{36.} Treas. Reg. §301.6323(b)-1(a)(1)(iii).
- ^{37.} IRC §6323(b)(2).

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^{30.} IRC §6323(h)(6).

^{31.} IRC §6323(h)(1).

Casual Sale of Personal Property. A purchaser of household goods and personal effects in a sale of less than $$1,380^{38}$ prevails against a perfected tax lien. In order to prevail, the purchaser must not have made the purchases for resale purposes. In addition, the purchaser must not have any actual knowledge:

- Of the tax lien, or
- That the sale is one of a number of sales in which the taxpayer plans on disposing of substantially all household goods or personal effects.³⁹

Possessory Lien on Personal Property. Under state law, repairmen may have a lien on tangible personal property to secure the reasonable price of repair or improvement. If the repairman has continuously possessed the property since the time the lien arose, this lien prevails over a perfected tax lien.⁴⁰

State and Local Real Estate Taxes. State and local property taxes, including special assessments for improvements and charges for utilities or other public services furnished to the property by any governmental agency, take priority over a perfected tax lien.⁴¹

Attorney's Liens. A lien or contract providing reasonable attorney's fees for services in obtaining a judgment or settlement prevails over a perfected tax lien. The priority of the lien is limited to reasonable attorney compensation to secure a judgment or settlement and for work in claims to recover money or property. Legal services in connection with defending title to property or money are not included. The attorney's lien has priority whether or not the attorney knew of the tax lien at any time.⁴²

Deposit-Secured Loans. A deposit-secured loan made by a financial institution that is secured by an account with the financial institution prevails over a perfected tax lien. However, this priority only exists if the loan was made before the bank had actual notice or knowledge of the tax lien.⁴³

Commercial Financing Transactions. Many types of commercial financing transactions exist. Merchants may agree on minimum quantities of goods within their transactions. Bank financing can be obtained based on the minimum sales agreed upon. Further, a bank may take a security interest in a customer's presently owned and subsequently acquired commercial paper, accounts receivable, and inventory. Indeed, the types of commercial financing transactions possible between merchants and banks are virtually endless.

When such an arrangement exists, the arrangement takes priority over a perfected tax lien. The factors necessary for priority include the following.

- The lender or purchaser providing the financing must do so in the ordinary course of its business.
- If there is financing involved, the financing must be secured by collateral acquired by the taxpayer in the ordinary course of its business.
- If there is a purchasing agreement involved, the security purchased must be items other than inventory acquired by the taxpayer in the ordinary course of business.

Priority over a perfected tax lien is only provided to financing or purchasing done before the earlier of:

- The 46th day after the IRS filed the NFTL, or
- The date the lender or purchaser obtained actual knowledge of the tax lien.

- ^{40.} IRC §6323(b)(5).
- ^{41.} IRC §6323(b)(6).
- ^{42.} IRC §6323(b)(8).
- ^{43.} IRC §6323(b)(10).

3

2011 Chapter 3: IRS Update

79

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^{38.} This amount is indexed for inflation from 2011 onward.

^{39.} IRC §6323(b)(4).

Real Estate Construction Financing Agreement. Priority over a perfected tax lien is provided to a real estate construction or improvement financing agreement if:

- 1. The agreement is in writing;
- 2. The parties enter into the agreement before the IRS files an NFTL; and
- **3.** The agreement is to finance either:
 - a. Construction, improvement, or demolition; or
 - **b.** The raising or harvesting of farm crops, livestock, or other animals.⁴⁴ Only the security interest in the real estate that is the subject of the work to be done is given priority status.⁴⁵ When farming is the subject of the agreement, the security interest in the crops, livestock, or any other property that can be encumbered by the federal tax lien is given priority if the property is owned by the taxpayer at the time the NFTL is filed.⁴⁶

ELIMINATING THE TAX LIEN

Release

The taxpayer can file an administrative appeal with the IRS regarding a lien.⁴⁷ The appeal must be based on one of the following grounds.

- The tax liability, with interest, was paid.
- The tax liability was a deficiency that was assessed in violation of the procedures mandated in IRC §6213.
- The tax liability was assessed in violation of the Bankruptcy Code.
- The statute of limitations for collection expired before the NFTL was filed.⁴⁸

Discharge

Part or all of the property subject to a lien can be discharged from the lien. This removes the lien encumbrance from the property. Property may be discharged at the discretion of the IRS if the IRS determines that any of the following apply.

- The fair market value (FMV) of the encumbered property is at least double the amount of the unpaid tax liability plus the amount of other liens superior to the tax lien.
- It should discharge part of the property with a value up to the amount of partial payment received, taking into account IRS expenses on the case to date and other facts and circumstances.⁴⁹
- The property should be sold, with a subsequent lien being placed on the sale proceeds of the property to secure the government's interest in the same manner as with the original lien on the property. This discharge is only permitted with a property sale that results in the taxpayer totally relinquishing all interest in the property.

- ^{45.} Treas. Reg. §301.6323(c)-2(c)(1).
- ^{46.} Treas. Reg. §301.6323(c)-2(c)(2).
- ^{47.} IRC §6326(a).
- ^{48.} Treas. Reg. §301.6326-1(b).
- ^{49.} IRC §6325(b)(2)(A); Treas. Reg. §301.6325-1(b)(2)(i).

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^{44.} IRC §6323(c)(3).

RECENT CHANGES

Until recently, the IRS adhered to a general rule that in order to file a lien, a \$5,000 threshold in taxes was necessary.⁵⁰ On February 24, 2011, the IRS announced that the threshold of taxes owed was being increased to \$10,000 for lien enforcement.⁵¹ Consequently, fewer liens will be filed and many taxpayers' credit scores will not be adversely affected with an NFTL filing. However, liens may still be filed on amounts **less than \$10,000** when circumstances warrant.

Other IRS measures in the same announcement include expedited withdrawal of a lien upon payment of the balance of tax owed. Streamlining the lien withdrawal procedures and permitting collection personnel to withdraw the lien are among the steps taken to speed up the lien withdrawal process after payment of tax is received. In the past, substantial delays in this area were common.

Moreover, when the taxpayer owes \$25,000 or less, the IRS allows the withdrawal of a lien if the taxpayer does one of the following.

- Enters into a direct debit installment agreement (DDIA)
- Converts from a regular installment agreement to a DDIA
- Requests the withdrawal of a lien when an existing DDIA is in place

Liens generally are withdrawn after a probationary period that demonstrates that the direct debit payments within the DDIA are honored.

Note. To qualify for a lien withdrawal or to become eligible for a DDIA, the taxpayer must pay their balance down to \$25,000 or less (combined tax, penalty, and interest).

INSTALLMENT AGREEMENTS

The IRS may enter into an installment agreement (IA) if it determines that such an agreement will facilitate full or partial collection of a tax liability when the taxpayer is unable to make timely payment.⁵² The taxpayer applies for an IA by submitting Form 9465, *Installment Agreement Request*. Also required is Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, or a similar form. This form provides the IRS with the necessary financial information to determine the taxpayer's ability to pay the tax. It discloses monthly income, allowable expenses, and existing assets and liabilities.

The IRS assesses the taxpayer's ability to pay by reviewing the available monthly income minus allowable expenses as shown on Form 433-A or a similar form. In order for the IRS to approve an IA, the taxpayer's ability to maintain the appropriate payments over the life of the IA must be determined.

STREAMLINED AND GUARANTEED IA

When the outstanding tax liability is \$25,000 or less, including applicable interest and penalties, installment agreements can be arranged under streamlined procedures. The need for Form 433-A, financial analysis, and managerial approval is eliminated. Under this streamlined procedure, the IRS will grant an IA for payments that satisfy the full balance within a 5-year period. The filing of liens is likewise eliminated with this streamlined procedure. Moreover, these agreements are available to taxpayers who can immediately pay their tax liabilities in full. Use of an IA may allow the taxpayer to eliminate their tax liability on far easier terms or without the need to liquidate assets.

2011 Chapter 3: IRS Update

81

^{50.} IRM 5.12.2.4.1.

^{51.} IRS News Release IR-2011-20 (Feb. 24, 2011).

^{52.} IRC §6159(a).

Guaranteed IA

By statute, if the IRS determines that the taxpayer is unable to immediately pay, it must enter into an IA with the taxpayer if:

- The amount owed is \$10,000 or less (without regard to applicable interest and penalties);
- The IA requires the full payment of the tax liability within a 3-year term;
- The taxpayer has filed required returns and paid taxes in full for each of the past five taxable years; and
- The taxpayer has not entered into an IA during the preceding 5-year period.⁵³

The IRS website has an online payment agreement to facilitate applying for a guaranteed IA. A portion of this web page is shown here.⁵⁴

Online Payment Agreement Application

You can avoid unnecessary penalties and interest by paying your taxes in full and on time. This application will allow you or your authorized representative (Power of Attorney) to apply for an installment agreement if you cannot pay your taxes in full.

1 Determine your eligibility	2 Gather your information	3 Submit your application!
• You owe \$25,000 or less in combined tax, penalties and interest.	 Social Security number or Individual Tax ID number; 	 Apply for a payment agreement. Receive immediate notification of
• You have filed all required tax returns.	• Date of birth;	 Receive infinediate notification of approval.
	 Caller ID number, shown at the top of your recent notice; 	
	 PIN, if you have one. If not, you need your AGI; 	
	 Highest amount you can pay, and when you can pay it. 	
	 Also have your tax return handy to verify information. 	

Previously, a small business owing \$10,000 or less in tax could also qualify for a guaranteed IA. As part of the "Fresh Start" initiative announced February 24, 2011, small businesses that currently have employees can qualify for an inbusiness trust fund express installment agreement (IBTF-Express IA). These installment agreements generally do not require a financial statement or financial verification as part of the application process. The criteria to qualify for an IBTF-Express IA are as follows.

- 1. The taxpayer owes \$25,000 or less at the time the agreement is established.
- 2. The debt must be paid in full within 24 months or prior to the collection statute expiration date.
- 3. The taxpayer must enroll in a DDIA if the amount owed is between \$10,000 and \$25,000.
- 4. The taxpayer must be compliant with all filing and payment requirements.

Note. The guaranteed installment agreement was introduced by the Restructuring and Reform Act of 1998 and is one of several "taxpayer rights" provisions of that act.

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^{53.} IRC §6159(c).

^{54.} [www.irs.gov/individuals/article/0,,id=149373,00.html] Accessed on Aug. 10, 2011.

The IRS charges a \$105 fee for an installment agreement. This fee is reduced to \$52 if the payments are scheduled by electronic funds transfer (EFT). Low-income taxpayers can qualify for an even lower fee of \$43 by completing Form 13844, *Application for Reduced User Fee for Installment Agreements*. The fee for reinstating or reorganizing an installment agreement is \$45.

- 42044	Department of the Treasury — Internal Revenue Service
Form 13844 (January 2011)	Application For Reduced User Fee For Installment Agreements

The user fee for entering into an installment agreement after January 1, 2007 may be reduced to \$43 for individuals whose income falls below 250% of the criteria established by the poverty guidelines updated annually by the U.S. Department of Health and Human Services. The reduced user fee for individuals does not apply to corporations or partnerships. Use this form to apply for the reduced user fee. Please include the Form 433-A if your income has recently decreased and you wish to apply for the reduced fee. If your application is granted, the amount of any user fee collected in excess of \$43 will be applied against your Internal Revenue Code liabilities and reduce the amount of interest and penalties that may accrue. To request the reduced user fee, mail this form to: IRS, P.O. Box 219236, Stop 5050, Kansas City, MO 64121-9236.

If you are an individual, follow the steps below to determine if you qualify for a reduced installment agreement user fee.

- 1. **Family Unit Size** ______. Enter the total number of dependents (including yourself and your spouse) claimed on your current income tax return (Form 1040, Line 6d).
- 2. **Total Income**_____. Enter the amount of total income reported on your current income tax return (Form 1040, Line 22).
- 3. Compare the information you entered in items 1 and 2, above, to the Reduced User Fee Income Guidelines table below. Find the "Size of Family Unit" equal to the number you entered in item 1. Next, find the column which represents where you reside (48 Contiguous States and DC ..., Alaska or Hawaii). Compare the Total Income you entered in item 2 to the number in the row and column that corresponds to your family unit size and residence. For example, if you reside in one of the 48 contiguous states, and your family unit size from item 1 above is 4, and your Total Income from item 2 above is \$50,000, then you are qualified for a reduction of the installment agreement user fee because your income is less than the \$55,125 guideline amount.
- 4. If the total income you entered in item 2 is more than the amount shown for your family unit size and residence in the Reduced User Fee Income Guidelines table below, you do not qualify for a reduction of the installment agreement user fee.
- 5. If the total income you entered in item 2 is equal to or less than the amount shown for your family unit size and residence in the Reduced User Fee Income Guidelines table below, you may qualify for a reduction of the installment agreement user fee. If you qualify for a reduction of the user fee based on your income level, you must sign and date the certification portion of this form and submit it to the IRS within 30 days from the date of the Installment Agreement acceptance letter that you received. Applications submitted after the due date will not be considered for qualification.

Reduced User Fee Income Guidelines				
Size of Family Unit	48 Contiguous States and D.C.	Alaska	Hawaii	
1	\$27,075	\$33,825	\$31,150	
2	\$36,425	\$45,525	\$41,900	
3	\$45,775	\$57,225	\$52,650	
4	\$55,125	\$68,925	\$63,400	
5	\$64,475	\$80,625	\$74,150	
6	\$73,825	\$92,325	\$84,900	
7	\$83,175	\$104,025	\$95,650	
8	\$92,525	\$115,725	\$106,400	
For each additional person, add	\$9,350	\$11,700	\$10,750	

Source: Based on 2010 US Dept of Health & Human Services Poverty Guidelines, Federal Register, Vol. 75, No. 148, August 3, 2010, pp. 45628-45629.

Your Name (Last, First, Middle Initial) (Please Print)	Social Security Number (SSN) or Taxpayer Identification Number (TIN)
Spouse's Name (Last, First, Middle Initial) (Please Print)	Social Security Number (SSN) or
	Taxpayer Identification Number (TIN)

Certification: I certify under penalty of perjury that I am eligible for a reduction of the installment agreement user fee based on my family unit size and income.

Your Signature	Date
Spouse's Signature <i>(if it is a joint liability)</i>	Date
Catalog Number 49443R www.i	rs.gov Form 13844 (Rev. 1-2011)

2011 Chapter 3: IRS Update

83

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OFFERS IN COMPROMISE

An offer in compromise (OIC) is an agreement between the IRS and the taxpayer. The parties agree that the taxpayer will pay the IRS less than the full amount owed in exchange for a full settlement of the account.

The Tax Increase Prevention and Reconciliation Act of 2005 initiated major changes to the OIC program. These changes became effective July 16, 2006. As a result of recent financial hardships for many taxpayers, tax practitioners may now be working with these changes for the first time. These changes are reflected in IRC §7122.

Before submitting an OIC, the taxpayer must have filed all required tax returns for previous years or provide explanation of why return(s) were not filed.

To submit an OIC, Form 656, *Offer in Compromise*, and Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, are completed and submitted to the IRS.

Form 656 requires the applicant to indicate the grounds upon which an OIC is being submitted. There are two grounds from which to choose.

- 1. **Doubt as to collectability.** Doubt exists that the taxpayer could ever pay the full amount of taxes owed within the collections period due to insufficient assets and income.
- **2.** Effective tax administration (ETA). The taxpayer can pay the tax in full, but exceptional circumstances exist that would allow the IRS to consider an OIC.

When tax collection by the IRS would be unfair or inequitable or would create undue financial hardship, the ETA ground is used.

Note. Taxpayers who wish to file an offer on the grounds of doubt as to liability must file Form 656-L, *Offer in Compromise (Doubt as to Liability).*

REASONABLE COLLECTION POTENTIAL

The IRS quantifies the ability to collect taxes from the taxpayer once the OIC has been submitted. This is accomplished by calculating the **reasonable collection potential** (RCP) based on the figures indicated in the forms submitted with the offer. The RCP is represented by the following formula:

RCP = Net equity in assets + Amount collectible from future income after deducting living expenses

Generally, if the taxpayer's financial data indicates an ability to immediately pay the existing tax liability in full or through an installment agreement, the offer is rejected. However, special circumstances may provide a possible exception to this general rule. Such circumstances are reflected in an OIC filing based on ETA grounds.

Under the revised rules, an OIC submitted after July 16, 2006, must include a **partial payment** of the proposed offer amount.⁵⁵ Exceptions to this include:

- An OIC submitted on doubt as to liability grounds, and
- An OIC submitted by a lower-income taxpayer who obtains a waiver for the application user fee.

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^{55.} IRC §7122(c)(1)(A).

PAYMENT MODES

The taxpayer can submit an OIC that is structured according to one of two payment options. The payment option is selected by checking the box on page 2 of Form 656, *Offer in Compromise*, as shown here.

ayment Option 1	<u> </u>
Check here if you will pay your of	fer in five or fewer payments:
anouse a check for 20% of the offer amount(s) and date(s) of your future	r amount (waived if you are an individual and met the requirements for Low-Income certification) and fill in the payment(s).
20% of the offer amount is \$	leaving a balance of \$ to be paid as follows after the acceptance of your offer:
Amount of payment 1 \$	date
Amount of payment 2 \$	date
Amount of payment 3 \$	date
Amount of payment 4 \$	date
Amount of payment 5 \$	date
ayment Option 2	
	for in full in more than five months and new in monthly installments
Check here if you will pay your of	fer in full in more than five months and pay in monthly installments
	tallment (waived if you are an individual and met the requirements for Low-Income certification)
Enclose a check for one month's insi	tallment (waived if you are an individual and met the requirements for Low-Income certification)
Solution of the second se	
Se a check for one month's inst Second Second Se	tallment (waived if you are an individual and met the requirements for Low-Income certification) ed with the Form 656 and then \$ on the (day) of each month thereafter for a payments must equal the total Offer Amount. monthly payments while the IRS is considering the offer. Failure to make regular monthly payments

A submitted OIC requires payment of a \$150 user fee. For lower-income taxpayers, there is a checkbox to have the user fee waived. A qualifying lower-income taxpayer does not need to pay a user fee, the first payment of the offer, or the 20% upfront payment when otherwise required.

While the submitted offer is reviewed, the taxpayer must make any periodic payments in accordance with the terms of the offer submitted. If the offer is rejected, the IRS keeps the user fee and all payments made. Payments are applied to the balance of tax owed.

Under the new rules, an OIC is deemed accepted if it is not withdrawn, rejected, or returned within 24 months of the IRS receipt date.⁵⁶

JUDICIAL REVIEW

The 8th Circuit Court of Appeals ruled that courts can review an IRS decision to reject a taxpayer's submitted OIC.⁵⁷

85

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^{56.} IRC §7122(f).

^{57.} Ronald Speltz v. Comm'r, 454 F.3d 782 (2006).

FRAUD POTENTIAL

"Pennies on the Dollar"

There are two legitimate reasons for taxpayers to use the OIC program.

- 1. They may be able to resolve their tax debt for less than the full amount owed.
- **2.** Once the OIC application is filed, the IRS cannot continue any collection action until the OIC is accepted or denied.

Over the past several years, newly formed firms have been advertising that they can resolve a taxpayer's debt for "pennies-on-the-dollar." Because many offers are denied by the IRS, these firms typically work on a retainer basis with the taxpayer paying a substantial upfront fee to the firm. Once the fee is received, the firm may or may not attempt to resolve the tax debt using the OIC process. While the IRS does not have the authority to stop these "OIC mills," some state attorneys general have begun action against these fraudulent businesses.

Taxpayers that watch late-night television have likely seen the ads of Roni Deutch, the "Tax Lady." She advertised herself as owning the nation's largest tax-resolution firm. After receiving numerous complaints from clients that the firm collected large upfront fees but never produced any results, California Attorney General Edmund Brown, Jr., began an investigation. In an August 23, 2010, press release,⁵⁸ Brown announced that he had filed a \$34 million lawsuit against Deutch.

The press release noted that Deutch spent \$3 million per year on advertising her success in reducing tax debt. Deutch's firm grossed over \$25 million per year according to Brown. When potential customers called Deutch's office, they talked to a sales agent whose goal was to get as many clients as possible to hire the firm. The agents often told potential clients that Deutch successfully resolved 99% of their clients' tax debts. In actuality, a mere 10% were resolved. If a client requested a refund because they received no service, they often received a bill for services that were never performed.

On April 20, 2011, Brown asked the court to hold Deutch in contempt of court for shredding millions of pages of documents and failing to pay refunds to her clients in violation of a court order.

On May 12, 2011, Deutch closed her law firm, which employed 200 people. She continued to proclaim her innocence saying the firm had a \$10 million debt, she had a \$5 million personal debt, and she was unable to defend herself against charges that could land her in jail.

Note. While Roni Deutch and others have been taking advantage of taxpayers, this does not mean everyone offering OIC services is disreputable. There are many reputable tax professionals that help clients resolve their tax debts.

Delayed Collection Action

No levy on property can be made by the IRS once an OIC is made.⁵⁹ If the IRS rejects the offer, the property cannot be levied for another 30 days and the taxpayer has to appeal the denial.⁶⁰ Consequently, some taxpayers prepare an offer as a stall tactic to allow them time to gather funds to make a full payment to the IRS.

As a strategy to halt the submission of frivolous offers, the IRS can assess a \$5,000 penalty.⁶¹ The penalty can be assessed on both the taxpayer and the person submitting the frivolous offer.⁶²

62. IRC §6702(b).

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^{58.} [http://oag.ca.gov/news/press_release?id=1978&y=2010] Accessed on Jun. 28, 2011.

^{59.} IRC §6331(k)(1)(A).

^{60.} IRC §6331(k)(1)(B).

^{61.} IRC §6702(a).

LETTER RULINGS AND DETERMINATION LETTERS

A **letter ruling** (LR) constitutes a written interpretation and application of tax laws to a particular taxpayer's facts and circumstances. This is issued in response to the taxpayer's timely request. A request is timely if made before the filing of the tax return or report that will be affected by the LR.⁶³

A **determination letter** (DL) is a written application of previously announced principles and precedents to a specific set of facts. A DL is issued only through application of established and clear tax rules.⁶⁴

The LR and DL are among the methods used by the IRS to provide taxpayers with guidance. They are issued to further effective and sound tax administration. The detailed procedures for requesting an LR or DL are outlined in Rev. Proc. 2011-1. The first revenue procedure published each year updates these procedures. This section includes an overview of this very detailed revenue procedure.

STEPS TO REQUEST A LETTER RULING

Presubmission Conference

It may be helpful to request a presubmission conference⁶⁵ with the Associate Office to discuss substantive or procedural issues before actually drafting or submitting the LR or DL request. A presubmission conference is held at the discretion of the Associate Office, and only if:

- The identity of the taxpayer is provided to the Associate Office,
- The matter is one upon which an LR is normally issued,
- The taxpayer actually intends to make a request for a LR, and
- Time permits.⁶⁶

A presubmission conference can be scheduled by letter or telephone. The relevant IRS Associate Office contact numbers are found in Rev. Proc. 2011-1, Section 10.07. This conference can be held by telephone.

Submission of Required Information

Each request for an LR or DL must include:

- A complete statement of the facts relating to the transaction, including a detailed description of the transaction;
- True copies of related documents, such as contracts, wills, deeds, and other instruments;
- Copies of relevant foreign laws when applicable;
- Analysis of material facts and their bearing on the issues;
- Notification if a previous tax return for the taxpayer or related party is (or was previously) under examination, or before appeals or federal court;
- An indication whether a request involving the same or similar issue was previously filed or ruled on;
- The taxpayer's interpretation of any substantive tax law provisions involved;

3

^{63.} Rev. Proc. 2011-1, 2011-1 IRB 1.

^{64.} Ibid.

^{65.} Ibid.

^{66.} Ibid.

- A statement of authorities that are contrary and supportive of the taxpayer's view; and
- Identification of any known pending legislation on the issues involved.⁶⁷

Note. A request for an LR or DL in connection with a change in accounting method requires submission of Form 3115, *Application for Change in Accounting Method*, and a slightly different request procedure is used. This is addressed in Rev. Proc. 2011-1, Section 9.

A request for an LR or DL may include information or details about the taxpayer that the taxpayer does not want included in the final public version of the LR or DL. By separate letter placed on top of the request for a LR or DL, the taxpayer can provide a "**deletion statement.**" This deletion statement specifies the material the taxpayer wants deleted in the publicized LR or DL. Grounds for the deletion, as provided under IRC §6110(c), must be stated for each proposed deletion. Information that is privileged, private, or proprietary are examples of the types of information that can be deleted based on the grounds available.⁶⁸

Signatures

The LR or DL request **must be signed** by the taxpayer or taxpayer's representative. **A stamped or faxed signature is not acceptable.** The rules regarding authorized representation are provided under Circular 230.

In addition, a "penalties of perjury" statement signed by the taxpayer must accompany the request. The taxpayer's representative cannot sign this item.⁶⁹ In this statement, the taxpayer declares under penalties of perjury that the information submitted with the request has been personally examined and appears true, correct, and complete.⁷⁰

Fees

An LR or DL request must include the appropriate **user fee**. The particular user fee depends upon the subject matter and issues involved. These are outlined in the detailed "Schedule of Fees." The user fees range from zero to \$25,000. A check or money order payable to the United States Treasury must accompany the request. Rev. Proc. 2011-8 outlines the updated fees in connection with LR and DL requests. A "mass submitter" may obtain reduced user fees on particular issues with the use of standardized submission forms.⁷¹

Closing Agreements

The taxpayer may request a **closing agreement** with the ruling. A closing agreement can also be requested instead of submitting an LR request. It is an agreement between the taxpayer and the IRS that settles the outstanding tax issues permanently and conclusively. A closing agreement can be obtained when the taxpayer can demonstrate:

- Good reasons for the agreement, and
- That such an agreement will not be prejudicial to IRS interests.

In addition, the IRS can require a closing agreement from the taxpayer as a prerequisite to issuing the LR requested.⁷²

Note. Section 2.02 of Rev. Proc. 2011-1 specifically describes the use of closing agreements with LR requests. Presumably, a closing agreement could accompany a DL request as well.

- ^{59.} Rev. Proc. 2011-1, 2011-1 IRB 1.
- ^{70.} Ibid.
- ^{71.} Rev. Proc. 2011-8, 2011-1 IRB 237.
- ^{72.} Rev. Proc. 2011-1, 2011-1 IRB 1.

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^{67.} Ibid.

^{68.} IRC §6110(c).

IRS Processing of Requests for an LR or DL

All LR and DL requests are received and initially controlled by the Legal Processing Division of the Associate Chief Counsel for Procedure and Administration. Upon receipt, this office forwards the request to the Associate Office having jurisdiction over the matters involved in the request.

Within 21 days of receiving the request, a representative of a branch of the Associate Office contacts the taxpayer or taxpayer's representative to discuss the procedural issues in connection with the request. If the substantive issues are not too complicated, they are discussed as well. If possible, on each issue involved in the request, the branch representative advises the taxpayer:

- Whether the branch representative is recommending that the Associate Office rule as the taxpayer has requested,
- If the taxpayer should submit additional information,
- Whether the submitted request meets all of the necessary requirements or whether there are shortfalls, and
- If no tentative conclusion can be reached because of the nature of the transaction or issues involved.⁷³

During this discussion, the branch representative may request a meeting if necessary.

Taxpayer's Right to a Conference

The LR request procedure provides for a taxpayer-requested conference as a matter of right.⁷⁴ This conference is held at the Associate Office or by telephone. The individual attending the meeting on behalf of the IRS is someone who has the authority to sign the LR on behalf of the IRS. If requested, this meeting typically is held only after the IRS has had the opportunity to study the issues.

Note. Section 10 of Rev. Proc. 2011-1 specifically provides for a conference as a matter of right for an LR request. It does not refer to this right for a DL request. A conference may also be available with a DL request.

The taxpayer is entitled to only one conference as a matter of right. However, if an adverse ruling is proposed based on new issues or grounds that differ from those discussed at the initial conference, the Associate Office will offer a new meeting.⁷⁵

Right to Withdraw Request

After the conference and before the final ruling, the Associate Office verbally advises the taxpayer on the conclusions reached. If the anticipated ruling is adverse to the taxpayer, the Associate Office offers the taxpayer the opportunity to withdraw the LR request.⁷⁶ The taxpayer has 10 days to respond to this offer. If the LR request is withdrawn, the user fee is not refunded.⁷⁷ Furthermore, in the final stages of the ruling process, the IRS can request a draft-proposed LR from the taxpayer which the IRS can adopt or modify as part or all of its final ruling.⁷⁸

- ^{75.} Ibid.
- ^{76.} Ibid.
- 77. Ibid.
- ^{78.} Ibid.

3

^{73.} Ibid.

^{74.} Ibid.

Final Ruling

The taxpayer may rely, in good faith, on the final LR.⁷⁹ A taxpayer cannot rely on another taxpayer's LR.⁸⁰ The taxpayer generally has no right to appeal a final adverse LR decision. The IRS will use the taxpayer's LR when examining the taxpayer's returns. Although an LR is a matter of public record,⁸¹ it cannot be used or cited as precedent.⁸²

Unless a closing agreement was part of the LR, the IRS can **revoke** or **modify** an LR if it later is determined to be erroneous or not in accordance with IRS views.

Note. Treas. Reg. §601.201(l) contains detailed provisions on the effects of a final LR and addresses modifications and revocations of LRs.

TAXPAYER RIGHTS

TAXPAYER BILL OF RIGHTS

The Taxpayer Bill of Rights includes major changes that have gradually been made to various tax code and tax procedures since 1988. These changes reflect Congress's perceived need for additional pro-taxpayer measures as a balance against broad IRS powers in various areas of tax administration.

The current Taxpayer Bill of Rights (TBOR) has evolved through the passage of three laws which expand these protaxpayer provisions.

- 1. TBOR I: The Technical and Miscellaneous Revenue Act of 1988
- **2.** TBOR II: PL 104-168, 1996
- **3.** TBOR III: The IRS Restructuring and Reform Act of 1998 (IRS RARA)

The IRS RARA is very broad and contains a substantial number of additional safeguards for the taxpayer. This legislation provides these safeguards in several ways, including the following.

- The IRS was required to develop new pro-taxpayer programs or expand existing ones.
- Additional pro-taxpayer court procedures were provided for taxpayers to use in connection with a controversy with the IRS.
- New limits on the IRS's lien, levy, and property seizure powers were enacted.
- New steps to make it easier for taxpayers to interact with the IRS, resolve disputes, and pay outstanding tax liabilities were introduced.
- Certain interest and penalty provisions were reduced and IRS obligations to provide notices and explanations about tax rules and procedures to the taxpayer were increased.

While it is not possible to discuss all the numerous changes made by the IRS RARA, some of the more important ones that expand taxpayer rights follow.

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^{79.} Treas. Reg. §601.201(l)(5).

^{80.} Rev. Proc. 2011-1, 2011-1 IRB 1; Treas. Reg. §601.201(l)(1).

^{81.} IRC §6110.

^{82.} IRC §6110(k)(3).

BURDEN OF PROOF IN TAX LITIGATION

In a typical legal proceeding, one party has the **burden of proof.** The party having the burden of proof has the obligation to come forward with sufficient evidence to establish its case against the other party. If the evidence provided is insufficient, the party with the burden of proof does not prevail.

The IRS RARA consists of a provision to remove the disadvantage of burden of proof on factual issues from the taxpayer. Instead, the burden of proof can be shifted to the IRS. However, in order for the taxpayer to accomplish this procedural advantage against the IRS in tax litigation, the taxpayer must:

- Introduce credible evidence relevant to determining the taxpayer's tax liability,
- Prove sufficient compliance with recordkeeping requirements,
- · Prove previous cooperation with reasonable IRS requests for meetings and information, and
- Prove a net worth under the statutory limitations required for a shift of the burden of proof.

If the taxpayer satisfies these conditions, the burden of proof on factual issues shifts to the IRS.

Note. See the *RI Unlimited, Inc.*, case in Chapter 14, Rulings and Cases, for a case involving a shift in burden of proof to the IRS.

RECOVERY OF LEGAL FEES AND COSTS

Generally, taxpayer recovery of legal fees and costs incurred in connection with tax litigation is difficult. The amount of a successful recovery award is often substantially less than the actual costs. However, the IRS RARA made recovery of costs and fees easier. Pursuing fee recovery is also more economically feasible as a result of these changes.

In order to recover fees, several requirements must be met.

- The taxpayer must have incurred the fees in connection with the determination, collection, or refund of tax.
- The taxpayer must not have unreasonably prolonged the proceedings.
- The taxpayer must have been the "prevailing party."

The taxpayer is the **prevailing party** if:

- The taxpayer substantially prevailed in the controversy, or in most of the issues presented; and
- The taxpayer's net worth is below the requirements necessary for fee recovery.

Fee recovery is only available for an individual taxpayer with a net worth of under \$2 million, or \$4 million for a married couple when a joint tax return is at issue. Previously, if the taxpayer was a business, the same \$2 million limit on net worth applied. The IRS RARA increased the limit for a business taxpayer's net worth from \$2 million to \$7 million. This figure is indexed for inflation each year.

Even if the IRS wins a judgment against the taxpayer, the taxpayer can still be considered the prevailing party under changes made by the IRS RARA. When the IRS wins a judgment but the judgment equals an amount less than a **qualified offer** that the taxpayer made earlier to the IRS, the taxpayer is considered the prevailing party for fee recovery purposes. A **qualified offer** is an offer made by the taxpayer to the IRS under certain statutory guidelines.

In addition, it was previously the case that the only fees that could be recovered by the taxpayer were those incurred after the earlier of the date of the notice of deficiency or the date the taxpayer received a notice of appeals decision. This limitation meant that fees and costs incurred in addressing issues with the appeals office could not be recovered. Changes made by the IRS RARA now permit the recovery of these legal fees and costs.

91

3

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Moreover, there is a limit on the hourly rate of legal fee recovery. Previously, the hourly limit was \$110. Taxpayers often found that pursuing a fee recovery was not worthwhile given this low hourly rate. The IRS RARA increased the limit to \$125 per hour, and this figure is indexed for inflation.

EXPANSION OF INNOCENT SPOUSE RELIEF

The IRS RARA makes innocent spouse relief easier to obtain. Previously, it was necessary to meet understatement thresholds in order to qualify for relief. The IRS RARA eliminates these thresholds. The understatement of tax now must be attributable to an erroneous item of the other spouse. Previously, a "grossly erroneous" item was necessary to qualify.

The IRS RARA also makes a new election available to a taxpayer who, at the time of the election, is no longer married to or is separated from the other spouse. These taxpayers can elect to have their own tax liability limited to only that amount of tax attributable to their own income and tax items.

In addition, the IRS authorizes relief from tax liability for an innocent spouse if the taxpayer would not otherwise qualify for relief under the existing rules, and it would be inequitable to hold that spouse liable for any tax owed.

In 2011, the IRS announced that it will extend help to more innocent spouses.⁸³

- The IRS no longer applies the 2-year limit to new equitable relief requests or requests currently being considered by the agency.
- A taxpayer whose equitable relief request was previously denied due to the 2-year limit may reapply if the statute of limitations for the tax years involved has not expired.
- The IRS will not apply the 2-year limit in any pending litigation involving equitable relief. When litigation is final, the IRS will suspend collection action in certain situations.

TAXPAYER CONFIDENTIALITY PRIVILEGE

IRC §7525 was created by the IRS RARA. This section addresses confidentiality privileges in connection with the information a taxpayer has provided to certain tax professionals. This section serves to provide the traditional attorney-client privilege to clients with "federally authorized tax practitioners."⁸⁴ Such practitioners include attorneys, CPAs, enrolled agents, enrolled actuaries, and others authorized to practice before the IRS.⁸⁵ Some limitations on this privilege include the following.

- The privilege only applies for a noncriminal tax matter or proceeding.⁸⁶
- The privilege does not apply to a written communication from a tax professional regarding participation in a tax shelter.⁸⁷
- The privilege extends over tax advice.⁸⁸

The tax advice covered by the privilege is advice on a matter that is within the scope of the tax professional's authority to practice before the IRS.

- ^{85.} IRC §7525(a)(3)(a).
- ^{86.} IRC §7525(a)(2)(A), (B).
- ^{87.} IRC §7525(b).
- ^{88.} IRC §7525(a)(3)(B).

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^{83.} IRS News Release IR-2011-80 (Jul. 25, 2011).

^{84.} IRC §7525(a)(1).

In addition, because the attorney-client privilege has its own limitations, these limitations also apply in addition to the statutory tax code limitations noted above. For example, when an attorney is acting in a capacity other than as an attorney — such as strictly as a business advisor, accountant or tax preparer — the privilege does not exist.⁸⁹ Moreover, when information is provided by the client to an attorney or an attorney subordinate in front of other persons who are not attorneys, the client can be said to have waived the privilege. In addition, making previously privileged information public waives the privilege. The scope of the privilege is also determined by applicable federal case law.

Note. Like the traditional attorney-client privilege, the taxpayer confidentiality privilege **belongs to the client**, not the tax professional. The client must assert the privilege and can do so either verbally or in writing.

When the privilege is asserted, IRS agents are instructed to request a written statement from the tax professional that gives the reasons for the assertion of the privilege, and then the agent contacts IRS attorneys for guidance on the issue.⁹⁰

Note. See Chapter 12, Ethics, for more information regarding privileged communication with clients.

INTEREST ON REFUND AMOUNTS

Prior to the IRS RARA, the IRS charged 1% more on underpayments than the rate it paid to individual and other noncorporate taxpayers on overpayments. In addition, other special interest rates could subject corporate taxpayers to even greater interest rate differentials on overpayments and underpayments.

The IRS RARA mandates that the IRS pay the same interest rate on tax refunds that it charges on underpayments. This applies to individual and corporate taxpayers. In addition, this provision applies not only to income tax amounts but any other tax imposed by the Code. Moreover, the applicable interest rate on noncorporate overpayments is increased by 1% over the old rate amount (which is based on a formula that uses the federal short-term rate).

The effective date of these changes was January 1, 1999.

GUARANTEED INSTALLMENT AGREEMENT

The IRS RARA created IRC §6159(c). This provision requires the IRS to accept a taxpayer proposal for an installment agreement. These guaranteed installment agreements were discussed earlier in this chapter in the section entitled "Installment Agreements."

93

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^{89.} IRM 4.10.1.6.2.4 specifically indicates that the privilege does not apply to tax-preparation information.

^{90.} IRM 4.10.1.6.2.7.

TAXPAYER ADVOCATE SERVICE

The Taxpayer Advocate Service (TAS) is provided by the office of the National Taxpayer Advocate (NTA). The NTA, in its present form, is a result of the IRS RARA. The IRS RARA amended IRC §7803(c), which is the statutory provision for the NTA. This code section outlines the administration, function, and responsibilities of the NTA. Moreover, the IRS RARA provides for local taxpayer advocate (LTA) offices to be located in each state. The LTA offices are required by law to maintain separate telephone systems, fax lines, and mailing addresses from those of the IRS. The individual LTA offices report directly to the NTA office.

The TAS is an independent organization within the IRS whose primary responsibility is providing assistance to taxpayers to resolve issues with the IRS. A taxpayer qualifies for TAS assistance if the taxpayer:

- Suffers from or is about to suffer economic harm;
- Faces an immediate threat of adverse IRS action;
- Will likely incur significant costs if relief from IRS action is not granted;
- Will likely suffer irreparable injury or long-term adverse impact if relief from IRS action is not granted;
- Experiences a delay of more than 30 days in resolving a tax account problem;
- Has been advised by an IRS agent of a timeframe, either verbally or in writing, and at least 30 days have passed since the normal IRS response time on the particular issue being addressed;
- Faces a tax problem that has not received an appropriate resolution or response from the IRS;
- Is the victim of an IRS system or procedure that has failed to operate as intended or has failed to resolve the problem or dispute;
- Has rights impaired or is facing an inequitable situation because of the way the tax laws are administered; or
- Is an individual taxpayer or a member of a group of taxpayers to whom the NTA believes assistance should be provided due to compelling public policy reasons.

To request TAS assistance, the taxpayer completes Form 911, *Request for Taxpayer Advocate Service Assistance*, or calls (877) 777-4778. If the taxpayer qualifies for assistance, a TAS caseworker is assigned to the taxpayer's case. This caseworker becomes the single point of contact for the taxpayer and works with the case from inception to conclusion. The caseworker acts as mediator between the taxpayer and the particular IRS department with which the taxpayer is having difficulty.

TAS services are provided free of charge. The TAS does not have the power to stop or overturn IRS activity. Therefore, the TAS cannot lift wage garnishments or remove liens. The TAS, however, can make suggestions to key IRS personnel.

Note. The TAS office is frequently referred to as the NTA. However, the NTA is also an actual person who heads all TAS initiatives. The current NTA is Ms. Nina Olson.

94 2011 Chapter 3: IRS Update

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OMB No. 1545-1504

Request for Taxpa	of the Treasury - Internal F Yer Advocate on for Taxpayer A	Service Assistan	ce	Form 911 (Rev. 5-2011)
Section I – Taxpayer Informat	ion (See Pages 3 and 4 fo	r Form 911 Filing Requirements and In	structions for	r Completing this Form.)
1a. Your name as shown on tax return		1b. Taxpayer Identifying Number	(SSN, ITIN	, EIN)
2a. Spouse's name as shown on tax return (<i>if applicable</i>)		2b. Spouse's Taxpayer Identifyin	g Number (SSN, ITIN)
3a. Your current street address (Number,	Street, & Apt. Number)			
3b. City		3c. State (or Foreign Country)	3d. ZIP co	ode
4. Fax number (if applicable)5. Email	address	I		
6. Tax form(s)		7. Tax period(s)		
8. Person to contact		9a. Daytime phone number		nere if you consent to
10. Best time to call		Check if Cell Phone	about y answer	onfidential information our tax issue left on your ing machine or voice ge at this number.
 TTY/TDD Line Interprete Other (please specify) 12a. Please describe the tax issue you are (If more space is needed, attach addi 12b. Please describe the relief/assistance 	e experiencing and any dit tional sheets.))
I understand that Taxpayer Advocate Serv such contacts to be made. Further, by auth receive notice, pursuant to section 7602(c) 13a. Signature of Taxpayer or Corporate C	norizing the Taxpayer Adv of the Internal Revenue	vocate Service to contact third part Code, of third parties contacted in	ies, I under	stand that I will not with this request.
14a. Signature of spouse			14b. Date	signed
Section II – Representative Int	formation (Attach F	form 2848 if not already on file	with the IF	251
1. Name of authorized representative		2. Centralized Authorization File		
3. Current mailing address		 Daytime phone number Fax number 		Check if Cell Phone
6. Signature of representative			7. Date si	gned
Catalog Number 16965S	www	.irs.gov	l Fo	rm 911 (Rev. 5-2011)

2011 Chapter 3: IRS Update

95

TAXPAYER ASSISTANCE ORDERS

A taxpayer facing significant hardship may file an application for a taxpayer assistance order (TAO). The NTA can subsequently issue a TAO to assist the taxpayer.⁹¹ The NTA can also issue a TAO on its own motion when it sees a taxpayer facing significant hardship.⁹²

Significant taxpayer hardship includes:

- An immediate threat of adverse IRS action;
- A delay in resolving account problems of more than 30 days;
- Significant costs, including representation costs, if relief is not granted;
- Irreparable injury to the taxpayer if relief is not granted; and
- A long-term adverse impact on the taxpayer if relief is not granted.⁹³

Proposed regulations expand the definition of a 30-day delay and provide examples of significant hardship.⁹⁴ If an IRS employee is not following published administrative guidance, the NTA can take this into account in determining whether a TAO should be issued for the taxpayer.⁹⁵

A TAO can be issued to require the IRS to release levied property belonging to the taxpayer, cease collection activity, or other specific items indicated in the TAO itself. While a TAO can be issued to any IRS office, division, or function, it may not be directed at the IRS Criminal Investigation Division if it appears the TAO may impede a criminal investigation.⁹⁶

Note. Another requirement of the NTA is to report to Congress twice per year. This report discusses the various problems within the IRS that affect voluntary tax compliance. The most recent report was on June 28, 2011. The report can be found at www.irs.gov/pub/irs-utl/fy2012_ntaobjectives.pdf.

- ^{93.} IRC §7811(a)(2).
- 94. Treas. Reg. §301.7811-1(a)(4).

96. Treas. Reg. §301.7811-1(d).

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^{91.} IRC §7811(a)(1).

^{92.} IRC §7811(e).

^{95.} IRC §7811(a)(3).

SYSTEMIC ADVOCACY

The Office of Systemic Advocacy is the organization within the TAS that addresses large-scale, systemic issues that impact multiple taxpayers. A systemic issue impacts a segment of the taxpayer population. It involves systems, processes, policies, procedures, or legislation and requires study, analysis, recommendation(s), and action to effect a positive resolution. Systemic issues are not the same as individual taxpayer cases. Systemic Advocacy resolves problems by recommending administrative changes to IRS policy, procedures, and processes, or by proposing legislative remedies depending on the issue.

TAS receives issues through the systemic advocacy management system (SAMS), a database used to receive, prioritize, and work issues submitted by the public and IRS employees. Individuals, businesses, academic and research institutions, professional organizations, practitioners, and all other interested parties may submit issues by using the following procedure.

- 1. Go to the SAMS welcome page located at www.irs.gov/advocate/article/0,,id=117703,00.html.
- 2. Read the information on the welcome page, and click the button at the bottom of that page.
- **3.** Answer questions to determine whether a systemic issue exists. Based on the answers provided, the SAMS issue submission page appears.
- **4.** Complete the required fields and provide a brief description of the issue. (SAMS does not accept attachments and copy-and-paste text may not be accurately recognized.)
- 5. Do not include any personal information such as a social security number or any other tax data.
- **6.** Click the "Submit Issue" button.

After submitting the issue, an acknowledgement is sent via email to the taxpayer. Based on the facts presented, a decision is made whether the issue merits development as an advocacy project and, if so, it is assigned. As the issue is reviewed and the status is updated, additional emails may be sent.

If the SAMS website is unavailable, Form 14411, *Systemic Advocacy Issue Submission Form*, can be completed and faxed to (202) 622-3125.

97

	Systemic Advocad				
	Please do not submit tax	data (i.e.	, SSN, EIN, tax returns	s, etc.)	
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Driginator's Name					Telephone Numbe
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98 2011 Chapter 3: IRS Update

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PREPARING FOR AN AUDIT

APPLICABLE LIMITATIONS PERIOD

The general statutory limitations period in which the IRS must audit and assess any additional tax liability is three years.97

However, in instances in which the taxpayer understates gross income by more than 25%, the limitations period is **six** years.⁹⁸ When a trade or business is involved, **gross income** for purposes of the application of this limitations rule means the gross sales proceeds from the sale of goods. Reductions in those proceeds for the cost of goods sold (COGS) or other expenses of sale are disregarded.

Example 4. Claudia is the sole proprietor of Claudia's Custom Clothiers. She has been in the women's apparel retail business for several years. For the 2008 taxable year, Claudia filed her income tax return based on the following business activity for the year.

Revenue	\$40,000
Less: COGS	(10,000)
Less: other expenses	(12,000)
Net income	\$18,000

In addition, Claudia reported \$2,000 in dividend income and \$1,000 in interest income for the year.

During the 2008 taxable year, Claudia's business attempted to expand into the sale of children's clothing. Claudia forgot to report the activity from the sale of children's clothes on her 2008 tax return.

The business activity from the sale of children's clothing is as follows.

Revenue (children's clothes)	\$11,000
Less: COGS	(4,000)
Less: other expenses	(3,000)
Net income	\$ 4,000

Under Treas. Reg. §301.6501(e)-1, a 6-year limitations period applies if Claudia omitted more than 25% of the gross income that was originally reported on her return. Under this regulation, gross income is the total amount received or accrued from the sale of goods or services without taking into account COGS or other expenses.

Claudia's 2008 gross income under Treas. Reg. §301.6501(e)-1 is calculated as follows:

Gross business income reported	\$40,000
Dividend income reported	2,000
Interest income reported	1,000
Total 2008 gross income	\$43,000

In addition, Claudia's omitted gross income is the \$11,000 from the sale of children's clothing, without regard to the COGS or other expenses attributable to that income.

To determine if the omission of gross income is significant enough to trigger the 6-year limitations period, the omitted gross income is compared to the original gross income reported on Claudia's tax return.

This is calculated as follows: 11,000 omitted gross income \div 343,000 gross income reported = 25.58%. Because this omission is in excess of 25%, a 6-year limitations period applies to Claudia's 2008 income tax return.

Furthermore, even if Claudia files an amended return, the 6-year limitations period still applies to her 2008 taxable year.

99

^{97.} IRC §6501(a); Treas. Reg. §301.6501(a)-1(a).

^{98.} IRC §6501(e); Treas. Reg. §301.6501(e)-1.

The purpose of the extended 6-year limitations period is to provide the IRS with extra time to discover a major reporting deficiency when there would be no indication to the IRS that an underreporting existed. The limitations period applies to the taxpayer's total tax liability for the year, not just to the underreported income.

The **overstatement of basis** in the sale of a business asset may also trigger the lengthened 6-year statutory limitations period, even though proceeds from an asset sale are not typically considered to be ordinary gross income for the business that arises from the sale of goods.⁹⁹ However, courts have been split on this issue when litigated.

Note. Two recent cases on this issue can be found in Chapter 14, Rulings and Cases. In *Home Concrete and Supply, LLC,* the 4th Circuit ruled that an overstatement of basis **did not** trigger the 6-year limitation period, whereas in *Beard,* the 7th Circuit ruled that an overstatement of basis **did** trigger the extended limitations period.

In addition, an item of income is not considered omitted from the return if the return or an attached schedule or disclosure contains adequate information to alert the IRS to the nature and amount of the item.¹⁰⁰ The IRS has the burden of proving the omission of income when it invokes the 6-year limitations period.

When it is determined that the taxpayer filed a false or fraudulent return, there is **no limitations period**. Years involving a false or fraudulent return can be audited and assessed at any time.¹⁰¹ It is not necessary that the entire return be fraudulent for this indefinite limitations period to apply. It is sufficient that the return is fraudulent in any respect.¹⁰² For a joint return, the indefinite limitations period applies to both spouses even though only one spouse committed the fraud.¹⁰³

The fraud required to trigger the extended limitations period need not be fraud on the part of the taxpayer. Involvement of another person's fraud is sufficient. However, the IRS has indicated that fraud on the part of the tax preparer is not a basis for applying of the indefinite limitations period to the taxpayer.¹⁰⁴

After the filing of a fraudulent return, the subsequent filing of a correct return does not begin the running of the normal limitations period.¹⁰⁵

Note. IRC §6020 provides the IRS with the ability to prepare a return for a taxpayer. With such IRS-prepared returns, there is no applicable limitations period. Taxable years with IRS-prepared returns can be audited and assessed at any time.

^{103.} A. Raymond v. Comm'r, 61 TC Memo 2750 (1991).

^{105.} E. Badaracco, Sr. v. Comm'r, 464 U.S. 386 (1984).

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^{99.} CCA 200628021.

^{100.} The Colony, Inc. v. Comm'r, 357 U.S. 28 (1958).

^{101.} IRC §6501(c)(1); Treas. Reg. §301.6501(c)-1.

¹⁰² L.L. Lowy v. Comm'r, 288 F.2d 517 (1961).

^{104.} FSA-200104006.

AUDIT STATISTICS

Audit statistics can be found each year in the *IRS Data Book*. IRS data indicates that audit activity associated with individual returns has been steady over the past four years. There has been a slight increase for returns filed during the 2009 calendar year.¹⁰⁶ The following table summarizes the percentage of returns audited for the taxable years 2006 through 2009.¹⁰⁷

Calendar Year	2006	2007	2008	2009
Individual returns filed in calendar year Returns audited in calendar year	134,542,879 1,384,563	137,849,635 1,391,581	138,949,670 1,425,888	142,823,105 1,581,394
Percentage of returns audited	1.0%	1.0%	1.0%	1.1%

For individual tax returns, the recent increase in audit activity has largely centered on higher-income returns. Audit activity for lower-income returns has remained relatively steady. The following table summarizes the percentages of high-income level tax returns audited.

	Examination Coverage			
Reported Income Bracket	2008	2009	2010	
\$500,000 to under \$1 million	2.98%	2.77%	3.37%	
\$1 million to under \$5 million	4.02%	5.35%	6.67%	
\$5 million to under \$10 million	6.47%	7.52%	11.55%	
> \$10 million	9.77%	10.06%	18.38%	
Total percentage of audits for returns with > \$500,000 income	23.24%	25.70%	39.97%	

To summarize the table, 23.24% of all 2008 calendar year individual return audit activity was attributable to returns showing \$500,000 or more of income. Similar figures are shown for returns filed for the 2009 and 2010 calendar years. Over this 3-year period, audit activity for higher-income returns has increased substantially.¹⁰⁸ With increased IRS focus on offshore investment and account disclosure, continued increases in audit activity in connection with returns showing higher levels of income is expected.

TYPES OF AUDITS

There are generally three types of audits.

- **1.** Correspondence audit. An IRS letter requests additional information, an explanation, or documentation regarding one or more items shown on a filed tax return.
- 2. Office audit. An examination of a return is conducted through a meeting at an IRS office.
- **3.** Field audit. An audit is conducted at the taxpayer's residence or place of business to verify items reported by the taxpayer.

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^{106.} The 2009 calendar figures are presented in the 2010 IRS Data Book. This is the latest version available as of the date of this writing.

^{107.} IRS Data Book, 2007–2010.

^{108.} Ibid.

AREAS OF INCREASED AUDIT POTENTIAL

Certain types of economic activity have an increased risk of abuse by taxpayers, such as underreporting income or claiming inappropriate deductions. Whether these abuses are real or perceived, a tax return reporting activity in these areas may face an increased probability of an audit.

Common areas that may trigger an audit include the following.

- Claiming an amount of **itemized deductions** that is higher than the amount expected given the level of income reported
- The existence of **self-employment** income and expense deductions
- Claiming a home office deduction
- Claiming alimony
- Claiming **automobile** expenses
- Claiming meals and entertainment expenses
- Reporting income from a business that is associated with **receipt of cash** amounts
- Claiming a large amount of **cash charitable contributions** relative to the level of income

Note. Current IRS projects include audits of the first-time homebuyer credit and the adoption credit.

BASIC PREPARATION TECHNIQUES

Once the scope of the audit is determined, an appropriate plan of action for the organization and presentation of the necessary records can be developed.

Scope of the Audit

The auditor receives an internally produced IRS checklist indicating the various items or areas of the taxpayer's return to be verified by the examiner. These issues form the **scope** of the audit. However, with approval of the auditor's group manager, the scope of the audit can always be expanded. Permission for expansion of the audit's scope is typically granted.

The auditor can use several audit methods to verify tax return information.¹⁰⁹

- Analytical tests include the analysis of financial statements, including various relationships between reported figures to determine which ones might be the subject of further examination.
- **Documentation** includes examination of books and records to determine their accuracy and whether they corroborate the figures reported on the return.
- **Inquiry** includes interviews with the taxpayer and other third parties to verify or confirm the accuracy of the information furnished by the taxpayer or reported on the return.
- Inspection involves a physical examination of the taxpayer's assets.
- **Observation** includes onsite inspection of the taxpayer's business establishment to observe the nature of day-to-day business operations.
- **Testing** includes taking a representative sampling of transactional records from the taxpayer's information and verifying accuracy and proper reporting.¹¹⁰

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^{109.} IRM 4.10.3.1.

^{110.} Ibid.

3

2011 Workbook

A tax professional can usually determine the scope of the audit by reviewing IRS correspondence providing notice that an examination is to be scheduled. The scope of the audit may be limited to one or two items reported on a return. However, the scope can encompass a complete review of all items on a tax return for one or more years as appropriate.

Once the scope of the audit is determined, the tax professional can begin to develop an appropriate plan of action in connection with the presentation of the necessary records to the auditor.

Preparation of Client Records

Using an organized approach is the best way to effectively represent a client in an audit. The following five steps are most useful in arriving at an effective organization and presentation strategy for the client.

- **Step 1.** Isolation of Relevant Records. The first step is to review the client's records and isolate those documents that are most relevant to the items subject to examination within the scope of the audit. This information should include actual source documents that were used to arrive at the amounts reported on the return. It should also include other relevant documents, such as a deed or contract that corroborates the reported figures. The preparer should ensure that the relevant records isolated for review entirely explain and support the amounts being audited.
- **Step 2.** Organization of Relevant Records. Once the relevant source documents and other records are gathered, the next step is to use the documents to explain how the tax return amounts were computed. The relevant records should be organized in a fashion which facilitates concise and effective analysis.

For example, to address an auditor's concern over unreported income, reconciling schedules should be prepared. Source documents, such as bank deposit books and bank statements, should accompany the reconciliation schedules.

If business expenses or itemized deduction items are within the scope of the audit, corresponding invoices and expenditure source documentation should be sorted by category. Each separate category should be computed using a descriptive, itemized spreadsheet. The particular source documents should accompany the spreadsheet to which they are attributable. Placing the materials in the same order in which they appear on the tax return is helpful. The auditor will likely use a checklist that shows each line item on a return using the standard format of the tax return.

Using this approach supports the auditor's efficient review of the materials that substantiates the amounts on the tax return. If a particular item cannot be fully substantiated, an alternative mode of justification or verification should be considered.

- Temp. Treas. Reg. §1.274-5T may provide an alternative substantial compliance rule.
- The guidelines on evaluating evidence found in the Internal Revenue Manual (IRM) may provide guidance on alternative methods of verification, such as oral testimony from the taxpayer in connection with an expense.¹¹¹
- For smaller items that are difficult to document, the reasonable determination rule of IRM 4.10.7.4.2 might be used.

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^{111.} See IRM 4.10.7.3, *Evaluating Evidence and Underlying IRM sections*.

Step 3. Presentation of Records. Once the relevant material is organized, the material should be summarized in an appropriate cover letter sent to the IRS service center in care of the auditor assigned to the case.

In addition, the following practices should be used throughout the course of the audit.

- Document the progress of the audit in writing and use a detailed letter to confirm each step, including details of discussions and records reviewed, and confirm any additional information required and furnished.
- Address each individual issue separately within the correspondence to make it very clear how the issues arise, develop, and close throughout the audit procedure.
- When writing to the service center, always include a copy of the most recent prior item of correspondence. (This facilitates efficient, error-free matching of correspondence to the correct file at the service center.)
- Outline details of telephone discussions with the auditor or other IRS personnel in an acknowledgement letter to the auditor. Prepare a detailed account regularly and retain it in the client's file.
- Always send items of correspondence via certified mail, return receipt requested. (The U.S. Postal Service offers either a paper receipt or an online receipt that can be tracked and subsequently printed and placed in the client's file.)
- Keep copies of all material submitted in case the original is lost in the mail.

Use of these practices helps ensure that the tax professional's audit file for the client develops in a manner that adequately chronicles and documents the development and disposition of the issues throughout the audit.

- **Step 4.** Research of Issues. If the scope of the audit involves substantive tax law issues, these issues should be researched thoroughly, with a full understanding of the client's position as well as any probable counterarguments the auditor may make. The tax professional should be prepared to cite all appropriate Code sections, Treasury regulations, revenue rulings, or other supporting authority for the client's position. In addition, it is important to highlight relevant facts that may make the auditor's contrary position inapplicable to the taxpayer's facts.
- **Step 5.** Addressing Errors. In the course of reviewing the client's tax return and supporting documentation, it may become apparent that there was one or more errors on the return. There may be mathematical errors or errors in interpretation or legal theory. All communications with the auditor should be honest and involve complete and accurate information. If such errors are found, they should be corrected as soon as possible.

Close of the Audit

No Change Result. If the auditor determines that no changes to the return are necessary, a "no-change" letter is issued to the taxpayer at the audit's conclusion. This closes the audit. The audit cannot be reopened unless:

- There is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of fact;
- The closed case was based on an established IRS position that was erroneous at the time of the audit; or
- Failure to reopen the case would constitute a serious administrative omission.¹¹²

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^{112.} Rev. Proc. 2005-32, 2005-23 IRB 1206.

Proposed Adjustments with Client Agreement. If the audit results in the client's agreement to proposed changes, Form 4549, *Income Tax Examination Changes*, is issued to the taxpayer. This form requires approval of the area director and enables the immediate assessment of any additional tax owed as a result of the agreement. Signing the examination report and Form 4549 constitutes a waiver by the client of an appeals office conference and a challenge of the changes in Tax Court without first paying the assessed tax.

A closing agreement may be desirable. This is a legally binding agreement between the taxpayer and the IRS regarding the tax owed as a result of the changes made to the return.

An examination report will be sent to the taxpayer and a tax professional who has a power of attorney. After the examination report is reviewed and approved by the IRS, the taxpayer and tax professional are notified and the case is closed. The case will not be reopened unless one of the three factors outlined in Rev. Proc. 2005-32 (listed previously) exist.

At the time the examination report is presented by the auditor to the taxpayer for signature, the auditor typically requests that the taxpayer pay the applicable amount of tax, penalty, and interest. If the client agrees, written directions to the IRS on exactly how to apply the payment should be prepared and submitted with the payment.

If full payment cannot be made, the auditor is authorized to enter into an installment agreement.

Note. The taxpayer should sign all the closing forms, even if the tax professional is authorized to do so. This eliminates possible malpractice claims based on the tax professional's lack of authority to settle.

Proposed Adjustments with Client Disagreement. At the conclusion of the audit, the tax professional should advise the auditor both verbally and in writing of:

- Specific areas of disagreement, and
- A request for a meeting with the group manager.

If after the meeting with the group manager, the taxpayer and their tax professional **do not agree** with the IRS position, the taxpayer **should not sign** the examination report or other report form. Signing these forms waives the appeals office and certain Tax Court rights. The taxpayer can request that the case be transferred to the appeals office. If such a hearing is not requested, a 30-day letter is issued to provide the taxpayer with additional time to direct the case to the appeals office.

The taxpayer may agree with some of the adjustments and not others. The agreed adjustments and those the taxpayer disagrees with can be outlined on the examination report and related paperwork. The client may sign this paperwork without waiving any appeals office or Tax Court rights pertaining to the disputed issues. The examination report should indicate the particular positions taken by the taxpayer and reflect the agreement reached.

After payment of the tax and closure of the case for the agreed adjustments takes place, a 30-day letter is issued in connection with the disputed items.

105

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ELECTRONIC RECORDS

Rev. Proc. 98-25 provides the IRS with specific authority to request electronic records. Over the past several months, issues have developed in connection with business taxpayers using Intuit's QuickBooks software. Over the past several months, the IRS has purchased 1,500 to 2,000 QuickBooks licenses from Intuit Software.¹¹³

QuickBooks provides an archived, detailed history of financial transactions for each year that QuickBooks is used. While data for previous years can be condensed using a utility feature in QuickBooks, it remains to be seen whether this will create issues with the IRS or prevent access to prior-year data once the QuickBooks electronic records have been furnished. Revenue Procedure 98-25 neither directly addresses this issue nor provides any limitations on the access of data for prior years. However, revenue agents are instructed to review the electronic data only for the year(s) under review.¹¹⁴ If there is a decision to expand the exam to prior years, then the prior data would be subject to review.¹¹⁵

Electronic information management has become the standard in the private sector and is now being used to enhance the IRS examination process. Accounting records in electronic format provide significant advantages by:

- Reducing taxpayer and/or representative burden because electronic files do not need to be printed;
- Providing a complete set of the taxpayer's accounting records, decreasing the number of items included in the initial document request and follow-up requests; and
- Increasing efficiency of the examiner's analysis and testing of the books and records.

Note. See Chapter 8, Schedule C Audit Issues, in the 2010 *University of Illinois Federal Tax Workbook,* for a comprehensive discussion of a Schedule C audit procedure. This can be found on the accompanying CD.

IRS FUNDING UPDATE¹¹⁶

The IRS's appropriations in the 2011 fiscal year were cut by 0.2%. Funding levels for 2012 are currently under congressional review with the expectation of further cuts.

NTA Nina Olson testified before Congress on June 28, 2011, and released her mid-year report to Congress the following day. Her immediate concern over the cutbacks included the potential for harm to taxpayers and the likelihood of reduced revenue collections. Ms. Olson warned that recent budget cutbacks have curtailed the IRS's ability to effectively carry out some of its essential functions.

The NTA made previous suggestions that the IRS be exempt from congressional budget caps or reductions given its unique "accounts receivable collector" role for the federal government.

Ms. Olson's report disclosed that the IRS's ability to respond to taxpayer phone calls and correspondence has declined. The percentage of phone calls that the IRS answered from taxpayers seeking telephone assistance dropped from 87% to 74% from 2004 to 2010. She also noted that unanswered correspondence at the end of 2010 increased 135%.

She expressed major concerns about the impact of cutbacks on the essential functions of the TAS. The TAS handled approximately 169,000 cases in fiscal year 2004. In fiscal year 2010, the TAS received approximately 299,000 cases to address — a 77% increase. Ms. Olson noted that if the TAS faces further cutbacks, it may have to begin to refuse to help taxpayers who genuinely need assistance to resolve issues or disputes with the IRS.

^{113.} Gerry Kelly-Brenner, Senior Stakeholder Liaison Specialist, IRS SBSE Communications, Liaison, and Disclosure.

^{114.} Ibid.

^{115.} Ibid.

^{116.} [www.accountingtoday.com/news/Taxpayer-Advocate-Warns-Against-IRS-Budget-Cuts-59004-1.html] Accessed on Jul. 22, 2011.

The report also recommended a major change to IRS collection practices. The IRS should begin filing liens on the basis of the taxpayer's financial situation instead of automatically filing liens based solely on a dollar threshold.

Additional areas on which the NTA's office intends to focus efforts next year include:

- Revision of its contingency plan in the event of a federal government shutdown, which was a major concern earlier in 2011;
- Continued engagement with the public on the subject of simplifying the tax system, including which tax breaks taxpayers would be willing to forgo in exchange for a simpler tax system;
- Engagement with the public on increased compliance with the rules for the earned income credit, given the difficulty that certain groups of taxpayers have in documenting their qualifications for this credit; and
- Attention to the issue of increasing tax-related identity theft despite increased IRS awareness and action to help prevent such problems.

107

108 2011 Chapter 3: IRS Update

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