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Tenenbaum Law, P.C.  
Tax Attorneys



AGOSTINO & ASSOCIATES

KESTENBAUM & MARK LLP  
ATTORNEYS AT LAW

## LIU's Civil and Criminal Tax Controversy Forum - August 16, 2018

WHEN	WHERE
<p><b>Thursday, August 16, 2018</b>  <b>8:30 AM – 5:00 PM</b>  <b>Sign-in and Breakfast at 8:00 AM</b></p>	<p><b>LIU Post</b>  <b>720 Northern Blvd., Tilles Center</b>  <b>Brookville, NY 11548</b></p>

### PANELISTS, INCLUDE:

<p>Frank Agostino, Esq., Agostino &amp; Associates  Thomas E. Bishop, Baker Tilly Virchow Krause, LLP  James Caligure, Esq., IRS Office of Chief Counsel  Justin Campbell, Assistant Special Agent in Charge, NY  Field Office, IRS - Criminal Investigation  Joe Conley, Esq., Attorney-in-Charge, Suffolk County  DA's Office Tax Crimes Unit  Yvonne Cort, Esq., Capell Barnett Matalon &amp; Schoenfeld, LLP  Keisha Cummins, Paralegal Specialist, IRS  Noelle Geiger, Esq., Grassi &amp; Co.  Monica Koch, Esq., IRS, Office of Chief Counsel  Alan Katz, CPA, CFF, Guidepost Solutions LLC</p>	<p>Scott Kestenbaum, Esq., Kestenbaum &amp; Mark LLP  Bernard S. Mark, Esq., Kestenbaum &amp; Mark LLP  Christopher Morell, IRS Local Taxpayer Advocate  Argi O'Leary, Esq., Deputy Commissioner, NYS DTF  Brad Polizzano, Esq., Baker Tilly Virchow Krause, LLP  James Robnett, IRS Criminal Investigation  Lisa Salvaggio, CPA, NYS DTF  Michael Sardar, Esq., Kostelanetz &amp; Fink, LLP  Christine Scala, Sales Tax Auditor, NYS DTF  Malinda Sederquist, Esq., Agostino &amp; Associates  Karen Tenenbaum, Esq., Tenenbaum Law P.C.  Darol Tucker, IRS Local Taxpayer Advocate  Michael Wallace, EA, Agostino &amp; Associates</p>
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### TOPICS, INCLUDE:

IRS-Criminal Tax Update	Criminal Tax Prosecution & Defense	NYS-Criminal Tax Update
NYS Collection Update	IRS Collection Update	IRS Examination
TAS Update	Sales Tax & Cash Business Audits	Residency Update



APPROVED  
CONTINUING EDUCATION  
PROVIDER

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TIMED AGENDA  
LIU's Civil and Criminal Tax Controversy Forum  
August 16, 2018

- 8:30 – 8:35**                    **Welcome and Introductions**  
Frank Agostino, Esq., *Agostino & Associates*
- 8:35 – 9:00**                    **IRS – Criminal Tax Update**  
Michael Sardar, Esq., *Kostelanetz & Fink, LLP*  
Justin Campbell, Assistant Special Agent in Charge, NY Field Office, *IRS - Criminal Investigation*
- 9:00 – 9:55**                    **Criminal Tax Prosecution & Defense**  
Thomas Bishop, *Baker Tilly Virchow Krause, LLP*  
James Robnett, Special Agent in Charge, NY Field Office, *IRS Criminal Investigation*  
Alan Katz, CPA, CFF, *Guidepost Solutions LLC*  
Michael Sardar, Esq., *Kostelanetz & Fink, LLP*
- 9:55 – 10:45**                    **New York State – Criminal Tax Update**  
Malinda Sederquist, Esq., CPA, *Agostino & Associates*  
Joseph Conley, Esq., Attorney-in-Charge, *Suffolk County District Attorney's Office Tax Crimes Unit*  
Bernard Mark, Esq., *Kestenbaum & Mark LLP*  
Scott Kestenbaum, Esq., *Kestenbaum & Mark LLP*
- 10:45 – 11:05**                    **Break**
- 11:05 – 11:30**                    **New York State Collection Update Part 1**  
Yvonne Cort, Esq., *Cappell Barnett Matalon & Schoenfeld, LLP*  
Argi O'Leary, Esq., Deputy Commissioner, *NYS DTF*
- 11:30 – 11:55**                    **New York State Collection Update Part 2**  
Karen Tenenbaum, Esq., *Tenenbaum Law P.C.*  
Argi O'Leary, Esq., Deputy Commissioner, *NYS DTF*
- 11:55 – 12:20**                    **IRS Collection Update Part I**  
Frank Agostino, Esq., *Agostino & Associates*  
Darol Tucker, *IRS Local Taxpayer Advocate*  
Christopher Morell, *IRS Local Taxpayer Advocate*  
Monica Koch, Esq., *IRS Office of Chief Counsel*
- 12:20 – 1:20**                    **Lunch**
- 1:20 – 1:45**                    **IRS Collection Update Part II**

Frank Agostino, Esq., *Agostino & Associates*  
James Caligure, Esq., *IRS Office of Chief Counsel*  
Monica Koch, Esq., *IRS Office of Chief Counsel*

**1:45- 2:35**

**IRS Exam Part I**

Michael Wallace, EA, *Agostino & Associates*  
Keisha Cummins, Paralegal Specialist, *Department of Treasury*  
*IRS*  
Monica Koch, Esq., *IRS Office of Chief Counsel*  
Noelle Geiger, Esq., *Grassi & Co.*

**2:35 – 3:00**

**IRS Exam Part II**

Frank Agostino, Esq., *Agostino & Associates*  
Monica Koch, Esq., *IRS Office of Chief Counsel*  
James Caligure, Esq., *IRS Office of Chief Counsel*

**3:00 – 3:20**

**Break**

**3:20 – 4:10**

**Exam Update #1 – Sales Tax & Cash Business Audits**

Malinda Sederquist, Esq., CPA, *Agostino & Associates*  
Christine Scala, Sales Tax Auditor II, *NYSDTF*  
Noelle Geiger, Esq., *Grassi & Co.*

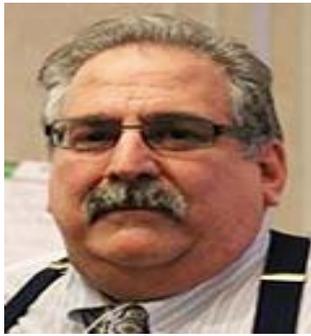
**4:10 – 4:55**

**Residency Update**

Noelle Geiger, Esq., *Grassi & Co.*  
Lisa Salvaggio, CPA, IFAAB Tax Auditor II, *NYSDTF*  
Brad Polizzano, Esq., *Baker Tilly Virchow Krause, LLP*

**4:55 – 5:00**

**Closing Remarks**



## **Frank Agostino, Esq.**

*President*

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### **Profile**

Frank Agostino is the president of Agostino & Associates, P.C., a law firm in Hackensack, New Jersey specializing in civil and white collar criminal litigation, tax controversies and tax planning.

Prior to entering private practice, Mr. Agostino was an attorney with the Internal Revenue Service's District Counsel in Springfield, Illinois and Newark, New Jersey. He also served as a Special Assistant United States Attorney, where he prosecuted primarily criminal tax cases.

As an adjunct professor, Mr. Agostino taught tax controversy at Rutgers School of Law and served as the co-director of the Rutgers Federal Tax Law Clinic.

Mr. Agostino is a frequent speaker and author on tax controversy and litigation matters. He serves on the Advisory Board of the Journal of Tax Practice and Procedure. Mr. Agostino is actively involved with the American Bar Association and the New York County Lawyers' Association.

Mr. Agostino is also the President of the Taxpayers Assistance Corp., which provides tax and legal advice to low income taxpayers in the NY/NJ area.

### **Recent Publications**

- *Tax Practitioner's Guide to Identity Theft* (CCH Inc., 2017, ISBN 978-0-8080-4556-4)
- *Recent Developments in FATCA Compliance*, 93 TAXES 51 (July 2015)
- *A 21st-Century Approach to Litigating Valuation Issues*, 17 J. TAX PRAC. & PROC. 47 (Apr.-May 2015)
- *Reviving Disallowed Charitable Conservation Easement Deductions*, 146 TAX NOTES 449 (Apr. 27, 2015)
- *Be Prepared: The IRS's Duty to Foster Voluntary Compliance Through Code Secs. 6014(a) and 6020(a)*, 17 J. TAX PRAC. & PROC. 5 (Feb.-Mar. 2014)

### **Practice Areas**

- Civil Tax
- Criminal Tax
- White Collar Defense

### **Education**

- LL.M., Taxation, New York University School of Law
- J.D., New York Law School
- B.A., City College of New York

### **Awards & Recognition**

- Recipient, ABA's 2012 Janet Spragens Pro Bono Award
- Recipient, NJ State Bar Association's 2015 Pro Bono Award

### **Admitted In**

- New York
- New Jersey
- Tax Court

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## **Thomas E. Bishop, EA**

*Senior Manager*

**212 792 4854**  
**thomas.bishop@bakertilly.com**

Thomas Bishop is a senior manager in Baker Tilly's Forensic, Litigation & Valuation Services group. He joined the firm in 2017 and brings over 25 years of experience to the practice. Tom provides litigation and investigative support to municipalities, internal and external counsel, senior management and boards of directors.

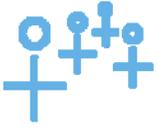
Tom joins Baker Tilly following over two decades with the Internal Revenue Service's Criminal Investigation division where he provided executive-level leadership to their largest field office. He directed high-profile, sensitive and complex criminal investigations involving voluntary disclosures, offshore banking related crimes, tax evasion, money laundering, Ponzi schemes and anti-trust related financial crimes. Most recently, Tom served as Director of International Field Operations overseeing global investigations.

### **Specific experience**

- > Conducts forensic investigations in a wide array of sensitive program areas including public corruption, corporate fraud, and identity theft
- > Performs investigations on behalf of federal, state and local governments seeking to identify and control fraud, waste and abuse
- > Conducts investigations with external counsel into violations of the Foreign Corrupt Practices Act (FCPA)
- > Leads and investigates various fraud theft, and embezzlement schemes
- > Recommends changes to internal controls for audit committees
- > Provides expert witness testimony

### **Industry involvement**

Tom frequently lectures and presents on federal tax matters, international tax administration, offshore banking and the IRS Voluntary Disclosure Program to various industry organizations including the American Bar Association; New York City Bar Association; Nassau County Bar Association; Suffolk County Bar Association; New York State Society of CPAs; and The Practising Law Institute.



## Resume, continued

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### Education

Pennsylvania State University  
Bachelor of Science in accounting

The Federal Law Enforcement Training Center  
Brunswick, GA

**Jim Caligure, Esq.**  
**Internal Revenue Service, Office of Chief Counsel**

Jim Caligure has been an attorney with the IRS Office of Chief Counsel in Westbury, New York since 2008. Prior to entering government service, he worked at a private tax controversy firm on Long Island. He has extensive experience litigating individual, small business, and estate and gift tax cases in the United States Tax Court. Jim is also a member of a team of IRS attorneys assigned to international tax compliance issues. He has served as a Special Assistant United States Attorney for bankruptcy cases in the Eastern District of New York. Jim is currently an Adjunct Accounting Professor at Hofstra University Zarb School of Business.

## Justin Campbell

### Internal Revenue Service, Criminal Investigation

Justin Campbell is an Assistant Special Agent in Charge in the New York Field Office of IRS – Criminal Investigation (CI). He began this position in June 2017. He oversees CI's field operations on Long Island, which includes investigations involving tax fraud, public corruption, cybercrimes, transnational organized crime, and narcotics-related financial crimes. Prior to this position, Mr. Campbell served as the Deputy Chief of Staff at CI headquarters in Washington, D.C. In that role, he worked closely with the Chief and Deputy Chief as they managed the global operations of CI.

Mr. Campbell began his career with CI in 2001 in the Houston Field Office. From 2001 – 2012, he served as a special agent investigating a variety of CI investigative priorities, including tax and non-tax criminal schemes. In 2013, he promoted to the position of Supervisory Special Agent in the Washington, D.C. Field Office of CI. In that role, he oversaw sensitive investigations involving public corruption, major corporations, financial institutions, and taxpayers. In 2015, he was selected to form CI's east coast Cyber Crimes Unit. Mr. Campbell holds a Bachelor's of Business Administration in Accounting from Sam Houston State University in Huntsville, Texas.

**Joseph T. Conley III**  
**Suffolk County District Attorney's Office**  
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Joseph Conley is the Attorney-in-Charge of the Suffolk County District Attorney's Office Tax Crimes Unit. The Tax Crimes Unit consists of lawyers, investigators and auditors assigned to investigate and prosecute violations of the New York State Penal and Tax Laws. In his fifteen-year career at the SCDAO, Mr. Conley served in several investigative bureaus focusing on complex investigations. Mr. Conley helped create the Tax Crimes Unit in 2005 leading to the convictions of hundreds of defendants for wide-ranging violations of the New York State Tax Law resulting in the recovery of millions of dollars in lost revenue every year. Initiatives by the SCDAO Tax Crimes Unit have resulted in convictions for the evasion of sales/use tax on the purchase of personal luxury yachts, trafficking of untaxed cigarettes, and a 2006 initiative that exposed significant abuse of the STAR property tax program. The Tax Crimes Unit has also partnered with the Internal Revenue Service and successfully prosecuted dozens of individuals and companies for evading payroll taxes.

Mr. Conley previously worked at the New York State Department of Taxation and Finance as the Deputy Attorney-in-Charge of the Manhattan Special Investigations Unit from 2010 until rejoining the SCDAO in 2011. Mr. Conley represented the Department at administrative hearings, helped lead a proactive unit in the investigation of criminal and civil violations of the Tax Laws and developed training programs for auditors and investigators. Mr. Conley was also cross-designated as an Assistant District Attorney for Queens County to prosecute preparer fraud cases.

Mr. Conley holds the rank of Major in the New York Army National Guard serving in the Judge Advocate General's Corp. While deployed to Afghanistan in support of Operation Enduring Freedom, MAJ Conley served as the Command Judge Advocate to Training Assistance Group VII and Chief Legal Mentor & Trainer to Afghan National Security Forces at the Kabul Military Training Center. MAJ Conley has held positions as defense counsel for Trial Defense Services, earning special recognition for his zealous advocacy of clients and as Trial Counsel for the 42nd Infantry Division and Combined Joint Task Force Phoenix VII. MAJ Conley is currently serving as the Deputy Staff Judge Advocate of the 42ID.

Mr. Conley has provided lectures and training assistance to numerous organizations and entities including: District Attorney's Offices throughout the state, the New York State Department of Taxation and Finance, New York Prosecutors Training Institute, National White Collar Crime Center and the Long Island Tax Symposium.

He holds a Bachelor of Arts degree from Keuka College and a Juris Doctor degree from St. John's University School of Law.

## **BIOGRAPHY**

### **YVONNE R. CORT, ESQ.**



Yvonne is counsel to the law firm of Karen J. Tenenbaum, P. C. She concentrates on resolving Federal and New York State tax controversies, including issues involving income tax, sales tax audits, residency audits, and responsible person assessments, offers in compromise and installment agreements. She is the current Chair of the Tax Law Committee of the Nassau County Bar Association and former Chair (2005-2007) of the IRS Liaison Committee. She is also a member of the New York State Liaison Committee, the Suffolk County Bar Association (Taxation Law Committee), the American Bar Association (Tax Section), the New York State Bar Association (Tax Section) and the Suffolk County Women's Bar Association.

Yvonne has published articles on various tax topics in numerous accounting and legal publications, and is a regular speaker on tax issues for professional groups, such as the Nassau County Bar Association, the Suffolk County Bar Association, the Foundation for Accounting Education, The Tax and Accounting Institute (Long Island University at C. W. Post), the New York Society for Independent Accountants, and the Suffolk County Women's Bar Association as well as each year at the Long Island Tax Practitioner Symposium co-sponsored by the Internal Revenue Service and the National Conference of CPA Practitioners (Nassau/Suffolk Chapter). Yvonne has been a guest on the radio at WLIE (540 AM), "Legal Ease", and WHPC (90.3 FM) "Law You Should Know." In addition, Yvonne has been quoted in Newsday, and interviewed for News 12 Long Island, with respect to negotiating with the IRS.

Yvonne received her B. A. *magna cum laude* from the University of Rochester, and her J.D. from the University of Pennsylvania Law School. She has clerked for the Merit Systems Protection Board in Washington D.C., and for an appellate level state court in Pennsylvania. Yvonne is admitted to the Bar in New York and Pennsylvania.

#### **Yvonne R. Cort, Esq.**

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## Keisha Cummins

### IRS – Office of Chief Counsel

Keisha Cummins is a Paralegal Specialist with the Office of Chief Counsel in the IRS. She is an accomplished legal professional with over 20 years of experience in the financial and legal industries. She has spearheaded many small business initiatives and is well respected and trusted in business development. Ms. Cummins received her B.S. in Business Management and her MBA in Organizational Development & Management from LIU, Brooklyn. She is a Brooklyn native with strong community ties and a passion for influencing, challenging and motivating others to dream beyond limits. When her contagious energy isn't spent in professional and personal development, she enjoys cooking recipes from her Caribbean roots.



## Noelle Geiger, JD

Tax Principal, Director of Tax Controversy Services

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Noelle Geiger, JD, is a Tax Principal at Grassi & Co. and serves as the Tax Controversy Services Leader for the firm. She has over 20 years of experience handling tax dispute resolution matters. She represents individuals, corporations, partnerships and estates before the Internal Revenue Service (IRS) and state taxing authorities at the pre-audit, audit and appeal stages. The clients served are in the following industries: construction, manufacturing and distribution, healthcare, high net worth and family offices,

Noelle has extensive experience handling both New York State and New York City residency audits that examine domicile, statutory residency, allocation of income and resident credits as well as situations involving potential dual residency. Domicile planning is a helpful tool for clients who wish to navigate how their future intentions might impact their state tax or estate tax residency.

She is frequently called upon by criminal tax attorneys whose clients need a KOVEL accountant. Some other types of matters she handles include: Identity Theft cases, sales tax examinations with appeals in multi-states, and innocent spouse cases.

She assists non-filers with offshore and domestic voluntary disclosures and works to bring them back into compliance. Noelle negotiates the release and withdrawals of liens, levies and warrants. She also assists clients who may need installment payment agreements or have collection issues. Noelle has successfully negotiated substantial penalty abatements for many clients.

Noelle is an active speaker at various industry events some of which include:

Relief from Joint and Several Liability Representing the Innocent Spouse, Zicklin Tax Seminar at Baruch College, NYC, December 7, 2015

The Accountant's Role in a Criminal Tax Investigation, New England IRS Representation Conference, Foxwoods Hotel and Casino, November 19, 2015;

New York State Residency Audits, Civil and Criminal Tax Controversy Updates, Long Island University, Westbury, NY, August 13, 2015

Noelle attends IRS Practitioner Liaison Committee and the New York State Practitioner Liaison Meetings to meet with the government to identify systemic problems occurring during dealings between the IRS and New York State.

Noelle was a former Chair of the Nassau Bar Tax Committee and is a member of the New York City Bar Association where she also serves on its State and Local Tax Committee. She

was previously the chairperson for the Nassau Chapter of the New York State Society of Certified Public Accountants (NYSSCPA) Attorney and Accountant Joint Committee. Noelle also served on the Executive Board for the NYSSCPA Nassau Chapter and served as the Editor of the NYSSCPA Nassau Chapter's newsletter.

Noelle holds a Juris Doctor degree from Hofstra Law School and a Bachelor of Arts in Economics from Bucknell University.

## ALAN M. KATZ, CPA, CFF

Senior Forensic Auditor, Monitoring and Investigations Practice

### CONTACT INFORMATION

415 Madison Avenue  
New York, New York 10017  
646.553.1356 (o)  
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akatz@guidepostsolutions.com

### EDUCATION

- Bachelor of Science,  
Accounting, Queens College  
of the City of New York

### DESIGNATIONS

- Certified Public Accountant
- Certified in Financial  
Forensics

### AFFILIATIONS

- American Institute of  
Certified Public Accountants
- Federal Law Enforcement  
Officers Association

### AREAS OF EXPERTISE

- Forensic Accounting
- Financial Investigations
- White Collar Crime
- Asset Tracing
- Surveillance

Alan M. Katz joined Guidepost Solutions as a senior forensic auditor in 2013. Previously he spent 22 years as a Special Agent with the Department of Treasury Internal Revenue Service Criminal Investigation Division where he conducted complex white-collar financial investigations involving criminal tax, money laundering, bank fraud, bankruptcy fraud, contract fraud, labor racketeering, disadvantaged/minority business enterprise fraud, prevailing wage violations, kickbacks, extortion, union payoffs, organized crime influence, bank secrecy violations, as well as financial transactions designed to facilitate these activities.

Mr. Katz was the founding and lead agent assigned to the Federal Construction Fraud Task Force, which was created to investigate corruption within the construction industry. Those investigations yielded more than 60 prosecutions and 28 debarments and forfeiture orders exceeding \$180 million. He conducted and supervised all aspects of criminal investigations including document analysis, tracing financial transactions, preparing charts and exhibits, interviewing witnesses and subjects, securing evidence from outside sources, surveillance, undercover operations, executing arrest and search warrants, coordinating multi-agency involvement and executing criminal and civil forfeitures. Many of Mr. Katz' investigations included analyzing voluminous and highly sophisticated financial documents of individuals and businesses in an effort to detect patterns, anomalies and schemes in uncovering fraudulent activity, and, he has substantial experience deciphering and analyzing a business' accounting systems, books of original entry, financial statements and tax returns.

The success of Mr. Katz' investigations resulted in numerous awards including the Department of Transportation Secretary's Award for Meritorious Achievement in 2002, the Award for Excellence from the President's Council on Integrity and Efficiency in 2005, the True American Hero Award from the Federal Drug Agents Foundation in 2008, the Award of Excellence from the United States Department of

## ALAN M. KATZ, CPA, CFF

Senior Forensic Auditor, Monitoring and Investigations Practice

Transportation in 2010, the Investigator of the Year Award from the Federal Law Enforcement Foundation in 2011 and several awards from the United States Attorney's Office for the Eastern District of New York.

Earlier in his career, Mr. Katz was an auditor with a public accounting firm where he planned, coordinated and administered audit engagements; analyzed the books and records of diversified clients; reviewed and prepared financial statements, financial reports and tax returns; and prepared reports on internal controls and operating procedures.

Mr. Katz has spoken at more than 20 training programs for law enforcement agents, attorneys, accountants and auditors of various federal, state and local departments and agencies. He has also instructed at C.W. Post University.

### WORK HISTORY

- 2013 – Present, Guidepost Solutions LLC, Senior Forensic Auditor
- 1991 – 2013, United States Department of Treasury, Internal Revenue Service, Special Agent
- 1987 – 1991, Goldstein Golub Kessler & Company, P.C., Auditor

Monica E. Koch, Esq.  
Internal Revenue Service, Office of Chief Counsel  
Associate Area Counsel

Monica E. Koch graduated St. John's University in 1984 with a B.A. (magna cum laude) in Government, and minors in German and Business. She attended St. John's University School of Law and received her J.D. in 1987. She has worked for the Office of Chief Counsel - IRS since August 1987, first as a field attorney and currently in the position of Associate Area Counsel. She is actively involved in litigation before the United States Tax Court, and is also a Special Assistant United States Attorney for Bankruptcy matters

# **SCOTT L. KESTENBAUM, Associate**

**Kestenbaum & Mark LLP 40 Cutter Mill Road, Suite 300, Great Neck, NY 11021**



## **Admission**

- 2015, New York, U.S. Tax Court, U.S. District Court, Southern and Eastern Districts of New York

## **Membership**

- Nassau County Bar Association, Member, 2014-present
- New York City Bar Association, Member, Committee on Sports Law, 2014-present
- Sports Lawyers Association, Member, 2013-present

## **Awards**

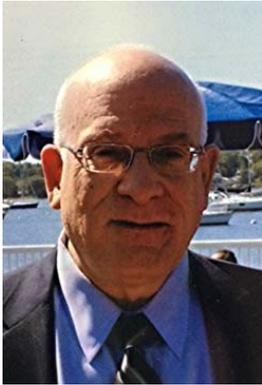
## **Publications**

- Uniform Alternative Dispute Resolution: The Answer to Preventing Unscrupulous Agent Activity, 14 Pepp. Disp. Resol. L.J. 55

## **Education**

- Benjamin N. Cardozo School of Law, J.D., 2014
- University of Michigan, B.A. English Language & Literature, With Distinction, 2011





# Bernard S. Mark

Partner at Kestenbaum & Mark

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## Practices-

- Federal and State Civil and Criminal Tax Litigation
- Tax and Estate Planning
- Estate Litigation and Administration

## Admission

- 1973, New York
- 1974, U.S. Tax Court
- 1981, New Jersey

## Membership

- Nassau County Bar Association, Member, Committee on Tax, 1980-Present
- American Bar Association Member, Committee on Taxation, 1985-Present

## Awards

- Selected as New York Metro Area Super Lawyer in Taxation, 2009-2011, 2013-2015
- Selected as Long Island Top Legal Eagle; Pulse Magazine, 2010
- Chief Counsel Special Achievement Award for Excellence, 1978\

## Education

- New York University School of Law, L.L.M. in Taxation, 1973
- Brooklyn Law School, J.D., 1972
- Queens College, B.A., 1969

ARGI O'LEARY  
Deputy Commissioner, Civil Enforcement Division

Argi O'Leary is Deputy Commissioner for the Civil Enforcement Division of the New York State Department of Taxation and Finance. She leads the Department's civil enforcement efforts to collect outstanding tax liabilities.

Ms. O'Leary oversees a staff of approximately 800 employees engaged in field collections, special collections, and call-center operations and is responsible for the collection of over \$1.6 billion in support of State and local programs and services. She also examines and implements best practices for enforcement programs across the Department and works with State, local and federal agencies to enhance opportunities for revenue collection.

Prior to her appointment as a Deputy Commissioner, Ms. O'Leary served the Department as the Assistant Deputy Commissioner for Litigation Strategy. Before joining the Department, she was in private practice with the New York City law firm Patterson Belknap Webb & Tyler LLP. She also served as an Assistant District Attorney in the New York County District Attorney's Office under Robert M. Morgenthau and as a law clerk to the Honorable Thomas C. Platt, United States District Judge for the Eastern District of New York.

Ms. O'Leary earned her Juris Doctor *cum laude* at Fordham University School of Law, as well as a Bachelor of Arts *magna cum laude* and a Master of Science from Boston College.



# Tenenbaum Law, P.C.

*Tax Attorneys*

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## BIOGRAPHY

**BRAD POLIZZANO, ESQ.**  
Tax Attorney – Tax Dispute Resolution

Brad is an associate at the law firm of Tenenbaum Law, P.C. and is licensed to practice law in New York. He concentrates on resolving Federal and New York State tax controversies, including issues involving income tax, offshore voluntary disclosures, residency audits, responsible person assessments, and tax collections.

Brad also advises clients on tax compliance, including gaming industry issues. He assists gaming industry stakeholders, such as operators, entrepreneurs, and professional poker players, with evaluating various tax considerations for entering into the U.S. internet gaming space. He was recently quoted in Fox Business, “Think You’ll Win a Super Bowl Bet? It’s Taxable,” January 28, 2015.

Brad earned his J.D. at St. John’s University and his LL.M. in Taxation at New York University. He is admitted to practice in the U.S. Tax Court. Brad writes about tax and gaming law issues at his blog *Taxes in the Back*, online at <http://taxdood.com>. Follow him on Twitter @taxdood.

**Brad J. Polizzano, Esq.**  
**Tenenbaum Law, P.C.**  
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**Concentrating in IRS & NYS Tax Matters**

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**James Robnett**

*Special Agent in Charge*

*New York Field Office*

*IRS - Criminal Investigation*

James Robnett is the Special Agent in Charge of the New York Field Office of IRS, Criminal Investigation, which serves the four Judicial Districts in the state of New York. The New York Field Office (NYFO) is comprised of sixteen investigative groups of Special Agents and professional staff that are responsible for investigating complex financial crimes. Prior to this assignment, James has served in a number of CI leadership roles including Supervisory Special Agent in the Nashville Field Office, Senior Analyst for the Southern Area of Operations, Assistant Special Agent in Charge for the Atlanta Field Office, Director of Special Investigative Techniques in Washington DC, Special Agent in Charge of the Tampa Field Office, and Special Agent in Charge of the Chicago Field Office until April of 2017, when he as assigned to New York. James joined IRS in 1986 as a Revenue Agent and then as a Special Agent for CI in 1994. James is a graduate of Winthrop University and a member of the IRS Senior Executive Service.

**Lisa Salvaggio, CPA**  
*Team Leader for the New York State Department of Tax and Finance*  
*Income Franchise Field Audit Bureau*  
*Long Island Regional Office Hauppauge, NY*

M. Lisa Salvaggio, CPA is a Team Leader for the New York State Department of Tax and Finance Income Franchise Field Audit Bureau in the Long Island Regional Office located in Hauppauge, New York. As a Team Leader, she is a first line supervisor directly overseeing the audits conducted by her team of field auditors. She has been with the Department for a total of 18 years, 9 of which she's been in her current position as a Team Leader. As part of the Income Franchise Field Audit Bureau, Lisa oversees field audits of the financial records of taxpayers to verify that businesses and individuals are in compliance with the tax laws, regulations and rules of the State of New York. Audits include, but aren't limited to: personal income tax returns, withholding tax returns, flow through entity returns, and small corporation returns. Lisa is also involved in internal training and staff development, Facilitated Self Assist Tax Preparation Program, and various other operational groups.

Prior to joining the Department of Tax and Finance, Lisa worked for KPMG Peat Marwick, LLP in Jericho, New York as well as a private company located in Plainview, New York.

Ms. Salvaggio earned her Master's of Science Degree in Taxation at Long Island University, Brookville, NY, as well as a Bachelor of Science Degree in Accounting at St. Joseph's College, Patchogue, NY. She is a member of the American Institute of Certified Public Accountants.

# MICHAEL SARDAR



## CONTACT

Email: [MSardar@kflaw.com](mailto:MSardar@kflaw.com)

Tel: 212.808.8100

**Michael Sardar** joined Kostelanetz & Fink, LLP in 2009. Mr. Sardar's practice focuses on all stages of civil and criminal tax controversies. He represents taxpayers before the Internal Revenue Service, state tax authorities, the Department of Justice, and local prosecutors. Mr. Sardar has vast experience representing clients making voluntary disclosures of unreported income to the Internal Revenue Service and state tax authorities.

Mr. Sardar has successfully represented scores of clients with unreported foreign assets who have repatriated over half a billion dollars of offshore assets through the IRS's Offshore Voluntary Disclosure Program and the Streamlined Compliance Procedures. Mr. Sardar also represents taxpayers in New York State and City residency audits and investigations. Mr. Sardar is the Vice-Chair of the New York County Lawyers' Association (NYC LA) Taxation Committee, member of the Committee on Personal Income Taxation, New York City Bar Association, as well as Co-Chair of the Sub-Committee on Offshore Enforcement of the ABA Committee on Civil and Criminal Tax Penalties. Michael lectures frequently on tax controversy issues including foreign asset reporting and non compliance.

## REPRESENTATIVE MATTERS

- Mr. Sardar secured a favorable non-jail sentence for a client facing federal criminal charges relating to undeclared foreign bank accounts.

- Mr. Sardar convinced the New York County District Attorney's Office to abandon a criminal investigation of his client and successfully resolved the case in a civil manner.
- Mr. Sardar Successfully represented alleged "responsible officer" taxpayer assessed large penalties for unpaid withholding tax, entire assessment was canceled despite the fact that all of taxpayer's statutory and regulatory remedies were time-barred.
- Mr. Sardar represented a wife in innocent spouse proceedings before the IRS and NYS, she was deemed an innocent spouse as to all taxes previously assessed.
- Mr. Sardar secured credit for \$3 million in taxes withheld on taxpayer's foreign account. which IRS had previously denied.
- Mr. Sardar successfully sought the return of cash seized from his client by U.S. Customs and Border Protection.
- Mr. Sardar successfully represented taxpayers in connection with a criminal referral to the Criminal Investigation Division (CI) of the IRS and resolved the matter civilly with no significant penalties against the taxpayers.
- Mr. Sardar represented a taxpayer in connection with an IRS criminal investigation which had been initiated by a whistle blower who was cooperating with the IRS. Mr. Sardar convinced the IRS Criminal Investigation Division to terminate the investigation with no charges against his client.

Prior to joining Kostelanetz & Fink, Mr. Sardar was a tax associate in the New York office of Heller Ehrman, LLP, where his practice focused on federal and state transactional tax matters. While at Heller Ehrman, Mr. Sardar also advised many nonprofit organizations on federal and state tax issues including general tax exemption and Unrelated Business Income Tax (UBIT). Mr. Sardar received his B.B.A., summa cum laude, from Baruch College in 2004, and his J.D. in 2007 from Cornell University Law School.

**Christine Scala**  
**Sales Tax Auditor II**  
**New York State Department of Taxation and Finance**  
**Long Island Regional Office**

Christine Scala is a Team Leader for the New York State Department of Tax and Finance Transaction Field Audit Bureau in the Long Island Regional Office located in Hauppauge, New York. As a Team Leader, she is a first line supervisor directly overseeing the audits conducted by her team of field auditors. She has been with the Department for a total of 9 years. As part of the Transaction Field Audit Bureau, Christine oversees field audits of business who are registered sales tax vendors. These audits are done in an effort to verify and ensure that businesses are in compliance with the tax laws, regulations and rules of the State of New York.

Prior to joining the Department of Tax and Finance, Christine worked as a staff accountant and an office manager of a manufacturing company.

Ms. Scala is in the process of earning her Masters of Science Degree in Taxation at Long Island University, Brookville, NY.

She obtained her Bachelor of Science Degree in Accounting at St. Joseph's College, Patchogue, NY.

**Malinda Sederquist, Esq., CPA**, is a tax controversy and litigation associate at Agostino & Associates, P.C. She has six years of experience working as a Tax Auditor for New York State Department of Taxation and Finance and six years of experience working as an Investigative Auditor for the Suffolk County District Attorney's Criminal Tax Unit. Her previous experience includes audits of personal tax returns, withholding tax returns, flow-through entity returns, small corporation returns and sales tax returns. Ms. Sederquist earned her Bachelor of Science Degree and Master's of Science Degree in Accounting at Long Island University, Southampton, N.Y. She received her Juris Doctor Degree from Touro College Jacob D. Fuchsberg Law Center, Islip, N.Y.



# Tenenbaum Law, P.C.

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*Tax Attorneys*

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## BIOGRAPHY

**KAREN J. TENENBAUM, ESQ., LL.M. (TAXATION), CPA**  
Tax Attorney – Tax Dispute Resolution

An attorney for over 30 years, Karen founded Tenenbaum Law, P.C., providing legal counsel to individuals and businesses facing IRS and NYS tax problems. Karen and her team have successfully represented clients in matters including:

- Federal & State Audits
- IRS Appeals & NY State Conciliation Conferences
- Federal & NYS Collection Issues, including Liens, Levies, Warrants & Seizures
- Offers in Compromise and Installment Agreements
- Responsible Officer Assessments
- NYS Residency Audits
- NYS Voluntary Disclosure

Karen is a frequent speaker on IRS and NYS tax issues for numerous professional groups, on topics such as New York State residency, IRS and NYS collections, and more. Karen's knowledge and leadership have established her as a leading tax attorney in the NY area. Karen was selected for inclusion in the 2014 edition of *New York Super Lawyers* as a practitioner in Tax Law.

• Past Chair, Nassau County Bar Association Tax Law Committee • Past Executive Board Member, New York State Society of Certified Public Accountants, Nassau Chapter • Long Island Center for Business & Professional Women, Achievers' Award recipient • New York State Society of Certified Public Accountants, Nassau Chapter, Samuel B. Traum Achievement Award recipient • Long Island Pulse Magazine "Top Ten Legal Eagle," Most Impressive Case Victory: Residency Matter • Named by Long Island Business News as among the Top 50 Most Influential Women in Business in 2014 • One of Legal Leaders' Long Island Top Rated Lawyers of 2015 • One of Super Lawyers' 2014 Top Women Attorneys in the New York Metro • Quoted in **Bloomberg Business** article *How New York Hunts Down Tax Refugees*; also included in American Institute of CPA's "CPA Letter Daily" newsletter

Karen received her LL.M. (Taxation) from New York University School of Law and her J.D. from Brooklyn Law School. Karen is admitted to the State Bar of New York and to the U.S. Tax Court. Karen is also a Certified Public Accountant.

**Karen J. Tenenbaum, Esq.**  
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**Darol Tucker**  
Brooklyn Taxpayer Advocate

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Darol Tucker is the Local Taxpayer Advocate in Brooklyn, New York. He assumed this position with the Taxpayer Advocate Service (TAS) in February 2015. He previously served as a Supervisory Revenue Officer in Albany, NY from 2012 until the beginning of 2015.

He started his career with the IRS in October 2005, in Syracuse, NY as a Revenue Officer. From there, he served as a Recruiting Agent with the IRS Recruitment Office from November 2010 until August 2012, where he was responsible for all of the IRS recruiting efforts for both North and South Carolina.

Prior to joining the IRS, Darol served and retired from the US Army after 26 years of service from February 1978 to February 2004, where he served in various leadership positions.

Darol graduated from Columbia College (Missouri) where he majored in Business Administration.

**Michael Wallace, E.A.** is an Enrolled Agent with Agostino & Associates, P.C., assisting the team of attorneys with various tax controversy matters. Prior to joining Agostino & Associates, Mr. Wallace worked in the pharmaceutical industry in finance and compliance operations. Mr. Wallace has worked in the field of tax as a preparer, instructor and taxpayer representative. Mr. Wallace earned his B.S. degree in Accounting from Rutgers University.



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**Department of Justice**  
U.S. Attorney's Office  
Eastern District of New York

FOR IMMEDIATE RELEASE

Wednesday, August 1, 2018

## **Owner of Long Island Commercial Check Cashing Companies Indicted for Financial Fraud**

### **John Drago Also Charged with Tax Fraud for Paying Employees Off the Books Through His Management Company, Hogwarts Inc.**

An eight-count indictment was unsealed today in federal court in Central Islip charging John Drago, the owner and compliance officer of the Kayla Companies, with multiple criminal violations of the Bank Secrecy Act, including failure to file required Currency Transaction Reports ("CTRs") for customers receiving in excess of \$10,000. Drago is also charged in the indictment with failure to collect and pay taxes. Drago was arrested today, and arraigned this afternoon before United States Magistrate Judge A. Kathleen Tomlinson. Drago was released on a \$500,000 bond.

Richard P. Donoghue, United States Attorney for the Eastern District of New York, and Justin Campbell, Assistant Special Agent-in-Charge, Internal Revenue Service Criminal Investigation, New York (IRS-CI), announced the indictment.

"As alleged in the indictment, Drago flagrantly violated his obligations as the owner of check cashing businesses to follow federal regulations designed to prevent such businesses from being used to facilitate money laundering; he also failed to fulfill his responsibility as an employer to pay the proper taxes," stated United States Attorney Donoghue. "This Office and our law enforcement partners are committed to ensuring the integrity of financial institutions, including check cashing businesses."

"Check cashers provide a valuable service to our community," stated IRS-CI Assistant Special Agent-in-Charge Campbell. "However, when they commit tax fraud, IRS-CI will aggressively investigate and seek prosecution of those involved."

According to the indictment, Drago owned and operated check cashing businesses on Long Island, including Kayla Check Cashing Corp., North Island Check Cashing Corp., South Island Check Cashing Corp., East Island Check Cashing Corp., Bay Shore Check Cashing Corp. and Brentwood Check Cashing Corp. (collectively, the "Kayla Companies"). The operation was administered from the offices of Kayla Check Cashing Corp. in Farmingdale, New York. Hogwarts, Inc., was a management company owned by Drago through which employees of the Kayla Companies were paid.

Financial institutions are required to file a CTR for each transaction in cash in excess of \$10,000. In addition, a CTR is required to be filed by the financial institution when multiple checks, the total value of which exceeds \$10,000, are cashed in a single day.

As alleged in the indictment, from January 2010 to October 31, 2013, Drago instructed employees to cash multiple checks in excess of \$10,000 in a single day for certain customers without filing required CTRs. Between August 1, 2010 and October 31, 2013, Drago directed employees to deposit and cash, over the course of several days, checks that had been submitted together on a single day in amounts in excess of \$10,000. Drago also instructed employees to tell certain customers who presented individual checks in amounts exceeding \$10,000 to return with multiple checks in amounts that were less than \$10,000 to avoid the reporting requirement for such financial transactions. As a result of these practices, Drago is also charged with failing to file CTRs and failing to develop, implement and maintain an effective anti-money laundering program for the Kayla Companies.

In addition, between April 1, 2012 and July 31, 2013, Drago paid overtime wages and commissions to employee of the Kayla Companies in cash and failed to inform the IRS of the payment of these cash wages. Drago falsely underreported to the IRS the gross wages paid to his employees in order to avoid paying the full amount of Federal Insurance Contribution Act taxes that the Kayla Companies owed.

The charges in the indictment are allegations, and the defendant is presumed innocent unless and until proven guilty. If convicted, Drago faces a maximum sentence of 10 years' imprisonment.

The government's case is being handled by the Office's Long Island Criminal Division. Assistant United States Attorney Burton T. Ryan, Jr., is in charge of the prosecution.

**The Defendant:**

JOHN DRAGO

Age: 54

St. James, New York

E.D.N.Y. Docket No. 18-CR-394 (SJF)

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**Attachment(s):**

[Download Drago Indictment](#)

**Topic(s):**

Tax

**Component(s):**

[USAO - New York, Eastern](#)

**Contact:**

John Marzulli

Tyler Daniels

United States Attorney's Office

(718) 254-6323

Updated August 1, 2018



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**Department of Justice**  
U.S. Attorney's Office  
Southern District of New York

FOR IMMEDIATE RELEASE

Wednesday, July 18, 2018

## **Tax Preparer Arrested For Fraudulent Scheme To Steal Over \$1 Million From His Clients**

Geoffrey S. Berman, the United States Attorney for the Southern District of New York, James D. Robnett, the Special Agent-in-Charge of the New York Field Office of the Internal Revenue Service, Criminal Investigation ("IRS-CI"), and Nonie Manion, Acting Commissioner of the New York State Department of Taxation and Finance ("NYSDF"), announced today the arrest of TOM SHIN on charges of aiding the preparation of a false tax return and wire fraud. The Complaint charges that SHIN, a tax preparer in New York, participated in a scheme to obtain over \$1.3 million of his clients' money that was intended to be paid to the IRS and NYSDTF for taxes the clients owed. SHIN was arrested this morning and will be presented today in Manhattan federal court before U.S. Magistrate Judge Debra Freeman.

U.S. Attorney Geoffrey S. Berman said: "As alleged, the defendant betrayed his clients' trust and engaged in a brazen scheme to defraud his clients of more than \$1.3 million that was intended to be used to pay taxes owed to the federal and state governments. Thanks to the investigative work of the IRS and the NYSDTF, the defendant will be prosecuted for his actions."

IRS-CI Special Agent-in-Charge James D. Robnett said: "The IRS enforces the nation's tax laws, but also takes particular interest in cases where someone, for their own personal gain, allegedly takes what belongs to others. Our special agents are uniquely qualified to assist state and federal law enforcement agencies with these types of investigations by following the money."

NYSDF Acting Commissioner Nonie Manion said: "The blatant deceit and theft allegedly carried out by this tax preparer is unconscionable. The honesty and integrity New Yorkers expect from their tax preparer must never be compromised, which is why we'll continue to work with all levels of law enforcement to root out unscrupulous preparers and hold them accountable."

According to the allegations in the Complaint unsealed today[1]:

SHIN was hired to prepare joint federal and state tax returns for two individuals (the "Clients") for tax year 2017. SHIN showed the Clients completed tax return forms indicating that the Clients owed approximately \$1.3 million in taxes. However, SHIN actually filed false returns on behalf of the Clients without their knowledge, which concealed the Clients' tax liability. SHIN then, in connection with applications for extensions of time to file his personal tax returns, directed tax authorities to withdraw approximately \$1.3 million from the Clients' bank account, and then filed personal tax returns seeking an approximately \$1.3

million refund. The net result of the alleged scheme would have been a transfer of approximately \$1.3 million from the Clients' bank account to SHIN.

\* \* \*

SHIN, 36, of Staten Island, New York, is charged with one count of aiding the preparation of a false tax return, which carries a maximum penalty of three years in prison, and one count of wire fraud, which carries a maximum penalty of 20 years in prison. The maximum potential sentences in this case are prescribed by Congress and are provided here for informational purposes only, as any sentencing of the defendant will be determined by the judge.

This case is being handled by the Office's General Crimes Unit. Assistant United States Attorney Brett M. Kalikow is in charge of the prosecution.

The charges contained in the Complaint are merely accusations, and the defendant is presumed innocent unless and until proven guilty.

[1] As the introductory phrase signifies, the entirety of the text of the Complaint and the description of the Complaint forth herein constitute only allegations, and every fact described should be treated as an allegation.

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**Attachment(s):**

[Download U.S. v. Tom Shin complaint.pdf](#)

**Topic(s):**

Financial Fraud  
Tax

**Component(s):**

[USAO - New York, Southern](#)

**Press Release Number:**

18-248

Updated July 18, 2018



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**Department of Justice**  
U.S. Attorney's Office  
Eastern District of New York

FOR IMMEDIATE RELEASE

Wednesday, August 1, 2018

## **Former Suffolk County Legislator Fred Towle, Jr., Pleads Guilty to Making a False Tax Return**

### **Towle Failed to Report More Than \$1 Million in Consulting and Expediting Fees**

Earlier today, in federal court in Central Islip, Fred Towle, Jr., pleaded guilty to making and subscribing a false tax return for the calendar year 2012 that underreported business income in order to avoid paying the proper tax owed. The guilty plea was entered before United States Magistrate Judge A. Kathleen Tomlinson. When sentenced, Towle faces a statutory maximum of three years in prison and a fine of up to \$250,000. As part of his plea, Towle has agreed to pay \$307,427 in restitution, the full amount of his tax liabilities.

Richard P. Donoghue, United States Attorney for the Eastern District of New York, William F. Sweeney, Jr., Assistant Director-in-Charge, Federal Bureau of Investigation, New York Field Office (FBI), and Justin Campbell, Assistant Special Agent-in-Charge, Internal Revenue Service-Criminal Investigation, New York (IRS-CI), announced the guilty plea.

"By his guilty plea, Fred Towle, Jr., has admitted cheating the United States out of hundreds of thousands of dollars owed in taxes by filing a false tax return that concealed a considerable amount of income he had earned from his businesses," stated United States Attorney Donoghue. "This Office, together with our partners at the FBI and the IRS, recognizes that tax evasion victimizes every law-abiding, taxpaying American and we will vigorously prosecute those like the defendant who believe they're above the law."

"Despite his attempt to evade tax payments, Towle could not evade the inevitable repercussions of his actions, as he will now have to repay everything he owes," stated FBI Assistant Director-in-Charge Sweeney. "For anyone under the misguided notion that our government can be successfully manipulated, today's guilty plea evidently says otherwise. While maintaining a consistent partnership with the IRS, the FBI will not cease to investigate such manipulative individuals."

"Federal income tax compliance should be equally shared among all Americans, especially those who have held a public trust position," stated IRS-CI Assistant Special Agent-in-Charge Campbell. "Mr. Towle's plea today, serves as an important reminder that IRS-CI is committed along with the United States Attorney's Office and our law enforcement partners in bringing to justice those who skirt their tax responsibilities."

During the relevant time period, Towle was the sole owner of a company called East Coast Marketing, which was utilized by Towle to, among other things, consult with political candidates and assist homeowners in expediting approvals for permits made to various governmental entities in Suffolk County. According to court documents filed in connection with the case, in 2012, Towle falsely reported no taxable income from businesses controlled by him, including East Coast Marketing, despite earning approximately \$246,000 in taxable corporate income for that year. In total, between tax years 2012 and 2014, Towle failed to declare approximately \$1.2 million in income, resulting in a tax loss to the United States of approximately \$307,427.

The government's case is being handled by the Office's Long Island Criminal Division. Assistant United States Attorneys Raymond A. Tierney and Catherine M. Mirabile are in charge of the prosecution.

**The Defendant:**

FRED TOWLE, Jr.

Age: 52

Shirley, New York

E.D.N.Y. Docket No. 18-CR-368 (JMA)

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**Topic(s):**

Tax

**Component(s):**

Federal Bureau of Investigation (FBI)

USAO - New York, Eastern

**Contact:**

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United States Attorney's Office

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Updated August 1, 2018



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Department of Justice  
U.S. Attorney's Office  
Eastern District of New York

FOR IMMEDIATE RELEASE

Tuesday, May 29, 2018

**Gerard Terry, Former Chairman of the North Hempstead  
Democratic Party and Nassau County Board of Elections,  
Sentenced to Three Years in Prison for Tax Evasion**

**Defendant Evaded Over \$1.3 Million in Federal Tax Due While Holding at Least Six  
Government Jobs**

Earlier today, in federal court in Central Islip, Gerard Terry, former Chairman of the Democratic Party in North Hempstead and head of the Nassau County Board of Elections, was sentenced to three years' imprisonment, to be followed by three years' supervised release, \$992,057 in restitution and \$31,000 in forfeiture, following his guilty plea on October 12, 2017 to tax evasion. The sentencing proceeding was held before United States District Judge Joanna Seybert.

Richard P. Donoghue, United States Attorney for the Eastern District of New York, William F. Sweeney, Jr., Assistant Director-in-Charge, Federal Bureau of Investigation, New York Field Office (FBI), and James Robnett, Special Agent-in-Charge, Internal Revenue Service Criminal Investigation, New York (IRS-CI), announced the sentence.

"Gerard Terry lived by a different standard than the taxpayers he served, taking money from them in payment for the numerous governmental and quasi-governmental jobs he held, while failing to pay the taxes he owed on those jobs," stated United States Attorney Donoghue. "Together with our law enforcement partners, we will continue to work to ensure that there is one standard and one standard only — that taxpayers, regardless of who they are, will have to pay their fair share or be held to account."

"While reaping the benefits of a salary funded by taxpayer dollars, Gerard Terry rendered himself exempt from paying taxes on this earned income," stated FBI Assistant Director-in-Charge Sweeney. "It seems today he has learned his lesson—the time to pay up has come."

"Our politicians and county officials hold positions of trust in the eyes of the public," stated IRS-CI Special Agent-in-Charge Robnett. "Mr. Terry, a licensed attorney, went to great lengths to evade his tax obligations with the United States, but he ultimately hurt all American citizens who work for a living and pay their fair share for the government services and protections we enjoy."

Terry, an attorney licensed to practice in New York State, willfully evaded substantial income tax owed by him, having earned income from numerous government and quasi-government positions in Nassau County,

including the Democratic Party in the Town of North Hempstead, the Nassau County Board of Elections, the Town of North Hempstead, the Long Beach Housing Authority, the North Hempstead Housing Authority, the Freeport Community Development Agency, the Roosevelt Public Library, the Village of Port Washington, and the Village of Manorhaven. Since January 2000, Terry has failed to pay a federal tax debt of almost \$1.4 million, despite earning over \$250,000 per year.

According to court documents, during the period charged in the indictment, Terry failed to file personal Form 1040 tax returns, filing years later and only after vigorous pursuit by the IRS. Even then, Terry filed Forms 1040 that contained false information and failed to report income. Terry has still failed to file returns for tax years 2009 and 2010.

Terry also evaded the IRS's attempts at levy collection, cashing hundreds of wage and compensation checks worth over \$500,000, rather than depositing them into checking or savings accounts where they could be seized. When he did deposit checks into his checking account, he did so in the minimum amounts necessary to cover checks and payments for his own personal expenses, making sure there were not sufficient funds upon which the IRS could levy. Terry also created and utilized a checking account in the name of a corporate shell and had one of his employers make direct payments to his credit card rather than issuing him a paycheck. He also pressured colleagues at his various government and publicly funded jobs not to report wages paid to him and not to comply with IRS notices of levy.

The government's case is being handled by the Office's Long Island Criminal Division. Assistant United States Attorney Artie McConnell is in charge of the prosecution.

**The Defendant:**

GERARD TERRY

Age: 62

Roslyn, New York

E.D.N.Y. Docket No. 17-CR-37 (JS)

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**Topic(s):**

Tax

**Component(s):**

Federal Bureau of Investigation (FBI)

USAO - New York, Eastern

**Contact:**

John Marzulli

Tyler Daniels

United States Attorney's Office

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Updated May 29, 2018

## JUSTICE NEWS

### Department of Justice

Office of Public Affairs

FOR IMMEDIATE RELEASE

Wednesday, May 23, 2018

### **Owner Of Queens Karaoke Bar Pleads Guilty To Failure To Pay Employment Tax**

A resident of Queens, New York, pleaded guilty today to failing to collect and pay over employment tax, announced Principal Deputy Assistant Attorney General Richard E. Zuckerman of the Justice Department's Tax Division.

According to court documents, Kae Wook Lee was the sole owner and chief executive officer of Mona Lisa 7 Corporation, through which he operated a karaoke bar in the Flushing neighborhood of Queens. Between 2011 and 2013, Lee diverted part of his karaoke business's receipts to bank accounts in the names of shell corporations he created. Lee then withdrew funds from those bank accounts to pay employees' wages in cash without collecting or paying over employment taxes to the Internal Revenue Service (IRS). Lee concealed the cash payroll from his accountant and signed and filed false tax returns that underreported employee wages. The tax loss to the IRS caused by the defendant's conduct was \$612,500.

U.S. District Judge I. Leo Glasser scheduled sentencing for September 6, 2018. Lee faces a statutory maximum sentence of five years in prison, as well as a period of supervised release, restitution, and monetary penalties.

Principal Deputy Assistant Attorney General Zuckerman thanked special agents of IRS Criminal Investigation, who conducted the investigation, and Tax Division Trial Attorneys Mark Kotila and Sean Green, who are prosecuting the case.

Additional information about the Tax Division and its enforcement efforts can be found on the division's website.

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**Component(s):**  
Tax Division

**Press Release Number:**  
18-680

*Updated May 23, 2018*

# Buffalo Tax Preparer Charged with Filing Fraudulent Tax Returns

*Defendant faces two felonies in case investigated by the New York State Tax Department*

**For Release:** Immediate, Tuesday, March 27, 2018

**For press inquiries only, contact:** James Gazzale, 518-457-7377



The New York State Department of Taxation and Finance today announced the arrest of a Buffalo tax preparer on felony charges of preparing and filing fraudulent income tax returns.

Dorothea Fleming, 54, of 78 Sanford Street, was employed as a tax preparer at Pro-File Tax and Insurance Coalition, formerly known as Capital Tax Service, 1220 Hertel Avenue, also in Buffalo. She was arraigned before Buffalo City Court Judge Betty Calvo-Torres and charged with third-degree criminal tax fraud and first-degree offering a false instrument for filing, both felonies.

The defendant, released on her own recognizance, is alleged to have fraudulently inflated wages on returns she filed to increase the earned income tax credit paid to the taxpayer.

Fleming pleaded guilty to two misdemeanor counts of offering a false instrument for filing on October 22, 2014. After violating the terms of her sentence in that case, she was resentenced on March 4, 2016. That sentence included a prohibition against preparing returns for one year.

If convicted on the latest charges, Fleming could face a sentence of up to seven years in prison. Her next court date has not been scheduled.

“We work diligently to protect taxpayers from unscrupulous tax preparers,” said Acting Commissioner Nonie Manion. “Filers, though, need to do their homework before hiring a tax professional and should carefully review their returns before signing them.”

**Tax preparer checklist**

To help consumers screen potential tax preparers, the Tax Department has published a [checklist](#) at [Tips for hiring a tax preparer](#). Use the checklist as a guide before you hire a preparer.

If you're aware of a tax preparer who has engaged in illegal or improper conduct, you can [file a tax preparer complaint](#) online or contact the New York State Tax Department at 518-530-HELP (option #2). The information is kept confidential. The Tax Department promptly reviews each complaint and takes corrective action when appropriate.

A criminal complaint is only an accusation; the defendant is presumed innocent until proven guilty. The case will be prosecuted by the Erie County District Attorney.

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*Updated: March 27, 2018*

# Owner of Two Syracuse Car Dealerships Facing Felony Charges

*Accused of failing to pay NYS more than \$206,000 in sales tax*

**For Release:** Immediate, Monday, January 08, 2018

**For press inquiries only, contact:** James Gazzale, 518-457-7377



**Samy S. Guindy**

The New York State Department of Taxation and Finance today announced that the owner of two used car dealerships in Syracuse has been arrested for allegedly failing to pay New York State \$206,573 in sales tax.

Samy S. Guindy, 53, of 2746 W. Foxhill Lane, Camillus, operates Auto Hunter, Inc., 2524 Lodi Street, and previously operated the now-shuttered Auto Solution of CNY, Inc., 1120 W. Genesee Street. He was arrested by investigators with the Tax Department's Criminal Investigations Division and arraigned before Syracuse City Court Judge Ted Limpert.

Guindy faces separate felony counts for each company. In both cases, the defendant pleaded not guilty and was released on his own recognizance. His next court date has not been scheduled.

## **Auto Solution of CNY**

Guindy was charged with one count of 2nd degree grand larceny, 11 counts of 3rd degree criminal tax fraud, and 11 counts of 1st degree offering a false instrument for filing, all felonies. Guindy allegedly underreported sales made at Auto Solution of CNY, Inc., from December 2010 through August 2015, failing to remit to the state at least \$68,856 in sales tax.

## **Auto Hunter, Inc.**

The defendant was charged with one count of 2nd degree grand larceny, 19 counts of 3rd degree criminal tax fraud, and 19 counts of 1st degree offering a false instrument for filing, all felonies. Guindy

allegedly underreported sales made at Auto Hunter, Inc., from December 2010 through May 2017, failing to remit at least \$137,717 in sales tax.

If convicted, Guindy could face a sentence of up to 15 years in prison.

“Sales tax fraud deprives the state and the communities where these businesses operate of revenue needed for vital services, and forces honest taxpayers to shoulder the burden,” said Acting Tax Commissioner Nonie Manion. “We thank the Onondaga County DA for prosecuting this case.”

A criminal complaint is only an accusation; the defendant is presumed innocent until proven guilty. The case will be prosecuted by the Onondaga County District Attorney.

### **Sales Tax Resources**

Registered sales tax vendors must file a sales tax return by its due date, even if they have no tax due for the filing period. Vendors can access the [Sales Tax Web File](#) webpage for resources to help prepare and file an accurate sales tax return on time to avoid penalties. Resources include filing instructions, guidance, videos, and demos.

Assistance for sales tax vendors is also available in six languages, including Spanish, Chinese, Russian, Italian, Korean, and Haitian Creole at [Welcome new vendors](#).

### **Report Fraud**

New Yorkers aware of sales tax evasion or fraud can anonymously report it [online](#) or by phone at 518-457-0578. The Tax Department promptly reviews each complaint and takes corrective action when appropriate.

###

*Updated: January 08, 2018*

## JUSTICE NEWS

### Department of Justice

Office of Public Affairs

FOR IMMEDIATE RELEASE

Friday, May 4, 2018

### **New York Resident Pleads Guilty to Conspiracy to Defraud the United States**

A Brooklyn, New York, resident pleaded guilty today to conspiracy to defraud the government and theft of public funds, announced Principal Deputy Assistant Attorney General Richard E. Zuckerman of the Justice Department's Tax Division.

According to court documents, Akim Martin, also known as Akim Davis, 41, conspired with others to file fraudulent tax returns for companies and individual taxpayers. As part of the scheme, from March 2009 through March 2013, Martin and his coconspirators filed false tax returns in the names of businesses they purportedly owned and operated, claiming phony deductions for wages paid to employees that did not exist. Martin and his conspirators, in turn, then filed fraudulent tax returns in the names of the employees claiming bogus tax refunds.

Martin and his conspirators obtained the personal identifying information (PII) to use on the employees' false tax returns by stealing it and by recruiting individuals to provide their information in exchange for a cut of the proceeds. Martin cashed and deposited fraudulently obtained refund checks into bank accounts that he controlled and spent the money on his personal expenses. Martin's conduct resulted in a loss exceeding \$550,000.

Sentencing is scheduled for August 24, 2018, before U.S. District Court Judge Carol Bagley Amon. Martin faces a statutory maximum sentence of 15 years in prison. He also faces a period of supervised release, restitution and monetary penalties.

Principal Deputy Assistant Attorney General Zuckerman thanked special agents of IRS Criminal Investigation, who conducted the investigation, and Tax Division Trial Attorneys Jason M. Scheff and Ann M. Cherry, who are prosecuting these cases.

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**Topic(s):**

Tax

**Press Release Number:**

18-579

**Component(s):**

Tax Division

*Updated May 4, 2018*



THE UNITED STATES ATTORNEY'S OFFICE  
EASTERN DISTRICT *of* NEW YORK

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Department of Justice  
U.S. Attorney's Office  
Eastern District of New York

FOR IMMEDIATE RELEASE

Thursday, March 22, 2018

## **Four Individuals Charged with Conspiring to Defraud the United States by Failing to Comply with Foreign Account Tax Compliance Act**

A grand jury in Brooklyn has returned a five-count superseding indictment charging Panayiotis Kyriacou, Arvinsingh Canaye, Adrian Baron, and Linda Bullock with conspiracies to defraud the United States by obstructing the functions of the Internal Revenue Service in its administration of the Foreign Account Tax Compliance Act ("FATCA"). FATCA is a federal law that requires foreign financial institutions to identify their U.S. customers and report information ("FATCA Information") about financial accounts held by U.S. taxpayers either directly or through a foreign entity. FATCA's primary aim is to prevent U.S. taxpayers from using foreign accounts to facilitate the commission of federal tax offenses.

Last month, a grand jury in Brooklyn charged Kyriacou, Canaye, Baron, Bullock, and others with conspiracy to commit securities fraud and money laundering conspiracy.

Richard P. Donoghue, United States Attorney for the Eastern District of New York, Richard E. Zuckerman, Principal Deputy Assistant Attorney General of the Justice Department's Tax Division, William F. Sweeney, Jr., Assistant Director-in-Charge, Federal Bureau of Investigation, New York Field Office (FBI), and James D. Robnett, Special Agent-in-Charge, Internal Revenue Service Criminal Investigation, New York (IRS-CI), announced the new charges.

"As alleged in the superseding indictment, Kyriacou, Canaye, Baron, and Bullock agreed to defraud the United States by opening foreign bank and brokerage accounts without collecting FATCA information to report to the IRS," stated United States Attorney Donoghue. "The charges announced today reflect the commitment of this Office and our law enforcement partners to combat tax evasion by identifying fraudulent offshore safe havens that facilitate hiding financial assets from the IRS and to prosecute those individuals who violate U.S. tax laws."

Mr. Donoghue thanked the U.S. Securities and Exchange Commission (SEC), both the New York Regional Office and the Washington, D.C. Office, the City of London Police, the U.K.'s Financial Conduct Authority and the Hungarian National Bureau of Investigation for their significant cooperation and assistance during the investigation.

“The Justice Department and the Internal Revenue Service are committed to investigating and prosecuting those who promote and facilitate the use of offshore bank accounts to evade U.S. tax,” said Principal Deputy Assistant Attorney General Zuckerman. “We will continue to pursue those around the globe who seek to violate the Foreign Account Tax Compliance Act and to help U.S. taxpayers conceal such accounts from the Treasury Department and the IRS.”

“Government fraud, in all its many forms, places ethical U.S. taxpayers at a significant disadvantage,” stated FBI Assistant Director-in-Charge Sweeney. “Those charged allegedly thought they could bypass federal laws in order to benefit and enrich themselves. Today, they are being held accountable.”

“Devising schemes to evade the reporting requirements of the Foreign Account Tax Compliance Act is a serious violation of the trust between registered foreign financial institutions and the Internal Revenue Service,” stated IRS-CI Special Agent-in-Charge Robnett. “Criminal Investigation and Large Business & International will continue monitoring compliance with FATCA and will seek prosecution for any registered individuals or entities suspected of willfully aiding U.S. taxpayers with evading reporting requirements.”

### The Beaufort Scheme

As alleged in the superseding indictment, between August 2016 and February 2018, Kyriacou, an investment manager at Beaufort Securities, and Canaye, a general manager at Beaufort Management, together with others, conspired to defraud the United States by failing to comply with FATCA. Specifically, in the fall of 2016, an Undercover Agent contacted Kyriacou and stated that he was a U.S. citizen interested in opening brokerage accounts at Beaufort Securities from which he could execute trades in several multi-million dollar stock manipulation deals. In furtherance of the stock manipulation scheme, Kyriacou and Beaufort Securities opened six brokerage accounts for the Undercover Agent. Notwithstanding that a U.S. citizen would be the beneficial owner of each of the accounts, at no time did Kyriacou or Beaufort Securities request FATCA Information from the Undercover Agent.

In July 2017, Kyriacou introduced the Undercover Agent to Canaye and advised that Canaye could assist with the Undercover Agent’s schemes. After meeting with the Undercover Agent and discussing the stock manipulation scheme, in January 2018, Canaye and Beaufort Management opened six global business corporations for the Undercover Agent. The Undercover Agent’s name did not appear on any of the account opening documents.

### The Loyal Scheme

In June 2017, the Undercover Agent met with Baron, Loyal Bank’s Chief Business Officer. During the meeting, the Undercover Agent explained that he was a U.S. citizen and was involved in stock manipulation schemes. The Undercover Agent further explained that he was interested in opening multiple corporate bank accounts at Loyal Bank. In July 2017, the Undercover Agent met with Baron and Bullock, Loyal Bank’s Chief Executive Officer. During the meeting, the Undercover Agent described how his stock manipulation deals operated, including the need to circumvent the IRS’s reporting requirements under FATCA. In July and August 2017, Loyal Bank opened multiple bank accounts for the Undercover Agent. At no time did Loyal Bank request or collect FATCA Information from the Undercover Agent.

The charges in the superseding indictment are merely allegations, and the defendants are presumed innocent unless and until proven guilty.

The case is being handled by the Office’s Business and Securities Fraud Section. Assistant United States Attorneys Jacquelyn M. Kasulis, Michael T. Keilty and David Gopstein are in charge of the prosecution. The Criminal Division’s Office of International Affairs provided significant assistance in this matter.

### The Defendants:

PANAYIOTIS KYRIACOU, also known as "Peter Kyriacou"

Age: 26

Residence: London, England

ARVINSIGH CANAYE, also known as "Vinesh Canaye"

Age: 30

Residence: Mauritius

ADRIAN BARON

Age: 63

Residence: Budapest, Hungary

LINDA BULLOCK

Age: 57

Residence: St. Vincent/Grenadines

E.D.N.Y. Docket No. 18-CR-102 (S-1) (KAM)

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**Attachment(s):**

[Download Beaufort Superseding Indictment .pdf](#)

**Topic(s):**

Tax

**Component(s):**

[Federal Bureau of Investigation \(FBI\)](#)

[USAO - New York, Eastern](#)

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Updated March 22, 2018



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Department of Justice  
U.S. Attorney's Office  
Southern District of New York

FOR IMMEDIATE RELEASE

Wednesday, October 25, 2017

## **White Plains Accountant Sentenced To 22 Months In Prison For \$23 Million Tax Fraud Scheme**

Joon H. Kim, the Acting United States Attorney for the Southern District of New York, announced that JOSEPH CERVONE was sentenced to 22 months in prison on tax fraud charges. CERVONE plead guilty on March 29, 2017, to one count of endeavoring to obstruct and impede the due administration of the internal revenue laws and one count of subscribing to false tax returns before U.S. District Judge Nelson S. Román, who imposed today's sentence.

According to the Information previously filed in White Plains federal court and court proceedings:

From 2009 through 2012, CERVONE, a certified public accountant with an office in White Plains, obstructed and impeded the IRS by filing false tax returns claiming more than \$23 million of energy and coal credits on behalf of his clients in order to obtain tax refunds. In addition, CERVONE also filed false tax returns for the tax years 2010 and 2011 that failed to report income relating to personal expenses paid on behalf of CERVONE from funds obtained as a result of his clients' false tax returns.

\* \* \*

In addition to the prison term, CERVONE, 64, of White Plains, New York, was sentenced to one year of supervised release and a \$15,000 fine.

Mr. Kim praised the outstanding efforts of the Internal Revenue Service - Criminal Investigation. He also thanked U.S. Department of Justice's Tax Division for its significant assistance in the investigation

This case is being handled by the Office's White Plains Division. Assistant U.S. Attorney John P. Collins Jr. is in charge of the prosecution.

**Topic(s):**

Tax

**Component(s):**

USAO - New York, Southern

**Press Release Number:**

17-346

Updated October 25, 2017



## Tax Controversies and Form 5472's Reporting and Record-Keeping Requirements of Foreign-Owned U.S. Corporations and Foreign Corporations Doing Business in the US

By *Frank Agostino, Esq. and Phillip Colasanto, Esq.*

As of 2015, over 6.8 million United States (US) workers were employed by foreign-owned companies.<sup>1</sup> To ensure that foreign investment and foreign business activity is reported and taxed, Internal Revenue Code (IRC) §§ 6038A and 6038C impose reporting and substantiation requirements on foreign-controlled businesses. IRS Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, is used to report the information required under IRC §§ 6038A and 6038C. The consequence for failing to file IRS Form 5472 includes the denial of deductions for payments to related parties,<sup>2</sup> an initial \$25,000 failure to file penalty, and continuation penalties of \$25,000 per 30-day period until the taxpayer gets into compliance. Below, we review the reporting and record-keeping requirements of Foreign-Owned U.S. Corporations and Foreign Corporations doing business in the US.

### **IRC §§ 6038A and 6038C Require Foreign-Owned US Corporations and Foreign Corporations Engaged in US Business to File Form 5472**

That related-party transactions (as defined by I.R.C. § 6038A(b) which is discussed further in the following section) should be subject to extra scrutiny is not unique to foreign business activity. Transfer pricing examinations under IRC § 482 are routine. Historically, the IRS had trouble obtaining transfer pricing data from foreign companies.<sup>3</sup> The reporting and recordkeeping requirements of IRC §§ 6038A and 6038C were intended to reduce transfer pricing abuses and assist the IRS in examining related-party transactions involving foreign investors and corporations. A US business that is foreign-owned is subject to IRC § 6038A. Foreign corporations with US operations are governed by IRC § 6038C.

IRC § 6038A “**Information with respect to foreign-owned corporations**” provides:

If, at any time during a taxable year, a corporation . . .

1. is a domestic corporation (in accordance with I.R.C. § 7701(a)(3) & (a)(4)), and
2. is **25-percent foreign-owned**, such corporation shall furnish, at such time and in such manner as the Secretary shall by regulations prescribe, the information described in



## Form 5472's Reporting and Record-Keeping Requirements

*By Frank Agostino, Esq. and Phillip Colasanto, Esq.*

subsection (b) and such corporation shall maintain . . . **such records as may be appropriate to determine the correct treatment of transactions with related parties as the Secretary shall by regulations prescribe . . .**<sup>4</sup> (emphasis added).

IRC § 6038C, “**Information with respect to foreign corporations engaged in U.S. business,**” provides:

**If a foreign corporation . . . is engaged in a trade or business within the United States** at any time during a taxable year—

- (A) such corporation shall furnish . . . the information described in subsection (b) and
- (B) such corporation shall maintain . . . such records as may be appropriate to determine the liability of such corporation for tax under this title as the Secretary shall by regulations prescribe . . .<sup>5</sup>

Despite the statutory separation, the two tax provisions share the same regulations (i.e., those under IRC § 6038A), and corporations subject to either provision must supply the IRS with information each year on Form 5472.

The regulations treat domestic disregarded entities, which are wholly owned by a foreign person, as US domestic corporations for Form 5472 filing purposes.<sup>6</sup> Disregarded entities must submit the Form 5472 with a pro forma Form 1120.

### **IRC § 6038A, Treas. Reg. § 1.6038A-1, and the Who, What, When, and Where of Filing Form 5472.**

The Form 5472 requests information the IRS deems necessary to investigate whether foreigners are manipulating related-party transactions and consequently decreasing US tax revenues. To this end, Form 5472 requires identifying information from reporting corporations and 25% foreign shareholders. Regarding what information must be provided, IRC § 6038C(b)(1) adopts<sup>7</sup> the requirements of IRC § 6038A(b), which include:



## Form 5472's Reporting and Record-Keeping Requirements

By Frank Agostino, Esq. and Phillip Colasanto, Esq.

- (A) the name;
- (B) principal place of business;
- (C) nature of the business; and
- (D) the country or countries in which each related party—with any transaction with the reporting corporation—is organized or resides.<sup>8</sup>

Once the related party is listed, information regarding how the reporting corporation is related to each related party must be provided.<sup>9</sup> Then, any transactions between the reporting corporation and each foreign person which is a related party must be detailed.<sup>10</sup>

IRC § 6038A and Treas. Reg. § 1.6038A-2 through 1.6038A-7 detail which foreign-owned US corporations and foreign corporations engaged in trade or business within the US must file Form 5472, what records must be maintained, and what information must be available for audit.

IRC § 6038A(c)(1) defines a *reporting corporation* required to file Form 5472 (sometimes the "Taxpayer") as a domestic corporation that is *25-percent foreign-owned*. Foreign-owned means ownership by one foreign person of either 25 percent of the voting stock or 25 percent of the value of all classes of the domestic corporation's stock. A "foreign person" is any person who is not a "United States person" under IRC § 7701(a)(30). The attribution rules, under IRC § 318, apply when determining if a corporation is 25-percent foreign-owned and whether someone is a related party for IRC § 6038A purposes.

Form 5472 is also required from each foreign or domestic related party with which the reporting corporation had a reportable transaction.<sup>11</sup> Under IRC § 6038A(b), the term *related party* means:

1. any 25-percent foreign shareholders of the reporting corporation;
2. any person related, as defined by § 267(b)<sup>12</sup> and 707(b)(1),<sup>13</sup> to the reporting corporation or to a 25-percent foreign shareholder of the reporting corporation; and,
3. any other person related to the reporting corporation, as defined under § 482.<sup>14</sup>



## Form 5472's Reporting and Record-Keeping Requirements

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Reportable transactions are defined in Treas. Reg. § 1.6038A-2(b)(3)&(4). Related-party transactions reported on Form 5472 include:

1. sales or stock or property;
2. commissions paid and received;
3. rents and royalties paid;
4. consideration for services; and
5. amounts loaned and borrowed.<sup>15</sup>

### There is a Small Amounts Exception

Treas. Reg. § 1.6038A-2(b)(7) provides that, “[i]f any actual amount required under this section does not exceed \$50,000, the amount may be reported as “\$50,000 or less.”

### The Preparer May Use Reasonable Estimates

Treas. Reg. § 1.6038A-2(b)(6)(i) provides that “[a]ny amount reported under this section is considered to be a reasonable estimate if it is at least 75 percent and not more than 125 percent of the actual amount.”

### There is a Small Corporation Exception that Excuses Some Recordkeeping Requirements

Reporting corporations with less than \$10,000,000.00 in gross receipts for a taxable year must file a Form 5472 but they are excused from the heightened record maintenance requirements in Treas. Reg. § 1.6038A-3 and the requirement to have an authorized agent, under Treas. Reg. § 1.6038A-5.<sup>16</sup>

### The How, When, & Where of Filing Form 5472

Form 5472 is due on the due date of the Taxpayer's Form 1120, including extensions. Form 5472 should be attached to the corporation's income tax return on the filing deadline, which also includes extensions.<sup>17</sup> Disregarded entities cannot file their Form 5472 electronically. Form 5472 should be attached to the Form 1120 and filed either:



## Form 5472's Reporting and Record-Keeping Requirements

*By Frank Agostino, Esq. and Phillip Colasanto, Esq.*

electronically; via fax (300 DPI or higher) to (855) 887-7737; or mailed to Internal Revenue Service, 201 West Rivercenter Blvd., PIN Unit, Stop 97, Covington, KY 41011.

### **The Penalty for Failing to File Form 5472 Starts at \$25,000**

Failure to file Form 5472 can result in a penalty of \$25,000.00 per year (was \$10,000.00 prior to 2018).<sup>18</sup> There is also a continuation penalty. This means that if the Taxpayer does not file a substantially complete Form 5472 within 90 days of being notified to do so by the IRS,<sup>19</sup> the IRS can assess an additional \$25,000.00 penalty for each 30-day period that the taxpayer fails to cure the failure to file. Unlike other continuation penalties, there is no limit to the continuation penalty for a failure to file Form 5472.<sup>20</sup> The Fifth Amendment implications of this penalty are beyond the scope of this overview.

### **The \$25,000 Penalty Applies to Forms 5472 that are Not Substantially Complete**

Treas. Reg. § 1.6038A-4(a)(1) memorializes the IRS's position that filing a Form 5472 that is not "substantially complete" (i.e., a substantially incomplete filing) should be penalized as a failure to file.<sup>21</sup>

By contrast, Treas. Reg. § 1.6038A-2(b) provides:

- (6) Reasonable estimate -
  - (i) Estimate within 25 percent of actual amount. Any amount reported under this section is considered to be a reasonable estimate if it is at least 75 percent and not more than 125 percent of the actual amount.
  - (ii) Other estimates. If any amount reported under this paragraph (b) of this section fails to meet the reasonable estimate test of paragraph (b)(6)(i) of this section, **the reporting corporation nevertheless may show that such amount is a reasonable estimate by making an affirmative showing of relevant facts and circumstances in a written statement containing a declaration that it is made under the penalties of perjury.** The District Director



## Form 5472's Reporting and Record-Keeping Requirements

By Frank Agostino, Esq. and Phillip Colasanto, Esq.

shall determine whether the amount reported was a reasonable estimate.

- (7) Small amounts. If any actual amount required under this section does not exceed \$50,000, the amount may be reported as "\$50,000 or less." (emphasis added).

Against this background, whether an item "under or over-reported" on a Form 5472 renders the Form 5472 "substantially incomplete" is determined case by case considering the safe harbors provided by regulation.<sup>22</sup> The IRS guidance suggests that the tax professional contesting the penalty should perform a two-prong balancing test: (1) what is the magnitude of the errors<sup>23</sup> and (2) what is the effect of the noncompliance on the IRS ability to audit the information as required by statute and regulations.<sup>24</sup> Stated another way, tax professionals should argue that the regulations on whether a Form 5472 complies or substantially complies with the statute and regulations essentially incorporates the Beard test for whether a return is validly filed, as adopted by the Tax Court in *Beard v. Commissioner*, 82 T.C. 766 (1984).<sup>25</sup>

### **The IRS rarely applies the First Time Abatement procedure to Form 5472 based penalties**

Several readers that filed "quiet disclosures" to cure IRC § 6038A non-compliance have reported that the IRS has been automatically imposing Form 5472 penalties whenever a Form 5472 is filed late. This automatic penalty is authorized by IRM 21.8.2.21.2 (4-28-2017). The automatic penalty assessment causes the IRS to issue a CP 215 notice to the taxpayer. The CP 215 notice starts the collection process. Tax professionals receiving CP 215 notices should file a request under the Freedom of Information Act ("FOIA") requesting verification of the IRS's compliance with IRC § 6751(b)'s managerial approval requirement.<sup>26</sup>

The first-time abatement (FTA)<sup>27</sup> penalty relief provisions rarely apply to event-based filing requirements, such as with Form 5472.<sup>28</sup> However, the IRM authorizes abatement of the Form 5472 penalty if the related abatement on the Form 1120 was made using FTA.

### **The Penalty Can Be Excused or Mitigated on a Showing of Reasonable Cause**

IRC § 6038A(d)(3) and Treas. Reg. § 1.6038A-4(b)(1) provide that "[c]ertain failures may be excused for reasonable cause, including not timely filing Form 5472, not maintaining or causing another to maintain records as required by § 1.6038A-3."



## Form 5472's Reporting and Record-Keeping Requirements

*By Frank Agostino, Esq. and Phillip Colasanto, Esq.*

To show that reasonable cause exists, Treas. Reg. § 1.6038A-4(b)(2) requires that the Taxpayer make an affirmative showing of the facts in a written statement signed by the Taxpayer and submitted under penalties of perjury.

Treas. Reg. § 1.6038A-4(b)(2)(iii) explains that the IRS determines whether a taxpayer acted with reasonable cause and in good faith on a case-by-case basis, considering all facts and circumstances.

Under Treas. Reg. § 1.6038A-4(b)(2) reasonable cause includes but is not limited to:

- (A) Reliance on an information return;
- (B) Professional advice;
- (C) A reasonable belief that the reporting corporation it is not owned by a 25-percent foreign shareholder; and
- (D) An honest misunderstanding of fact or law that is reasonable in light of the experience and knowledge of the taxpayer.

Small taxpayers requesting penalty abatements should direct the examiner's attention to Treas. Reg. § 1.6038A-4(b)(2)(ii) which provides:

**The District Director shall apply the reasonable cause exception liberally in the case of a small corporation that had no knowledge of the requirements imposed by section 6038A; has limited presence in and contact with the United States; and promptly and fully complies with all requests by the District Director to file Form 5472, and to furnish books, records, or other materials relevant to the reportable transaction. A small corporation is a corporation whose gross receipts for a taxable year are \$20,000,000 or less. (emphasis added)**

Tax professionals preparing reasonable cause statements should address the items referred to IRM Exhibit 21.8.2-2, *Failure to File or Late-Filed Form 5472-Decision Tree*.



## **Form 5472's Reporting and Record-Keeping Requirements**

*By Frank Agostino, Esq. and Phillip Colasanto, Esq.*

### **The Statute of Limitation to Penalize a Taxpayer and/or Audit a Form 5472 does not begin until the Form 5472 is filed**

Besides the penalties resulting from not filing or late filing Forms 5472, failing to file Form 5472 extends the time that the IRS has to audit the taxpayer's return.

Effective for tax years beginning after March 18, 2010, IRC § 6501(c)(8) states:

In the case of any information which is required to be reported to the Secretary pursuant to under . . . section[s] . . . 6038, 6038A, 6038B, 6038D, 6046, 6046A, or 6048, **the time for assessment of any tax imposed by this title with respect to regarding any tax return, event, or period to which such information relates shall not expire before the date which is 3 years after the date on which the Secretary is furnished the information required to be reported under such section.** (emphasis added)

The statute of limitations for tax returns requiring a Form 5472 does not begin until the Form 5472 is filed. Failure to file Form 5472 thus risks giving the IRS an indefinite amount of time to assess penalties against the taxpayer.

### **The Recordkeeping Requirements of IRC § 6038A and IRC § 6038C have procedural and substantive due process consequences for the examination of Taxpayers**

Tax professionals accustomed to domestic substantiation cases will quickly observe that the first difference between the examination of a domestic and foreign corporation is that IRC § 6038A imposes a penalty for failure to maintain (or cause another to maintain) records as required.<sup>29</sup> Failure to maintain adequate records also comes with a \$25,000.00 penalty per year.<sup>30</sup> The IRC § 6038A penalty is also subject to a limitless continuation penalty.<sup>31</sup> The penalties for failing to maintain records in IRC § 6038C which applies to foreign corporations engaged in US trade or business mirrors the language and requirements of IRC § 6038A.

Penalties, including continuation penalties, for violations of both failure to file and failure to maintain adequate books and records can run concurrently; meaning that if a foreign-owned US corporation does not comply with both, it will be subject to two \$25,000 penalties and to potentially double continuation penalties, which would amount to



## Form 5472's Reporting and Record-Keeping Requirements

*By Frank Agostino, Esq. and Phillip Colasanto, Esq.*

\$50,000 per 30-day period.<sup>32</sup>

Professionals representing small corporations should know that although small corporations must maintain records to substantiate deductions, they are exempt from penalties for failure to maintain these records.<sup>33</sup> Likewise, reporting corporations making or receiving gross payments from foreign related parties regarding related party transactions will not be penalized for a failure to maintain records (or for a failure to authorize an agent under Treas. Reg. § 1.6038A-5) if the value of the transactions is not more than \$5,000,000.00 or 10% of the company's U.S. gross income.<sup>34</sup>

The second difference between the examinations in domestic substantiation cases and cases involving foreign corporations is the IRS's claim that the Cohan Rule (which allows the estimate of an expense where the taxpayer has established that the expense is a business expense but cannot prove the amount of the expense) does not apply.<sup>35</sup>

The IRS's position results from the tension between Treas. Reg § 1.6038A-2's authorization of "reasonable estimates" for return preparation and the IRS discretion to reduce or deny the deduction for any amount paid or incurred by Taxpayer to a related party when the taxpayer has not kept "adequate records."

As explained above, for purposes of determining whether a Form 5472 is filed, Treas. Reg. § 1.6038A-2(b)(6) authorizes a tax preparer's use of reasonable estimates. In traditional audits, the tax professional argues that under the Cohan Rule taxpayers unable to produce records of actual expenditures may use indirect methods to substantiate their estimates and deductions.

By contrast, in the absence of books and records, IRC § 6038A(e)(3) allows the IRS to determine, in its sole discretion:

(A) the amount of the deduction allowed under subtitle A for any amount paid or incurred by the reporting corporation to the related party in connection with such transaction, and

(B) the cost to the reporting corporation of any property acquired in such transaction from the related party (or transferred by such corporation in such transaction to the related party).



## Form 5472's Reporting and Record-Keeping Requirements

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IRS examiners contend that absent records, IRC § 6038A(e)(3) gives the IRS the discretion to reduce or deny the deduction for any amount paid or incurred by Taxpayer to a related party based on the failure to maintain adequate records.<sup>36</sup> The IRS claims that the noncompliance penalty of IRC § 6038A(e)(3) also applies in the case of a failure to substantially and timely comply with a summons to produce records or testimony during the examination.<sup>37</sup>

There are no reported cases on whether the Tax Court can review the reasonableness of the IRS's exercise of discretion or on what the limits of that exercise of discretion might be.

### **Read together IRC § 6038A(e)(3) and IRC § 982 mean that failing to comply with the formal document requests issued by the IRS during an examination will preclude de novo review of an IRS determination**

Another major difference in the Form 5472 examination is the document request process. Document requests in domestic examinations are not self-enforcing. If a taxpayer ignores or refuses to comply with an IDR or a summons, the IRS must bring a proceeding in US District Court to obtain the documents. The taxpayer's failure to comply with an IRS document request had little consequence if the taxpayer petitioned the Tax Court. In *Greenberg's Express*, the Tax Court held that the Tax Court trial is a de novo proceeding in which the administrative record is irrelevant.<sup>38</sup>

In Form 5472 examinations the IRS is authorized by IRC § 982(c)(1) to issue a Formal Document Request (FDR) to any taxpayer to request foreign-based documentation.

An FDR is "any request (made after the normal request procedures have failed to produce the requested documentation) for the production of foreign-based documentation which is mailed by registered or certified mail to the taxpayer at his last known address and which sets forth" certain information.

Documentation includes books and records; "foreign-based documentation" is defined as "any documentation which is outside the United States and which may be relevant or material to the tax treatment of the examined item." IRC § 982(d)(1), (2).

The FDR discourages taxpayers from delaying or refusing to disclose certain foreign-based information to the IRS.<sup>39</sup> If the taxpayer fails to substantially comply with the FDR within 90 days of the mailing of the request and fails to bring a proceeding to have the FDR quashed, the statute imposes an exclusionary rule. In any subsequent civil



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proceeding concerning the tax treatment of an examined item, the court then having jurisdiction, on motion of the IRS, can prohibit the taxpayer from introducing any foreign-based documentation covered by the FDR.<sup>40</sup> An exception to this exclusionary rule will apply if the taxpayer establishes in that subsequent civil proceeding reasonable cause for non-compliance with the FDR.<sup>41</sup>

Any person mailed an FDR may begin a proceeding to quash the FDR if the proceeding is filed within 90 days after the FDR was mailed.<sup>42</sup> If the taxpayer files a proceeding, the Secretary may seek to compel compliance with the FDR in the same proceeding. If the taxpayer files a petition to quash the FDR but does not prevail, *res judicata* (which is a legal doctrine that prevents litigants from re-litigating a previously litigated matter or issue) applies so that the exclusionary rule will apply in any such subsequent civil proceeding if the taxpayer continues to fail to substantially comply with the FDR.

### Appeals Considers Challenges to Form 5472 Penalties Post Assessment

IRC § 6038A(d) authorizes the IRS to assess applicable penalties without first sending a notice of deficiency. Existing procedures provide for the automatic assessment of the Form 5472 penalty. Appeal rights for Form 5472 are post-assessment pre-payment penalty rights.<sup>43</sup>

IRC § 6751(b) provides: "No penalty under [the I.R.C.] shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate."

To comply with IRC § 6751(b), the initial penalty is asserted on a Form 8278, *Assessment and Abatement of Miscellaneous Civil Penalties*.<sup>44</sup> Once this Form 8278 is processed, the taxpayer will be sent a CP215, *Notice of Penalty Charge*.<sup>45</sup> The collection process begins, regardless of whether the taxpayer includes with the late Forms 5472 a statement of reasonable cause or a Form 843 request for abatement.<sup>46</sup>

If the taxpayer does not pay the penalty after the CP 215 notice, the IRS sends a CP 504B, *Notice of intent to seize (levy) your property or rights to property*, pursuant to IRC § 6330. This notice provides the taxpayer with the option of pursuing an Appeals conference, by filing a Form 9423, *Collection Appeal Request*. More importantly, a taxpayer can also file a Form 12153, *Request for a Collection Due Process or Equivalent Hearing*.



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To request Appeals Office consideration of the penalty and preserve the taxpayer's rights for Tax Court prepayment review of the penalty, the taxpayer should request a *de novo* review of the penalty by requesting a Collection Due Process Hearing on Form 12153.

The Form 12153 should also request that the Appeals Office verify compliance with IRC § 6751(b). Form 5472 based penalties must be approved, in writing, by the revenue agent's manager, under IRC § 6751(b). The manager must approve the case-control, sign the notice letters, and approve the penalty by signing the Form 8278 prior to closing the case. Tax professionals challenging the Form 5472 based penalty should request that the Appeals Office verify the IRS compliance with IRC § 6751(b).

To obtain an expedited hearing, along with the Form 12153, the taxpayer should submit a Qualified Offer under IRC § 7430. IRM 8.7.15.1.4 (10-01-2012) provides that cases with qualified offers must be expedited and the Appeals Office will try to resolve the issues within 90 days of when the qualified offer is filed.

### **Substantive Tax relating to Form 5472 Tax Deficiency are Litigated In Deficiency Proceedings While Penalty Appeals are Litigated in Post-Collection Due Process Hearing Litigation Before the Tax Court**

If the IRS examination of Forms 5472 results in a deficiency determination, the taxpayer can file a petition for redetermination of the deficiency in the Tax Court. To date, the Tax Court has only issued one opinion: *ASAT, Inc. v. Comm'r*, 108 T.C. 147 (1997). *ASAT* reinforces the importance of recordkeeping and internal controls:

Section 6038A was enacted to insure that the IRS would have either timely access to the information necessary to make a complete analysis of costs between related parties or the right to make an adjustment based solely on the information that it did have. **Whether the taxpayer can later justify a cost is irrelevant:**

Accordingly, the amounts established by the Secretary cannot be overturned by a court on the basis that they diverge from actual costs or other amounts incurred, or on the basis that they do not clearly reflect income. **The fact that amounts established by the Secretary can be proven to be clearly erroneous, by reference to**



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**information or materials that were not within the Secretary's knowledge or possession, would not alone, in the conferees' view, be sufficient cause for a court to redetermine allowable amounts of deductions and the costs of goods sold. \* \* \* [H. Conf. Rept. 101-386, at 594 (1989).]<sup>47</sup> (Emphasis added)**

By contrast, the Form 5472 compliance-related penalties are not subject to the notice of deficiency requirement in IRC § 6212 (i.e., the penalties are immediately assessable). If the taxpayer disagrees with the Appeals Office's determination made at the Collection Due Process hearing, the taxpayer may appeal to the US Tax Court. The Tax Court is the only post-assessment pre-payment forum available outside of bankruptcy.

Under IRC § 6330, a taxpayer has 30 days from the IRS's determination (which must be left at taxpayer's dwelling or sent by certified or registered mail to the taxpayer's last known address)<sup>48</sup> to petition for relief in Tax Court.<sup>49</sup>

To initiate a Tax Court case, the taxpayer (now known as petitioner) will file a petition, designation for place of trial, and a statement with the taxpayer's identification number, which will accompany a filing fee of \$60 (made payable to Clerk, US Tax Court).

Petitions must include, among other items, facts and legal theories on why the petitioner should prevail. Any issue not contested in the petition is deemed conceded by petitioner (except for statutorily required issues, such as § 6751(b) compliance). Also, the notice being appealed must be attached and any taxpayer identification numbers (such as social security number) must be redacted.

### **Form 5472 Litigation before the US Court of Federal Claims or the US District Court**

Except for litigation about FDRs, most tax litigation relating to Form 5472 is brought by taxpayers in the Tax Court because it is a pre-payment forum. However, some taxpayers may want to litigate in the US Court of Federal Claims or the US District Court. Before commencing suit in these courts, the taxpayer must first pay the tax and file a claim for refund from the IRS. Claims for refund must include the grounds on which a refund is claimed and facts to support those grounds; all of which must be sworn to under penalties of perjury. There are no reported cases from US Court of Federal Claims or the US District Court that would allow us to opine on whether the refund litigation pertaining to Form 5472 is preferable to litigation before the Tax Court.



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### DIIRSP and Correcting the Failure to File a Form 5472

The *Delinquent International Information Return Submission Procedure* (“DIIRSP”) allows eligible taxpayers to correct their **failure to file**, as opposed to failure to comply with the record-keeping requirements, without penalty. DIIRSP allows taxpayers who are not compliant to file late returns if these criteria are met:

1. the taxpayer did not file one or more required international information returns;
2. the taxpayer has a reasonable cause for not timely filing the information return;
3. the taxpayer is not under a civil examination or criminal investigation by the IRS;  
and
4. the IRS has not already contacted the taxpayer regarding the delinquent return.<sup>50</sup>

If a taxpayer has not filed a Form 5472, due to a reasonable cause, and the IRS is neither investigating him nor has contacted him, then he can file his delinquent returns without being penalized.

The delinquent returns must be filed with a reasonable cause statement. This reasonable cause statement should include a certification that the foreign entity was not engaged in tax evasion. Reasonable cause statements should be attached to every delinquent return being filed. If the IRS does not accept the taxpayer's reasonable cause then a penalty may apply. Anecdotal data suggests that the IRS is applying reasonable cause liberally when delinquent Forms 5472 are filed under the DIIRSP procedure.

### Conclusion

One of the major trends in tax practice is the globalization of small business. To address the challenges of international tax administration, the IRS has increased its enforcement efforts on international information reporting and recordkeeping requirements and increased assessments of related penalties. Until recently, taxpayers, and many tax preparers, were unaware of the additional compliance obligations resulting from foreign investment in a domestic corporation or foreign business activity. The increased enforcement efforts together with the increased cost of non-compliance (i.e., penalties) now requires taxpayers to understand the reporting and recordkeeping requirements



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associated with IRS Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*.

If you have any questions about IRC § 6038A, IRC § 6038C, or Form 5472 please contact Frank Agostino, Esq. or Phillip Colasanto, Esq. at (201) 488-5400, ext. 105 or at [pcolasanto@agostinolaw.com](mailto:pcolasanto@agostinolaw.com).

<sup>1</sup> Kristen Bialik, Number of U.S. workers employed by foreign-owned companies is on the rise, available at <http://www.pewresearch.org/fact-tank/2017/12/14/number-of-u-s-workers-employed-by-foreign-owned-companies-is-on-the-rise/>.

<sup>2</sup> I.R.C. § 6038A(e)(3).

<sup>3</sup> See *United States v. Toyota Motor Corp.*, 561 F. Supp. 354 (C.D. Cal. 1983).

<sup>4</sup> I.R.C. § 6038A(a).

<sup>5</sup> I.R.C. § 6038C(a).

<sup>6</sup> See IRS Instructions for Form 5472, available at <https://www.irs.gov/pub/irs-pdf/i5472.pdf>; see also T.D. 9796.

<sup>7</sup> I.R.C. § 6038C(b)(1) states: "For purposes of subsection(a), the information described in this subsection is—the information described in section 6038A(b) . . . ."

<sup>8</sup> I.R.C. § 6038A(b)(1)(A).

<sup>9</sup> I.R.C. § 6038A(b)(1)(B).

<sup>10</sup> I.R.C. § 6038A(b)(1)(C).

<sup>11</sup> *Id.*

<sup>12</sup> I.R.C. § 267(b) defines person as: member of a family; an individual and a corporation more than 50 percent in value of the outstanding stock is owned, directly or indirectly, by or for such individual; two corporations which are members of the same control group; a grantor and a fiduciary of any trust; a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; a fiduciary of a trust and a beneficiary of the trust; a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor to both trusts; a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is grantor of that trust; a person and an organization to which section 501 applies and which is controlled directly or indirectly by such person or by members of the family of such individual; a corporation and a partnership if the same person owns more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest, or the profits interest, in the partnership; an S corporation and another S corporation if the same person owns more than 50 percent of the value of outstanding stock of each corporation; an S corporation and a C corporation if the same person owns more than 50 percent of the value of outstanding stock of each corporation; an executor of an estate and a beneficiary of an estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

<sup>13</sup> I.R.C. § 707(b)(1) disallows deductions for sales or exchanges of property between: a partnership and person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership; or, two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

<sup>14</sup> I.R.C. § 6038A(c)(2); I.R.C. § 482 allows the Secretary to distribute, apportion or allocate gross income, deductions, credits or allowances between or among two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

<sup>15</sup> Treas. Reg. § 1.6038A-2(b)(3).

<sup>16</sup> Treas. Reg. § 1.6038A-1(h).



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- <sup>17</sup> See IRS Instructions for Form 5472, available at <https://www.irs.gov/pub/irs-pdf/i5472.pdf>.
- <sup>18</sup> I.R.C. § 6038A(d)(1).
- <sup>19</sup> I.R.C. § 6038A(d)(2).
- <sup>20</sup> Treas. Reg. § 1.6038A-4(d)(4).
- <sup>21</sup> Treas. Reg. § 1.6038A-4(a)(1).
- <sup>22</sup> Chief Counsel Field Service Advisory 200026005 (March 8, 2000).
- <sup>23</sup> Chief Counsel Memorandum 200429007, P. 6 (May 28, 2004).
- <sup>24</sup> See PowerPoint Presentation regarding "Substantially Complete," Slides 17–18, available at [https://www.irs.gov/pub/int\\_practice\\_units/iga\\_c\\_17\\_03\\_01\\_02.pdf](https://www.irs.gov/pub/int_practice_units/iga_c_17_03_01_02.pdf).
- <sup>25</sup> *Beard* requires: (1) the information provided is sufficient for the IRS to calculate the tax liability; (2) the filing be a purported return; (3) an honest and reasonable attempt to comply with the tax laws; and (4) that the filing be signed under the penalty of perjury. *Beard*, 82 T.C. at 777.
- <sup>26</sup> I.R.M. 20.1.1.2.3 (11-21-2017).
- <sup>27</sup> I.R.M. 20.1.1.3.6.1(8) (11-21-2017).
- <sup>28</sup> I.R.M. 20.1.9.1.1(5) (10-24-2013).
- <sup>29</sup> I.R.C. § 6038A(d)(1)(B).
- <sup>30</sup> *Id.*
- <sup>31</sup> I.R.C. § 6038A(d)(2).
- <sup>32</sup> I.R.M. 20.1.9.5.4(2) (03-21-2013).
- <sup>33</sup> Treas. Reg. § 1.6038A-1(h).
- <sup>34</sup> Treas. Reg. § 1.6038A-1(i).
- <sup>35</sup> *Cohan v. Comm'r*, 39 F. 2d 540 (2d Cir. 1930).
- <sup>36</sup> Chief Counsel Field Service Advice 200132003 (April 25, 2001).
- <sup>37</sup> IRS Technical Assistance 200024051 (April 20, 2000).
- <sup>38</sup> *Greenberg's Express, Inc. v. Comm'r*, 62 T.C. 324 (1974).
- <sup>39</sup> *Yujuico v. United States*, 818 F.Supp. 285, 286 (N.D. Cal.1993).
- <sup>40</sup> I.R.C. § 982(a).
- <sup>41</sup> I.R.C. § 982(b)(1).
- <sup>42</sup> The procedures concerning a Formal Document Request generally incorporate (but are not identical to) those required to enforce an IRS summons. The IRS must satisfy the technical statutory requirements of § 982 and establish that: (1) the investigation is being conducted for a legitimate purpose; (2) the inquiry may relate to that purpose; (3) the information sought is not already in the possession of the IRS; and (4) the administrative steps required by the Internal Revenue Code have been followed
- <sup>43</sup> I.R.M. 20.1.9.1.1(5), Appeal Rights. Appeals offers a prepayment, post assessment appeal process for all international penalties. See I.R.M. 8.11.5, Penalties Worked in Appeals, International Penalties. Also, Appeals provides for an accelerated process for certain international penalties. See I.R.M. 8.11.5.2, International Penalty—Accelerated Appeals Consideration.
- <sup>44</sup> I.R.M. 20.1.9.5.3 (03-21-2013).
- <sup>45</sup> I.R.M. 20.1.9.5.2 (11-30-2015).
- <sup>46</sup> I.R.M. 21.8.2.21.2 (4-28-2017).
- <sup>47</sup> *ASAT, Inc. v. Comm'r*, 108 T.C. 147, 171 (1997).
- <sup>48</sup> I.R.C. § 6330(a)(2).
- <sup>49</sup> I.R.C. § 6330(d)(1).
- <sup>50</sup> See IRS website regarding DIIRSP available at <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures>.

## TAC-TIP: Due Diligence Checklist to Protect Clients Facing Passport Revocation

In the December 2017 edition of the Agostino & Associates Monthly Journal of Tax Controversy, tax professionals were alerted about a new Internal Revenue Service ("IRS" or "Service") initiative which allows the IRS to certify certain delinquent taxpayers to the State Department for passport revocation (the "Passport Article").<sup>1</sup> As detailed in the article, taxpayers with "seriously delinquent tax debt," as that term is defined in IRC §7345, are subject to losing their passports (or having applications for new passports denied) unless they get into good standing with the IRS. This TAC-Tip is aimed at providing tax professionals who represent taxpayers potentially subject to this new IRS initiative with a checklist of tools they can use to protect their clients.

Preliminarily and as explained in the Passport Article, the notice provisions for passport revocation are not strong, and there is no internal appeals process within the IRS once the certification is made. Tax professionals are cautioned to act quickly to prevent certification because once certification is made to the State Department reversal of the certification is likely to be a drawn out and expensive process.

The tax professional should remember that the Taxpayer Bill of Rights requires the IRS to evaluate, in each individual case, whether a certification for passport revocation appropriately balances the need for efficient tax collection with the legitimate taxpayer concern that any collection action be no more intrusive than necessary. The IRS has stated an intention to apply its rules for passport revocation in a prophylactic way, but that policy may run afoul of the Taxpayer Bill of Rights at 26 U.S.C. §7803(a)(3). If the IRS actions violate the Taxpayer Bill of Rights, that may be a basis for the taxpayer to request the Taxpayer Advocate Service to prevent certification or to have a certification reversed.

### Step #1: Know the Rules

To properly advise the taxpayer facing passport revocation, the tax professional must know the rules. The statute is IRC §7345, which provides that taxpayers with "seriously delinquent tax debts" risk the loss of their passports.

IRC §7345 defines a "*seriously delinquent tax debt*" as a legally enforceable and assessed tax liability of more than \$51,000 (including unpaid taxes, interest, and penalties) **that is not the subject of**

1. an innocent spouse request under IRC § 6015,
2. a collection due process hearing under IRC § 6330,
3. an installment agreement under IRC § 6159, or
4. an offer in compromise under IRC § 7122.

The \$51,000 represents an inflation adjustment from the original \$50,000 threshold when IRC §7345 was

initially enacted in December 2015.

Certain amounts are excluded from the computation of whether the \$51,000 threshold has been reached by Internal Revenue Manual ("IRM") 5.19.1.5.19.2 (December 26, 2017), *Seriously Delinquent Tax Debt*.

These include:

1. FBAR Penalties,
2. Child Support Based Assessments,
3. Affordable Care Act Assessments,
4. Individual Shared Responsibility Payments, and
5. Criminal Restitution Assessments

In addition to the statutory definition of "seriously delinquent tax debt," the IRS has adopted discretionary exceptions (i.e., situations where the IRS will not certify a taxpayer who otherwise has a "seriously delinquent tax debt.") IRM 5.19.1.5.19.4 (12-26-2017), *Discretionary Certification Exclusions*, excludes the following from seriously delinquent tax debt:

1. Debt determined to be currently not collectible (CNC) due to hardship;
2. Debt that resulted from identity theft;
3. Debts of taxpayers in a Disaster Zone;
4. Debt of a taxpayer in bankruptcy;
5. Debt included in a pending Offer in Compromise;
6. Debt included in a pending Installment Agreement; and
7. Debt subject to a pending claim where the resulting adjustment is expected to result in no balance due.

Tax professionals must know of the definition of "seriously delinquent tax debt" and the discretionary exceptions set forth above.

### Step #2: Know the Facts

This should go without saying, but we will say it anyway. Get the facts from your client. Question your client thoroughly. Remind your client you can only help if you know the facts. Ask your client about possible exceptions that might apply to prevent automatic certification by the IRS. Also, ask your client about the hardships that losing a passport might impose on him. Prepare yourself to argue that under the Taxpayer Bill of Rights, the IRS has an obligation to evaluate, for each individual taxpayer, whether a certification for passport revocation appropriately balances the need for efficient tax collection with the legitimate taxpayer concern that any collection action be no more intrusive than necessary.

### Step #3: Review IRS Freeze Codes and Evaluate Whether Any Do or Should Apply to Taxpayer

Once armed with the facts, the tax professional should review the taxpayer's IRS account transcripts. Taxpayers can quickly obtain their account transcripts at <https://www.irs.gov/individuals/get-transcript>.

Tax professionals after filing a Form 2848, *Power of Attorney and Declaration of Representative*, executed by the taxpayer can quickly obtain transcripts from the IRS.

Once the tax professional has the transcripts, they should be reviewed for IRS codes that might prevent certification. The list of IRS codes can be found at [https://www.irs.gov/pub/irs-utl/transaction\\_codes\\_pocket\\_guide.pdf](https://www.irs.gov/pub/irs-utl/transaction_codes_pocket_guide.pdf).

The pocket guide explains the "freeze codes" that should appear on the transcript that prevent nonconsensual enforced collection action against a taxpayer. For those of you that are not familiar with "freeze codes," the IRM has an entire Part devoted to freeze codes, *IRM §21.5.6, Freeze Codes (August 24, 2017)*.<sup>2</sup> The Codes themselves are listed in IRS Publication 6209, Master File Freeze Codes, Section 8A.4.<sup>3</sup> The tax professional should review the taxpayer's IRS transcripts and look for certain "Master File" codes that will generate a Freeze Code for the taxpayer's account. At the end of this document, we reproduce a chart listing some of the more important Master File codes from that document that prevent a certification of "seriously delinquent tax debt" by the IRS to the State Department. Some codes to look for are 480 (Offer in Compromise Pending), 520 (Legal Action Pending) and 530 (Currently Not Collectible Account). In addition, there are numerous codes for abatements of various penalties.

#### Step #4: Evaluate Whether the Taxpayer Can Get in Good Standing with the IRS or Whether Any Exceptions Apply

If certification has not yet been made, the taxpayer can pay to bring his debt below the threshold for "seriously delinquent tax debt" status, which as of 2018 is \$51,000.

If the taxpayer cannot pay the debt down, the tax professional should evaluate filing:

1. Form 8857 - Request for Innocent Spouse Relief
2. Form 656 - Offer in Compromise
3. Form 9465 - Installment Agreement Request
4. Form 12153 - Request for a Collection Due Process or Equivalent Hearing
5. Form 911 - Request for Taxpayer Advocate Service Assistance

The tax professional should also review the above-listed exceptions to see if any might be available to avoid an IRS certification to the State Department. These are all options for preventing a certification before it happens.

#### Step #5: Assistance Available from the Taxpayer Advocate Service

Form 911 is a request for the intervention of the Taxpayer Advocate Service ("TAS") on behalf of the taxpayer. Form 911 may be obtained directly on the IRS website, <https://www.irs.gov/pub/irs-pdf/f911.pdf>.

The Taxpayer Advocate Service is the taxpayer's representative within the IRS. The office exists to ensure that taxpayers are treated fairly by the IRS. If your taxpayer has a special hardship that the IRS is not taking enough, the TAS is there to help. TAS information may be found at <https://www.irs.gov/taxpayer-advocate>.

On the form, the tax professional should request that the Taxpayer Advocate enter an order prohibiting the certification to the State Department because revocation would pose a serious hardship to the taxpayer under Treas. Reg. §301.7811-1(a)(4).

The Taxpayer Advocate Service has issued over 800 Taxpayer Assistance Orders (TAOs) ordering the IRS not to certify the taxpayers identified in each such order to the State Department for passport revocation.<sup>4</sup> The Taxpayer Advocate Service has objected to several aspects of the IRS' implementation of the passport revocation certification program authorized by IRC §7345 and has demonstrated a willingness to act on behalf of taxpayers who face real hardships ignored by the IRS.

Step #6: Request a Hearing Pursuant to IRC §7345(e)

The only notice that the IRS will give the taxpayer of passport revocation is the Notice CP 508C. The IRS explains the import of this Notice on its website, <https://www.irs.gov/individuals/understanding-your-cp508cnotice>.

The website notes that taxpayers who receive the Notice should take action within 30 days. Time is therefore of the essence. IRC §7345(e) provides that “after the Commissioner notifies an individual under subsection (d), the taxpayer may bring a civil action against the United States in a district court of the United States or the Tax Court to determine whether the certification was erroneous or whether the Commissioner has failed to reverse the certification. We anticipate that most taxpayers will file petitions with the United States Tax Court.

Step #7: Please Contact Desa Lazar @ TAC or other LITC for Legal Assistance

TAC is the Taxpayers Assistance Center, Inc., a nonprofit whose mission is to provide legal services to taxpayers who cannot afford representation. There are also various other clinics in the NY/NJ area for low-income taxpayers who need help protecting their legal rights with the IRS. In NY, Brooklyn and Queens Legal Services has a low-income taxpayer clinic ("LITC"), and there are others in the Bronx and at Fordham Law School, Hofstra Law School, and Touro Law School. The Legal Aid Society also assists low-income taxpayers. In NJ, there are Legal Services Clinics in Edison, Jersey City, and Camden. Rutgers Law School also has a clinic to assist low-income taxpayers. If TAC cannot help you, it can provide you with contact information for these and other legal resources. Do not wait until it is too late to get the representation that your taxpayer may need.

Chart of Certain Transaction Codes from Publication 6209 That Will Generate a Freeze Code<sup>5</sup>

<b>Collection Alternative Preventing Certification</b>	<b>Account Transcript Code</b>	<b>IRS Form to File if Code Not Present</b>
Innocent Spouse Request under IRC § 6015	971	8857
A Collection Due Process Hearing under IRC § 6330	971	12153
An Installment Agreement under IRC § 6159	488	9465
An Offer in Compromise under IRC § 7122	480	656

Debt Determined to Be Currently Not Collectible (CNC) Due to Hardship	530	433-A; 433-F
Debt That Resulted from Identity Theft	n/a	14039
Debts of Taxpayers in a Disaster Zone	502, 503	n/a
Debt of a Taxpayer in Bankruptcy	520	n/a
Debt Included in a Pending Offer in Compromise	480, 780, 670, 971	656
Debt Included in a Pending Installment Agreement	670, 971	946
Debt Subject to a Pending Claim Where the Resulting Adjustment Is Expected to Result in No Balance Due	470	843
Taxpayer in Combat Zone	502, 503	n/a
Taxpayer in the Military	500	n/a

## **Endnotes:**

1. See <https://docs.google.com/viewer?a=v&pid=sites&srcid=ZGVmYXVsdGRvbWFpbmFybWF0ZXJpYWxzGd4Ojl4Mjc3YWUyNDQ0M2E2Yzg>.
2. This section of the IRM may be accessed at [https://www.irs.gov/irm/part21/irm\\_21-005-006r](https://www.irs.gov/irm/part21/irm_21-005-006r).
3. Publication 6209 may be accessed at the following link: [https://www.irs.gov/pub/irs-utl/6209\\_Section%208A\\_2014.pdf](https://www.irs.gov/pub/irs-utl/6209_Section%208A_2014.pdf)
4. <https://taxpayeradvocate.irs.gov/news/nta-blog-irs-rolls-out-passport-certification-program-refusing-toadopt-taxpayer-protections-and-exclude-taxpayers-working-with-tas?category=Tax%20News>
5. IRS Transaction Codes Definitions & Descriptions available at [https://www.auditdetective.com/Transaction\\_Code\\_Definitions.html](https://www.auditdetective.com/Transaction_Code_Definitions.html)

## Reporting Requirements for Foreign Trusts with U.S. Owners - Form 3520A

By Frank Agostino, Esq. and Edward N. Mazlish, Esq.<sup>1</sup>

On May 21, 2018, the Internal Revenue Service ("IRS") announced several new campaigns.<sup>2</sup> One of the non-compliance areas targeted for enhanced review is Form 3520 and Form 3520-A non-compliance, including the associated penalties. In the last two editions of this newsletter, we offered guidance to tax professionals regarding the reporting requirements for U.S. persons who received gifts from foreign persons and conducted business with foreign persons.<sup>3</sup> We have tried not to repeat those recommendations here. With the announcement of this IRS campaign, we review best practices for controversies involving foreign trusts with U.S. owners (Form 3520-A).

### What is the IRS Form 3520-A?

The IRS requires all foreign trusts with U.S. owners to file an information return Form 3520-A, *Annual Information Return of a Foreign Trust with a U.S. Owner*.<sup>4</sup> The form provides the IRS with information about the foreign trust, the foreign trust's beneficiaries, and any U.S. Person treated as an owner of the foreign trust under the grantor trust rules.<sup>5</sup> All foreign trusts with U.S. owners must file Form 3520-A, except for certain Canadian retirement plans.<sup>6</sup>

### Form 3520-A is required by Section § 6048(b) of the Internal Revenue Code and IRS Notice 97-34.

Section § 6048(b) of the Internal Revenue Code ("IRC" or "Code") requires any foreign trust with a U.S. Person (as that term is defined in the Code) as an owner to file Form 3520-A with the IRS.<sup>7</sup> IRS Notice 97-34 provides guidance on the filing requirements and penalties.<sup>8</sup>

Form 3520-A returns must be filed by the 15th day of the third month after the close of the trust's tax year.<sup>9</sup> Extensions of time to file may be obtained by filing a separate Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*.<sup>10</sup> The Form 7004 is separate from any extensions of time the taxpayer/owner may have requested for filing his individual income tax returns.

The Code requires the trustee to file the return, but if the trustee fails to file or files an incomplete or incorrect return, penalties may be imposed on the U.S. owners of the trust.<sup>11</sup> Form 3520-A must be filed with the Internal Revenue Service Center, P.O. Box 409101, Ogden, UT 84409.<sup>12</sup> Besides filing the Form 3520-A with the IRS, the trustee must also send copies of the Foreign Grantor Trust Owner Statement to the owners of the trust and the Foreign Grantor Trust Beneficiary Statement to the trust beneficiaries by the 15th day of the third month after the close of the trust's tax year.<sup>13</sup>

Form 3520-A is an informational return. Absent non-compliant conduct, IRC § 6048 imposes no separate tax. It prescribes penalties for failure to file<sup>14</sup> and for failing to provide records during an examination.

#### The "Owner" of a "Foreign" "Trust" has the obligation to file the Form 3520-A

Each U.S. Person treated as an owner of a foreign trust is responsible for ensuring that the trustee of the trust complies with the reporting requirements of IRC § 6048.<sup>15</sup> If the trustee does not submit the required information, each U.S. owner is subject to penalties under IRC § 6677.

#### The Owner of a Foreign Trust Can Appoint a U.S. Agent to File the Form 3520-A

The owners of a foreign trust may appoint a U.S. Agent to file Form 3520-A and respond to IRS inquiries.<sup>16</sup> The agreement appointing the agent must be in a form substantially similar to the one approved by the IRS in Notice 97-34. Once a U.S. agent is properly appointed and authorized to act, the IRS can deal with that person to ensure that the trust complies with all of its reporting obligations.

#### The Owner of the Trust, the U.S. Person, and the Foreign Trust Defined

To determine whether any U.S. Person has an obligation to file a Form 3520-A, the tax professional must consider:

- (1) Is there a U.S. Person that is an **owner** of the trust?
- (2) Is the foreign entity **a trust** for U.S. tax purposes?
- (3) If the foreign entity is a trust for U.S. tax purposes, **is it a foreign trust?**<sup>17</sup>

#### Generally, the Grantor is Considered the "Owner" of a Trust

A trust is a legal arrangement where legal title to property is transferred to a trustee, who manages the property to benefit the persons chosen by the creator of the trust.<sup>18</sup> The trustee is the legal owner of the trust's property, and the persons for whom the trust is created are called beneficiaries. While the beneficiaries are said to have "beneficial ownership" of the trust, in the sense they have a future ownership claim on trust assets, they are not considered "owners" for federal tax purposes.

Usually, the person who created the trust - who is also called a "settlor" or "grantor" - is the owner of the trust. The grantor trust rules in IRC §§ 671 - 679 explain that most often the settlor/grantor is treated as the owner of a trust for federal tax purposes notwithstanding his surrender of title to the property held by the trustee.

The grantor trust rules contain an attribution rule which imputes ownership by a spouse to the settlor/grantor.<sup>19</sup> Any power or interest held by a spouse of the settlor/grantor, either

upon the creation of the trust or that comes into existence after the creation of the trust, is deemed held by the settlor/grantor, as well.<sup>20</sup> The Code provides that a person other than the grantor with the power to vest himself of the corpus or income is treated as the owner of the trust rather than the settlor/grantor.<sup>21</sup> Finally, anyone who transfers property to a foreign trust is treated as an owner of that trust unless the transfer was at death or for fair market value consideration.<sup>22</sup>

Once the tax professional ascertains who the owners of the trust are, the next step is to determine whether any owner is a U.S. Person.

For Tax Purposes, the term "U.S. Person" is broadly defined

IRC § 7701(a) (3) defines the term "U.S. Person." The term includes:

- A. a citizen or *resident* of the United States;
- B. a domestic partnership;
- C. a domestic corporation;
- D. any estate, other than a foreign estate as defined in Section 7701(a)(31);  
and
- E. any trust, if
  - (i) a court within the United States can exercise primary supervision over the trust, and
  - (ii) one or more United States persons have the authority to control all or substantially all of the decisions of the trust.<sup>23</sup>

U.S. Persons include Citizens and Residents. Citizens include "accidental Americans" (i.e., citizens of a country other than the U.S. who are unaware that they are a U.S. citizen). Residents include lawful permanent residents of the U.S. (i.e. green card holders) and undocumented aliens under a substantial presence test. The nuances of who is a resident for tax purposes will be the subject of another article in the Agostino & Associates' Tax Controversy Journal.

A Trust is an Arrangement Where a Fiduciary Holds Property for a Beneficiary

The Code does not define the term "trust." However, IRS regulations define a trust as:

In general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually, the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust

under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. **Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility** and, therefore, are not associates in a joint enterprise for the conduct of business for profit.<sup>24</sup> (Emphasis added).

Simplifying put, a trust is generally a structure whereby a trustee takes title to property and manages it to benefit passive beneficiaries. This is to be distinguished from entities that use the trust form but are essentially business enterprises conducted for profit.<sup>25</sup>

A Foreign Trust is a Trust Controlled by Non-U.S. Persons that are Not Subject to the Jurisdiction of U.S. Courts.

A trust is a U.S. Person if (1) a court in the U.S. can exercise primary jurisdiction over the administration of the trust (the "Court test") and (2) one or more U.S. Persons have the authority to control all or substantially all of the decisions of the trust (the "Control test").<sup>26</sup> A trust which satisfies both the Court test and the Control test is a U.S. Person, whereas any other trust is a foreign trust.<sup>27</sup>

The regulations provide a safe harbor for the Court test. A trust satisfies the Court test if:

1. the trust instrument does not direct that the trust be administered outside the U.S.;
2. the trust is administered exclusively in the U.S.; and
3. the trust is not subject to an automatic migration provision which directs that if any U.S. court attempts to assert jurisdiction or otherwise supervise the administration of the trust, directly or indirectly, the trust will be deemed to have migrated from the U.S.<sup>28</sup>

The regulations do not provide a safe harbor for the Control test.<sup>29</sup> Instead, the regulations define "control":

The term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.<sup>30</sup>

Ministerial actions such as bookkeeping, collection of rents, and execution of investment instructions do not constitute control under the regulations.<sup>31</sup>

If the entity is a foreign trust with a U.S. Person as an owner, then its obligation to file Form 3520-A is triggered under IRC § 6048(b).

#### The Form 3520-A Reports the Foreign Trust's Income, Assets, and U.S. Owners

Form 3520-A<sup>32</sup> reports the trust's activities and financial position to the IRS. IRC § 6048(b)(1)(A) requires an accounting of the trust activities and operations, and IRC § 6048(b)(1)(B) requires that the trust furnish such information to the U.S. owners of the trust on forms prescribed by the Secretary.

Part I of the form requires disclosure of general information about the trust such as its name, country, taxpayer identification number and identity of any U.S. Agent if one has been appointed. Part I also requires that a copy of the trust document and other relevant documents be attached to the information return.

Part II of the form requires a detailed disclosure of the foreign trust's income statement. Information required to be provided includes: interest; dividends; gross rents/royalties; income/loss from partnerships and fiduciaries; capital gains/losses; ordinary gains/losses; other income; interest expense; foreign taxes paid; state and local taxes; amortization and depreciation; trustee advisor fees; charitable contributions; and other expenses.<sup>33</sup>

Part III of the form requires detailed disclosure of the foreign trust's balance sheet. Information required to be provided includes: cash on hand; accounts receivable; mortgages and notes receivable; inventories; government obligations; other marketable securities and non-marketable securities; depreciable assets; real property; other assets; accounts payable; contributions, gifts, and grants payable; mortgages and other notes payable; other liabilities; contributions to corpus; accumulated trust income; and any other item reflected in the trust's net worth.<sup>34</sup>

Form 3520-A also requires the completion and submission of a Foreign Grantor Trust Owner Statement for each owner, a Foreign Income Attributable to Owner form for each owner, and a Foreign Grantor Trust Beneficiary Statement for each beneficiary.<sup>35</sup> These forms must be sent to each respective person identified as an owner or beneficiary similar to the way a partnership must send a K-1 to each partner.<sup>36</sup>

#### The IRS Strictly Construes Form 3520-A Filing Requirements

The Code imposes a filing obligation on U.S. Persons who may not have full access to information in a foreign country to prepare Form 3520-A. The regulations provide that the refusal of a foreign trustee to provide information is not "reasonable cause" under IRC § 6677.

The issue whether a filing complies or substantially complies with the filing requirements is important because failing to file a "substantially complete" Form 3520-A can subject the filer to substantial penalties and failing to file a "substantially complete" form leaves open the statute of limitations on the assessment of taxes and penalties. Against this

background, one of the more frequently asked questions is how does a U.S. Person discharge his or her filing requirements if he or she cannot obtain the information from entities outside the U.S. to complete a Form 3520-A.

There is no hard and fast answer to the question. The IRS has issued internal guidance for applying the substantial compliance doctrine regarding international information reports.<sup>37</sup> A critical analysis of the guidance and IRS training materials suggest that the IRS will take a restrictive view of whether an international information return is "substantially complete"<sup>38</sup> and whether the taxpayer has "substantially complied" with his or her reporting obligations.<sup>39</sup>

Against this background, some authors recommend "best efforts" or "protective filings."<sup>40</sup> Stated another way, taxpayers who are unable to completely comply should file a Form 3520-A disclosing the information he or she can obtain and explaining why the other information is unavailable. Best efforts filings do not actually "comply" with Form 3520-A's filing requirements; instead, they explain the "impossibility of compliance" and lay the groundwork for applying the common law doctrine of "substantial compliance." Some courts will apply the doctrine of substantial compliance to avoid imposing penalties and adverse tax consequences against taxpayers that have done all that can reasonably be expected of them but have nonetheless violated the requirements of a statutory provision.<sup>41</sup> Like "reasonable cause" cases, each substantial compliance case turns on the taxpayer's conduct.

#### IRC § 6048 Provides a Penalty for Failure to Turn Over Records During an Examination

Filing a complete or substantially complete Form 3520-A results in no additional tax; the Form 3520-A is an information return. Failure to cooperate with the IRS agent assigned to the Form 3520-A examination changes this general rule. IRC § 6048 provides for an income inclusion for failure to turn over records requested by the examiner. Specifically, IRC § 6048(c)(2)(A) provides:

(A) In general. If adequate records are not provided to the Secretary to determine the proper treatment of any distribution from a foreign trust, ***such distribution shall be treated as an accumulation distribution includible in the gross income*** of the distributee under chapter 1 [emphasis supplied].

#### Failure to Cooperate During the Examination Can Preclude De Novo review of an IRS Penalty Determination

Unlike most tax cases, the adverse consequences resulting from failing to cooperate with the IRS agent working the Form 3520-A examination cannot be cured by the IRS Appeals Office or the United States Tax Court. In traditional tax cases, the taxpayer's failure to comply with an IRS document request had little consequence if the taxpayer petitioned the Tax Court. In *Greenberg's Express*, the Tax Court held that the Tax Court trial is a *de novo* proceeding in which the administrative record is irrelevant.<sup>42</sup>

In Form 3520-A examinations, if the taxpayer does not respond to the Revenue Agent's Information Document Request ("IDR") the IRS will issue a Formal Document Request ("FDR") for the production of foreign-based documentation under IRC § 982. By statute, the FDR is sent by registered or certified mail to the taxpayer's last known address.<sup>43</sup> The FDR must state the time and place for the taxpayer to produce the requested documentation, explain why the previous production by the taxpayer in response to the IDR was insufficient, and explain the consequences of failure to comply with the FDR.<sup>44</sup>

IRC § 982 defines "foreign-based documentation" as documentation, including but not limited to books and records, that is located outside the United States which may be relevant or material to the tax treatment of a particular item.<sup>45</sup>

The U.S. Person who receives a FDR must, within 90 days, respond or file a proceeding in the United States District Court to quash the request.<sup>46</sup> If within 90 days the taxpayer fails to either (a) respond or (b) institute a proceeding to quash the request, the taxpayer may be precluded in any later court proceeding from introducing any documentation that was the subject of that request.<sup>47</sup> The government's ability to exclude after-acquired evidence is subject to a reasonable cause exception.<sup>48</sup>

#### The Penalties for Failing to File or Late Filing of a Form 3520-A Can Equal 100% of the Value of the Assets for Each Year

If Form 3520-A is not properly and timely filed, the owners of the trust are subject to a penalty equal to the greater of \$10,000 or 5% of the reportable gross assets.<sup>49</sup> In addition, if the taxpayer does not correct a delinquency within 90 days after being notified by the IRS, then there is an additional penalty (i.e., a continuation penalty) of \$10,000 for each 30-day period (or fraction thereof) during which the delinquency remains uncured.<sup>50</sup> The penalty is limited only by the value of the assets.<sup>51</sup> Criminal penalties can also apply for the willful failure to file Form 3520-A.<sup>52</sup>

Form 3520-A is not a tax return. But because of the potential for income recharacterization, in addition to IRC § 6677 failure to file penalties, IRC § 6662(j) also imposes a penalty for "undisclosed foreign financial assets."<sup>53</sup>

Subsections (b)(7) and (j) of IRC § 6662 define an "undisclosed foreign financial asset" to include assets that IRC § 6048 requires to be reported on Form 3520-A. The penalty under § 6662(j)(3) for understating/underpaying a foreign financial asset is an additional 40% of any tax otherwise due because of failing to properly report.<sup>54</sup>

#### The IRS Strictly Construes the Reasonable Cause Defense to the IRC § 6677 Penalty

If the failure to file Form 3520-A was due to reasonable cause and not willful neglect, the IRC § 6677 penalty will not apply.<sup>55</sup> The reasonable cause exception under IRC § 6677(d) applies to both the initial and continuation penalties.<sup>56</sup> The Code does not define "reasonable cause" under IRC § 6677.<sup>57</sup> The IRM explains that the IRS evaluates

"reasonable cause" case-by-case.<sup>58</sup> Reasonable cause relief is available where the taxpayer exercised ordinary business care and prudence in determining tax obligations but nonetheless failed to comply with those obligations.<sup>59</sup>

The IRS administrative evaluation of the reasonable cause defense is more limited than in domestic cases.

First, IRM 20.1.9.14.5 (03-21-2013) provides that "[n]o reasonable cause should be considered until the taxpayer has filed the complete and accurate information required for all open years (not on extension)."

Second, IRC § 6677 excludes from reasonable cause that a foreign jurisdiction would impose a civil or criminal penalty either on the taxpayer or any other person for disclosing the required information.<sup>60</sup> Also excluded from reasonable cause is the refusal of a foreign trustee to provide information for any other reason, including (1) the difficulty in producing the required information or (2) provisions in the trust instrument that prevents disclosure of required information.<sup>61</sup>

Third, the IRM purports to further limit reasonable cause with international informational return reporting:

taxpayers who conduct business or transactions offshore or in foreign countries have a responsibility to exercise ordinary business care and prudence in determining their filing obligations and other requirements. It is not reasonable or prudent for taxpayers to have no knowledge of, or to solely rely on others for, the tax treatment of international transactions.<sup>62</sup>

Finally, in cases involving domestic issues, the IRS evaluates reasonable cause as of the due date of the tax return. When evaluating reasonable cause in cases involving continuation penalties, the IRS will deny penalty relief if the taxpayer fails to comply with the tax obligation within a reasonable time.<sup>63</sup>

Some tax litigators believe that the Courts will have a more lenient view than the IRS in determining whether a taxpayer has exercised ordinary business prudence and made a genuine effort to comply with his or her obligations under IRC § 6677.<sup>64</sup>

#### The IRC § 6677 Penalty is an Assessable Penalty

Unlike other international penalties, the Form 3520-A related penalties are not systemically assessed. But penalties assessed under IRC § 6677 are not subject to the deficiency rules.<sup>65</sup> Instead, IRM 20.1.9.14.2 (04-22-2011), *Penalty Letters, Notice Letters, and Notices* explains that the taxpayer will be advised of the status of his or her case by a series of letters. Letter 3804 provides the taxpayer with the opportunity to state the reasonable cause for failing to file such returns. If the examiner determines reasonable cause exists, he or she will send the taxpayer Letter 3943 (i.e., the closing acceptance letter) explaining that no penalties will be asserted.

If the examiner rejects the taxpayer's reasonable cause defense and determines that penalties should be asserted, before assessment of the penalty the IRS will comply with IRC § 6751(b). IRC § 6751(b) provides: "[n]o penalty under [the I.R.C.] shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." To comply with IRC § 6751(b), the examiner and his manager must approve the penalty on Form 8278 *Assessment and Abatement of Miscellaneous Civil Penalties* and send Letter 3946 to the taxpayer. The continuation penalties are also asserted on Form 8278.

Neither letter offers taxpayers pre-assessment appeals. Instead, at the Service Center, an assessment is made and a "CP series" notice and demand for payment (i.e., CP-15 or CP-215) is generated and sent to the taxpayer. The CP15 notice requests payment and explains that if a taxpayer wishes to dispute the penalty he or she must pay it first and then file a claim for refund. The CP215 notices notify the taxpayer of his or her ability to submit a reasonable cause statement or pay the penalty and then file a claim for refund. Neither the CP15 nor CP215 expressly provides for a pre-assessment appeal to the IRS Office of Appeals

Income recharacterization and Penalties assessed under IRC § 6662(j) are subject to the deficiency rules. The IRS must issue a Notice of Deficiency before assessing the tax.

#### The IRC § 6677 Penalty Should be Challenged in Collection Due Process Hearing

The penalties for failure to file Form 3520-A do not have pre-assessment appeal rights. Neither do the CP15 nor CP215 offer appeal rights. Administrative appeals *may* sometimes be offered under IRS procedures that created a post-assessment appeal for international penalty cases.<sup>66</sup>

If the taxpayer does not pay the penalty on the Letter CP15 or CP 215, the IRS will eventually send the taxpayer, (a) Letter L-1058 *Notice of Intent to Levy and Notice of Your Right to a Hearing*, (b) LT11 *Final Notice of Intent to Levy and Notice of Your Right to a Hearing* or (c) Letter 3172, *Notice of Federal Tax Lien Filing and Your Right to a Hearing under IRC 6320*. IRC §§ 6320 and 6330 allow the taxpayer receiving these forms to file IRS Form 12153 (Request for a Collection Due Process ("CDP") or Equivalent Hearing) to challenge his or her liability for the penalty before the Appeals Office. This hearing is a collection due process ("CDP") hearing.

Some IRS examiners have mused that the merits of an IRC § 6677 penalty cannot be challenged in an Appeals hearing under IRC §§ 6320 and 6330. We disagree. IRC § 6677 penalties are not subject to deficiency procedures.<sup>67</sup> Instead, IRC § 6677 penalties are assessed under IRC § 6671. IRC § 6665 provides that any penalty found anywhere in the Internal Revenue Code is treated as a "tax." Although neither the CP15 nor the CP 215 offer appeal rights, before the IRS can levy on the taxpayer's property to collect a "tax," IRC § 6330 requires the IRS to give the taxpayer notice of a right to a hearing.

Similarly, IRC § 6320 requires the IRS to give notice and, if requested, a hearing to taxpayers subjected to a federal tax lien. It is these notices that trigger the taxpayer's ability to challenge the merits of the IRC § 6677 penalties in a Collection Due Process proceeding.

If the taxpayer disagrees with the Appeals Office's determination made at the CDP hearing, the taxpayer may appeal to the U.S. Tax Court. Under IRC § 6330, a taxpayer has 30 days from the IRS's determination (which must be left at taxpayer's dwelling or sent by certified or registered mail to the taxpayer's last known address) to petition for relief in Tax Court. To initiate a Tax Court case, the taxpayer (now known as petitioner) will file a petition, designation for a place of trial, and a statement with the taxpayer's identification number, which will accompany a filing fee of \$60 (made payable to Clerk, U.S. Tax Court).

The Tax Court may be the only post-assessment pre-payment forum available to challenge the merits of the IRC § 6677 penalty outside of bankruptcy.

The IRC § 6662(j) penalty for undisclosed foreign financial assets is subject to the deficiency rules. So too is any recharacterization of trust income as an accumulation distribution includible in the taxpayer's gross income. Both penalties are challenged after the taxpayer receives the Notice of Deficiency, at which time the taxpayer can either file a prepayment suit in the Tax Court or pay the tax and follow the administrative exhaustion of remedies and preconditions to filing a refund suit.

#### The IRS Contends the Taxpayer Must Pay the Penalty in Full to Challenge it in Court

Whether the IRC § 6677 penalty can be challenged under IRC §§ 6320 and 6330 is important because the IRS claims that the penalty assessment under IRC § 6677 is not a "divisible tax" within the meaning of Flora v. United States.<sup>68</sup> This means that the taxpayer must pay the full IRC § 6677 penalty, including any continuation penalties, before challenging the penalty in Court.<sup>69</sup>

In Flora, the Supreme Court held that a taxpayer must pay the full tax due and exhaust administrative remedies with the IRS before a Court has jurisdiction to hear a tax refund case. However, the Court also noted that full payment is unnecessary in cases, such as excise taxes and employment taxes, where the tax due can be divisible into a tax on each transaction or event.

Whether the Flora rule applies to the IRC § 6677 penalties is important because of the continuation penalties. If the § 6677 penalties assessed are divisible, the taxpayer need pay only the initial penalty, file a claim, and sue for a refund. If the taxpayer establishes reasonable cause for the initial penalty, the IRS will likely be collaterally estopped from collecting the continuation penalties. If the tax is not divisible, the taxpayer must pay the entire amount of all penalties assessed before suing for a refund. The requirement that the penalty be paid in full prohibits taxpayers from obtaining an independent review of the IRS penalty determination.

Here, the IRM provides that the continuation penalties are assessed separately with individual Forms 8278.<sup>70</sup> The separate assessment procedure suggests that the initial penalty and each continuation penalty may be "divisible" assessments subject to the Flora rule. The IRS disagrees; so the tax professional must be prepared to address a motion to dismiss if the taxpayer pays the initial penalty and sues for a refund. If the § 6677 penalties assessed are divisible, the taxpayer need pay only one tax and then sue for a refund. If the taxpayer wins that case, the IRS will be collaterally estopped from collecting the other penalties assessed. But if the tax is not divisible, the taxpayer must pay the entire amount of all penalties assessed before suing for a refund. The total penalties cumulated may be a prohibitive amount that bars all but the wealthiest from prepaying the tax and suing for a refund.

### Non-Compliant Taxpayers Should Consider the Delinquent International Information Return Submission Procedures (DIIRSP)

At the outset of this article, we explained that the IRS is ramping up examination of Form 3520-A filings. In our previous articles, we recommended that tax professionals take advantage of the IRS Delinquent International Information Submission Procedure ("DIIRSP") while it is still available. We renew that advice.

### Conclusion

IRS Data Books show that each year, the IRS increasingly collects more revenue from penalties and that the IRS is imposing more penalties for the failure to file international information returns. The IRS campaigns suggest that the examination of international reporting will continue to increase as will penalty assessments. Consequently, all tax professionals need to understand these international reporting requirements to meet their tax responsibilities to their clients. The professionals at Agostino & Associates, P.C. can help you navigate these reporting obligations. Contact us if you have questions.

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<sup>2</sup> *IRS Announces the Identification and Selection of Six Large Business and International Compliance Campaigns*, available at <https://www.irs.gov/businesses/irs-announces-the-identification-and-selection-of-six-large-business-and-international-compliance-campaigns>.

<sup>3</sup> Our March 2018 newsletter may be accessed at the following link: <http://files.constantcontact.com/f7d16a55201/d5fd471b-cd54-4fb8-8e53-dc200c9e5470.pdf?ver=1521829119000>.

<sup>4</sup> *IRS Foreign Trust Reporting Requirements*, available at <https://www.irs.gov/businesses/international-businesses/foreign-trust-reporting-requirements>

<sup>5</sup> See IRS Instructions for Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, (2017) available at <https://www.irs.gov/pub/irs-pdf/i3520a.pdf>.

<sup>6</sup> The reporting requirements for those Canadian retirement trusts exempted from Form 3520-A requirements are set forth in IRS Notice 2003-75, RRSP and RRIF Information Reporting, and in IRS Rev. Proc. 2014-55, Election Procedures and Information Reporting With Respect to Certain Interests in Canadian Retirement Plans. Those requirements are beyond the scope of this article

but should be noted by any tax professional preparing tax returns for U.S. persons with interests in such trusts.

<sup>7</sup> I.R.C. § 6048(b); see also, IRS Instructions for Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, (2017) available at <https://www.irs.gov/pub/irs-pdf/i3520a.pdf>.

<sup>8</sup> See also IRM 20.1.9.14 (April 22, 2011).

<sup>9</sup> IRM 20.1.9.14.1(1) (March 21, 2013).

<sup>10</sup> IRS Instructions for Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, (2017) available at <https://www.irs.gov/pub/irs-pdf/i3520a.pdf>.

<sup>11</sup> I.R.C. § 6677 (a)-(c); see also, IRS Instructions for Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, (2017) available at <https://www.irs.gov/pub/irs-pdf/i3520a.pdf>.

<sup>12</sup> IRS Instructions for Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*, (2017) available at <https://www.irs.gov/pub/irs-pdf/i3520a.pdf>.

<sup>13</sup> See IRS Notice 97-34, 1997-25 I.R.B., Section IV-A.

<sup>14</sup> I.R.C. §§ 6048(b) and 6677(a)-(c).

<sup>15</sup> IRS Notice 97-34, 1997-25 I.R.B. Part IV.

<sup>16</sup> I.R.C. § 6048 (b)(2).

<sup>17</sup> See, e.g., Maryanne R. Kayan and Ashley A. Weyenberg, *Foreign Trusts: Form 3520 and Form 3520-A - Filing Deadlines and Liability of A Decedent's Estate*, ABA Probate and Property Magazine, Volume 27 No. 4 (2013).

<sup>18</sup> Treas. Reg. § 301.7701-4.

<sup>19</sup> I.R.C. § 672(e).

<sup>20</sup> I.R.C. § 672(e).

<sup>21</sup> I.R.C. § 678.

<sup>22</sup> I.R.C. § 679.

<sup>23</sup> I.R.C. § 7701(a)(30).

<sup>24</sup> Treas. Reg. § 7701-4(a).

<sup>25</sup> Treas. Reg. § 7701-4(b).

<sup>26</sup> I.R.C. § 7701(a)(30)(E).

<sup>27</sup> I.R.C. § 7701(a)(31)(B); Treas. Reg. § 301.7701-7(a).

<sup>28</sup> Treas. Reg. § 301.7701-7(c)(1),(4).

<sup>29</sup> Treas. Reg. § 301.7701-7(d).

<sup>30</sup> *Id.*

<sup>31</sup> Treas. Reg. § 301.7701-7(d)(1)(ii).

<sup>32</sup> A link to Form 3520-A may be accessed here: <https://www.irs.gov/pub/irs-pdf/f3520a.pdf>.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> See IRS Notice 97-34, 1997-25 I.R.B., Part IV, Section A.

<sup>37</sup> The internal guidance includes Chief Counsel Advice (“CCA”) 20429007 entitled “*Whether Form 5472 was Substantially Complete.*”

<sup>38</sup> LB&I International Practice Service Process Unit available at [https://www.irs.gov/pub/int\\_practice\\_units/FEN9434\\_02\\_05R.pdf](https://www.irs.gov/pub/int_practice_units/FEN9434_02_05R.pdf).

<sup>39</sup> *Id.* at page 3.

<sup>40</sup> Caroline Rule, *IRS Form 3520, Penalties, and Whether to Make a Protective Filing*, The CPA Journal, December 2017, available at <https://www.cpajournal.com/2017/12/19/irs-form-3520-penalties-whether-make-protective-filing/>.

<sup>41</sup> *Estate of Chamberlain v. Comm’r*, T.C. Memo. 1999-181.

<sup>42</sup> *Greenberg's Express, Inc. v. Comm’r*, 62 T.C. 324 (1974).

<sup>43</sup> I.R.C. § 982(c).

<sup>44</sup> *Id.*

<sup>45</sup> I.R.C. § 982(d)(1).

<sup>46</sup> I.R.C. § 982(c)(2).

<sup>47</sup> I.R.C. § 982(a).

<sup>48</sup> I.R.C. § 982(b)(1).

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<sup>49</sup> I.R.C. § 6677(b).

<sup>50</sup> I.R.C. § 667(a).

<sup>51</sup> Id.

<sup>52</sup> I.R.C. § 7203.

<sup>53</sup> I.R.C. § 6662(b)(7) and I.R.C. § 6662(j).

<sup>54</sup> I.R.C. § 6662(j)(3).

<sup>55</sup> I.R.C. § 6677(d).

<sup>56</sup> I.R.C. § 6677(d). See also IRM 20.1.9.22.5 (March 21, 2013)

<sup>57</sup> Strafford, *Navigating the IRS Penalty Abatement Procedures for Foreign Information Reporting Noncompliance*, (September 12, 2017), available at <http://media.straffordpub.com/products/navigating-the-irs-penalty-abatement-procedures-for-foreign-information-reporting-noncompliance-2017-09-12/presentation.pdf>.

<sup>58</sup> See IRM 20.1.1.3.2 (November 21, 2017).

<sup>59</sup> Id.

<sup>60</sup> I.R.C. § 6677(d).

<sup>61</sup> IRS Notice 97-34, 1997-25 I.R.B., Part VII.

<sup>62</sup> IRM 20.1.9.1.1(4) (October 24, 2013).

<sup>63</sup> IRM 20.1.1.3.2 (6) (November 21, 2017).

<sup>64</sup> Henry Stow Lovejoy, *Reasonable Cause for International Information Return Penalties - What is the Standard?*, *The Practical Lawyer*, Summer 2017, page 24–26, available at [https://d3n8a8pro7vhm.cloudfront.net/kflaw/pages/1279/attachments/original/1504730021/Article\\_on\\_reasonable\\_cause\\_in\\_international\\_info\\_returns\\_in\\_Practical\\_Tax\\_Lawyer\\_%2800467977x9E8E9%29.pdf?1504730021](https://d3n8a8pro7vhm.cloudfront.net/kflaw/pages/1279/attachments/original/1504730021/Article_on_reasonable_cause_in_international_info_returns_in_Practical_Tax_Lawyer_%2800467977x9E8E9%29.pdf?1504730021).

<sup>65</sup> I.R.C. § 6677(e).

<sup>66</sup> IRM 8.11.5.1 (1) (December 18, 2015).

<sup>67</sup> I.R.C. § 6677(e).

<sup>68</sup> 362 U.S. 145 (1960).

<sup>69</sup> I.R.S. Chief Couns. Memo. 201150029, December 16, 2011, available at <https://www.irs.gov/pub/irs-wd/1150029.pdf>.

<sup>70</sup> IRM 20.1.9.13.4(3) (July 8, 2015).

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**IRS Form 8938, *Statement of Specified Foreign Financial Assets***  
**By Frank Agostino, Esq. and Victor M. Nazario III, Esq.<sup>1</sup>**

During the last year, the Internal Revenue Service (“IRS”) has announced several compliance campaigns designed to verify a taxpayer’s compliance with the Foreign Account Tax Compliance Act (“FATCA”). These campaigns encourage better tax compliance from U.S. taxpayers, banks, and other financial organizations subject to U.S. taxation on their income and assets.<sup>2</sup> Among FATCA’s reporting requirements is section 6038D of the Internal Revenue Code (“Code”). This section provides that taxpayers holding financial assets outside the United States must report those assets to the IRS on Form 8938, *Statement of Specified Foreign Financial Assets*.<sup>3</sup> It also imposes penalties for noncompliance.<sup>4</sup>

This Article will review what tax professionals representing individuals should know about Form 8938 and controversies based on the audit of Form 8938.

**The Obligation to Report Foreign Financial Assets**

**What is IRS Form 8938?**

Form 8938 is used by U.S. taxpayers to report financial assets outside the United States to the IRS.<sup>5</sup> This FATCA requirement is in addition to the requirement to report foreign financial accounts on FinCEN Form 114, Report of Foreign Bank and Financial Accounts (“FBAR”) (formerly TD F 90-22.1).

Reporting thresholds vary based on whether a taxpayer files a joint income tax return or resides outside the United States.<sup>6</sup> Although Form 8938 also applies to certain entities that can hold specified foreign financial assets, such as corporations, trusts, and partnerships, this article solely focuses on individuals.

**When To File Form 8938?**

Taxpayers file Form 8938 with their annual individual income tax return, which is typically the 15th day of the 4th month after the close of the tax year (usually April 15th).<sup>7</sup>

**Who Must File Form 8938?**

To file Form 8938, a taxpayer must:

1. be a specified individual;
2. with an interest in a specified foreign financial asset, and
3. an asset value that exceeds the filing threshold.<sup>8</sup>

If a taxpayer has no individual income tax filing requirement for that year, then he or she “is not required to file Form 8938.”<sup>9</sup>

**Who is a Specified Individual?**

Under the Code, Treasury Regulations, and Instructions to Form 8938, a taxpayer is a specified individual if he or she is:

1. a U.S. Citizen;
2. a Resident Alien of the U.S. for any part of the tax year; or
3. a Non-Resident Alien who elected to be treated as a Resident Alien to file a joint income tax return or is a bona fide resident of American Samoa or Puerto Rico.<sup>10</sup>

If a taxpayer falls within one of the above categories, then section 6038D treats that taxpayer as a specified individual subject to Form 8938's reporting requirements.

### **What is an interest in a Specified Foreign Financial Asset?**

A U.S. taxpayer must own or have an interest in a specified foreign financial asset for the Form 8939 filing requirement to apply.<sup>11</sup> Section 6038D defines a specified foreign financial asset as:

1. a financial account maintained by a foreign financial institution;
2. stock or securities issued by a non-U.S. person;
3. any interest in a foreign entity; and
4. a financial instrument or contract where an issuer is a non-U.S. person.<sup>12</sup>

### **Examples of Assets That Must Be Reported on Form 8938**

An interest in a foreign entity includes (a) an interest in the capital or profits of a foreign partnership; (b) an interest in a foreign trust or estate if the individual knows of the interest through readily accessible information; and (c) stocks or bonds issued by a foreign corporation.<sup>13</sup> A financial instrument or contract includes (a) a note or debt instrument issued by a foreign person; (b) a foreign life insurance product; (c) any swap or similar type of financial instrument with a foreign counterpart; or (d) an option or derivative instrument with a foreign counterpart.<sup>14</sup> Foreign pensions or deferred compensation plans are also specified foreign financial assets if the asset's value exceeds the reporting threshold.<sup>15</sup>

### **Exempt Assets: Assets that Do Not Need to Be Reported on Form 8938**

A taxpayer need not file Form 8938 for specifically exempted assets, including:

1. foreign currency;
2. foreign social security or social insurance programs of a foreign government;
3. directly held or owned items in a foreign country, such as artwork, gold (and other precious metals), antiques, jewelry, cars, and other collectibles; and
4. a safe deposit box in a foreign financial institution.<sup>16</sup>

Note, that if the taxpayer held the artwork, gold (and other precious metals), antiques, jewelry, cars, and other collectibles solely for investment and later sold the asset to a foreign person, then a taxpayer must report that asset on Form 8938 when the sale value exceeds the reporting

threshold.<sup>17</sup>

Directly owned foreign real estate (e.g., vacation homes, personal residences, rental property) is an exempt asset.<sup>18</sup> By contrast, foreign real estate owned through a foreign entity; such as a corporation, partnership, trust, or even an estate; must be reported on Form 8938 if the interest's value exceeds the filing requirement.<sup>19</sup> Then, a taxpayer only must enter the value of the taxpayer's interest in the entity as opposed to the value of the underlying real estate.<sup>20</sup>

A taxpayer need not file Form 8938 if the taxpayer holds the specified foreign financial asset, like stocks, bonds, and ETFs, in their account with a U.S.-based financial institution.<sup>21</sup> A taxpayer need not report the foreign shares or securities if a U.S. mutual fund holds those shares or securities.<sup>22</sup>

### **When is a taxpayer required to report a Specified Foreign Financial Asset?**

To trigger the filing requirement, a taxpayer must have a specified foreign financial asset with a value that exceeds the filing threshold. This filing threshold is based on the asset's total value (or an aggregate value if a taxpayer has multiple specified foreign assets) and differs depending on the taxpayer's marital status and residency.

If a taxpayer lives in the United States and is unmarried, the taxpayer must report the foreign financial asset if the asset's value is more than \$50,000 on the last day of the tax year or \$75,000 at any time during the tax year (for multiple assets use the aggregate value).<sup>23</sup> If a taxpayer is married, files jointly, and lives in the United States, a taxpayer must report the foreign financial asset if the asset's value is more than \$100,000 on the last day of the tax year or \$150,000 at any time during the taxable year (for multiple assets use the aggregate value).<sup>24</sup> However, married U.S.-based taxpayers filing separately fall under the default rule; they must report the foreign financial asset if the asset's value exceeds \$50,000 on the last day of the taxable year or \$75,000 at any time during the taxable year (for multiple assets use the aggregate value).<sup>25</sup>

The threshold for U.S. taxpayers living abroad is higher than for U.S. residents. Non-resident U.S. taxpayers that are either unmarried or married and file separately must report the foreign financial asset if the asset's value exceeds \$200,000 on the last day of the taxable year or \$300,000 at any time during the taxable year (for multiple assets use the aggregate value).<sup>26</sup> Non-resident U.S. taxpayers who are married and file jointly must report the foreign financial asset if the asset's value exceeds \$400,000 on the last day of the taxable year or \$600,000 at any time during the taxable year (for multiple assets use the aggregate value).<sup>27</sup>

A U.S. taxpayer is considered as "living abroad" if they meet one of the presence tests:

1. their tax home is in a foreign country and they are a bona fide resident of the foreign country or countries for an uninterrupted period including an entire tax year, or
2. they are present in a foreign country or countries for at least 330 full days during any 12 consecutive months, which ends during the tax year being reported.<sup>28</sup>

## **How Are Foreign Financial Assets Valued For Purposes of Filing Form 8938?**

On Form 8938, a taxpayer must report the maximum value of each reported asset during the year. The maximum value is the asset's highest value, using a *reasonable estimate*, within that taxable year.<sup>29</sup> The asset's highest value is determined using the asset's fair market value where the property can be exchanged between a "willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having knowledge of all relevant facts."<sup>30</sup> The asset's maximum value must be determined "in the foreign currency and then converted to U.S. dollars."<sup>31</sup> When a taxpayer converts from a foreign currency to the U.S. Dollar, the IRS requires the source of the conversion rate, the exchange rate, and the determination date; all of which must be disclosed on Form 8938.<sup>32</sup>

To value foreign stock and securities or foreign companies and partnerships, a taxpayer can use the asset's fair market value.<sup>33</sup> If a taxpayer held foreign stock and securities in a foreign account, a taxpayer uses the account's fair market value.<sup>34</sup> If the taxpayer holds the foreign stock, security, or interest in a foreign company directly, the taxpayer uses the fair market value on the last day of the tax year.<sup>35</sup> Fair market value includes the consideration of applicable valuation discounts.<sup>36</sup>

### **Warning – Valuation Understatements**

If the IRS determines that a taxpayer valued a specified foreign financial asset incorrectly, the IRS could reconsider that value if a taxpayer did not provide "sufficient information."<sup>37</sup> If so, the IRS can presume the value of the foreign financial asset exceeded \$50,000 or \$75,000 for assessing penalties against a taxpayer.<sup>38</sup>

### **Duplicative Reporting Exception**

A taxpayer may not need to file a Form 8938 if a taxpayer, subject to these rules, reported the specified foreign financial asset on other forms with the IRS.<sup>39</sup>

To eliminate duplicative reporting, these other forms could report a foreign financial asset:

1. Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts* (in the case of a specified person that is the beneficiary of a foreign trust);
2. Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*;
3. Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*; or
4. Form 8865, *Return of U.S. Persons With Respect To Certain Foreign Partnerships*.<sup>40</sup>

Form 8938 requires taxpayers to identify the Form that reported the specified foreign financial asset (i.e. Form 3520, Form 5471, Form 8621, or Form 8865) and the number of other Forms used (i.e. how many of each form have been filed).<sup>41</sup>

Frequently asked questions include whether a taxpayer avoids filing other forms (Form 3520, Form 5741, Form 8621, and/or Form 8865) by filing Form 8938. The answer is no. A taxpayer cannot avoid filing Forms 8621, 5471, 3520, and/or 8865 by filing Form 8938 with the IRS.<sup>42</sup>

### **The Duplicative Report Exception Does Not Apply to the FBAR.**

The duplicative reporting exception does not apply to the Report of Foreign Bank and Financial Accounts (i.e. “FBAR”). If required, the FBAR must be filed even if the same information appears on the Form 8938. Taxpayers are required to file the FBAR, whenever:

1. a taxpayer has an ownership interest (i.e. the money in the account is mine) or signature authority over a foreign bank or financial account;<sup>43</sup> and
2. the foreign account, or multiple accounts, exceed \$10,000 at any time during the calendar year.<sup>44</sup>

A taxpayer must file an FBAR by April 15th.<sup>45</sup> While the due dates are the same, a taxpayer must file the FBAR separately from their own tax return and must file the form directly with the Department of Treasury through a specified website.<sup>46</sup>

### **IRS Examination of Foreign Financial Assets**

#### **The Treasury Inspector General’s Report (“TIGTA”) Will Result in More Form 8938 Examinations.**

During last year, the IRS has announced several compliance campaigns designed to verify the taxpayer’s compliance with FATCA. Pursuant to a recommendation made by the TIGTA, the IRS will now match data received from Form 8966, *FATCA Report* with individual Forms 8938.<sup>47</sup> The Form 8966 is the information reporting return filed by foreign financial institutions (“FFI”) to disclose the name, address, taxpayer identification number, account balance, and total withdrawals or receipts of U.S. taxpayers’ account.<sup>48</sup>

According to the recent TIGTA report, for audits not connected with a settlement program, the IRS made 75 failure to file Form 8938 penalty assessments against individual taxpayers between October 2016 and September 30, 2017.<sup>49</sup> The IRS assessed \$660,000 based on the failure to file penalty and \$520,000 in continuation penalties.<sup>50</sup> The TIGTA anticipates that matching the data supplied by FFIs on Form 8966 with the data taxpayers are filing on Form 8938 will detect non-compliance and increase compliance with section 6038. Based on the TIGTA report, tax professionals should anticipate that Form 8938-based examinations will be increasing.

#### **Non-Compliance Taxpayers Should Take Advantage of the Streamlined Program & Delinquent International Information Return Submission Procedures**

Taxpayers that did not file Forms 8938 can cure their non-compliance without penalty through the Offshore Streamlined Filing Compliance Program (“Streamlined Program”) or the Offshore Voluntary Disclosure Program (“OVDP”).<sup>51</sup> However, the OVDP option is ending on September

28, 2018, which is the final deadline to participate in the program. The Streamlined Program will continue for eligible taxpayers who did not willfully fail to file foreign financial assets and pay the related taxes on their assets.<sup>52</sup> The Streamlined Program allows certain taxpayers to file their returns and/or Form 8938 if a taxpayer:

1. certifies that their non-compliant conduct was due to reasonable cause;
2. is not under a civil examination or criminal investigation by the IRS, and
3. needs a valid taxpayer identification number or social security number.<sup>53</sup>

Tax Professionals should also consider the Delinquent International Information Return Submission Procedure (“DIIRSP”). DIIRSP allows eligible taxpayers to correct their failure to file without a penalty. DIIRSP also allows non-compliant taxpayers to file late Form 8938s if the taxpayer meets these criteria:

1. the taxpayer did not file one or more required international information returns;
2. the taxpayer has a reasonable cause for not timely filing the information return;
3. the taxpayer is not under a civil examination or criminal investigation by the IRS, and
4. the IRS has not already contacted the taxpayer regarding the delinquent return.<sup>54</sup>

A tax professional can file delinquent returns and attach a reasonable cause statement to Form 8938.<sup>55</sup> This reasonable cause statement will explain a taxpayer’s reason for failing to file Form 8938, including the facts and circumstances.<sup>56</sup> In this statement, a tax professional must certify that the taxpayer filing Form 8938, was not engaged in tax evasion.<sup>57</sup> If the IRS does not accept the taxpayer’s reasonable cause, then a penalty will apply.

### **The Failure to Report Foreign Financial Assets Gives the IRS an Unlimited Statute of Limitations to Examine the Taxpayer’s Return.**

Traditionally, if a taxpayer timely files his returns, the statute of limitations to examine and assess a taxpayer is three years.<sup>58</sup> If the taxpayer neglects to file the Form 8938 with his or her Form 1040, the statute of limitations to examine the Form 1040 does not start to run until the taxpayer files a complete Form 8938.<sup>59</sup> The IRS considers an incomplete Form 8938 to be the same as failing to file Form 8938.<sup>60</sup> Thus, failing to file a complete Form 8938 could cause an unlimited time for the IRS to commence the examination of a taxpayer’s return,<sup>61</sup> or a six-year statute of limitations if a taxpayer substantially omitted the financial asset.<sup>62</sup> A substantial omission occurs when a taxpayer’s omission of income or value exceeds \$5,000.<sup>63</sup>

### **Always Request and Review the Examiner’s Lead Sheets.**

The IRS procedures are designed to help the examiner determining the “substantially correct” tax liability.<sup>64</sup> Toward that end, revenue agents prepare lead sheets and work papers to identify issues. The lead sheets:

1. state the audit plan;
2. define the exam's scope;
3. summarize the IRS's evidence and techniques;
4. summarize the taxpayer's position on an issue and supporting work papers;<sup>65</sup>
5. support factual and technical conclusions regarding an audit issue;<sup>66</sup> and
6. memorialize managerial discussions on them.<sup>67</sup>

Audit examiners will even contemporaneously update their lead sheets in an audit. According to the TIGTA report, the IRS created a Form 8938 lead sheet for revenue agents assigned to Form 8938 examinations.<sup>68</sup> The Form 8938 lead sheet describes the basic concepts and procedures to guide an audit examiner's decision.<sup>69</sup> At the beginning and at the end of every examination of the tax return including a Form 8938, the tax professional should file a Freedom of Information Act ("FOIA") requesting the issue lead sheets including the Form 8938 lead sheets.

### **Know the Difference between an Information Document Request (IDR) and Foreign Document Requests ("FDR") and the Consequences of an Incomplete Response.**

In traditional audits, the IRS requests information from the taxpayer on Form 4564, *Information Document Request (IDR)*. IDRs are not self-enforcing. If the IRS makes an adjustment based on a taxpayer's failure to provide the documents requested, the tax professional can only provide the documents when he or she gets them. Because trial before the Tax Court is a de novo proceeding, and the Tax Court's decision is based on the merits of the record before it, as opposed to the IRS administrative record, the taxpayer's inability to produce domestic documents to the auditor has little consequence.

In examinations involving foreign income and assets, audit examiners issue formal document requests under Section 982, *Admissibility of documentation maintained in foreign countries*. Section 982 states that:

[i]f the taxpayer fails to *substantially comply*<sup>70</sup> with any formal document request arising out of the examination of the tax treatment of any item (hereinafter in this section referred to as the "examined item") before the 90th day after the date of the mailing of such request on motion by the Secretary, any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue *shall prohibit the introduction by the taxpayer of any foreign-based documentation* covered by such request.

Requests under Section 982 are sent on Letter 2261 also known as Formal Document Requests ("FDR"), explaining:

1. the time and place for the production of the documentation;
2. the reason the documentation previously produced (if any) is insufficient;
3. the description of the documentation being sought; and

4. the consequences to the taxpayer of failing to produce the documentation sought.<sup>71</sup>

A taxpayer who receives an FDR from the IRS may begin proceedings to quash the request within 90 days after mailing the FDR.<sup>72</sup> The standard for quashing a FDR is the same as for quashing an IRS summons.

To date, most tax professionals who cannot acquire documents requested in an FDR send letters to the IRS examiner with an explanation why the taxpayer contends his compliance was “substantial” and/or a reasonable cause exists for failing to produce the information.

The exception to Section 982(a)’s exclusionary rule is in Code Sec. 982(b):

Reasonable cause exception. (1) In general. Subsection (a) shall not apply with respect to any documentation if the taxpayer establishes that *the failure to provide the documentation as requested by the Secretary is due to reasonable cause.*

Section 982 excludes from the reasonable cause defense that “a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation.”

If a taxpayer’s case proceeds to litigation, Courts may evaluate Section 982’s “substantial compliance” and “reasonable cause” defenses to the Government’s motion to exclude on a case-by-case basis.<sup>73</sup>

Tax Professionals representing taxpayers in Form 8938 examination must know the difference between an IDR and an FDR and draft his or her responses accordingly.

### **The Penalties Resulting from Failure to Report Foreign Financial Assets**

#### **The Failure to File a Form 8938 Could Result in a \$60,000 Failure to File Penalty.**

A taxpayer’s failure to file Form 8938 with Form 1040 results in a \$10,000 penalty.<sup>74</sup> The IRS can immediately assess a penalty against a taxpayer. A taxpayer can even be assessed a penalty if a taxpayer filed Form 8938, but the IRS determined that a taxpayer did not provide “sufficient information” to show the total value of all the reported assets.<sup>75</sup>

After the IRS sends a taxpayer a Letter 4618, notifying the taxpayer of a failure to file Form 8938, a taxpayer has 90 days to correct the failure to file.<sup>76</sup> Failure to file Form 8938 after notification results in a continuation penalty of an additional \$10,000 penalty for each 30-day period that a taxpayer fails to cure the failure to file (\$10,000 per month).<sup>77</sup> The IRS can penalize a taxpayer up to \$60,000 for each failure to file: \$10,000 for failing to file and \$50,000 for the continuation penalty.<sup>78</sup>

#### **The Failure to Report Income and Financial Asset Could Result in a 40% Substantial**

## **Understatement Penalty.**

Besides the failure to file penalty, a taxpayer may be subject to an accuracy-related penalty associated with Form 8938 for failing to disclose the income from a foreign financial asset or to disclose other foreign financial assets. Unlike the failure to file penalties, accuracy-related penalties are subject to deficiency procedures, i.e., the IRS must send a statutory notice of deficiency to a taxpayer prior to assessing the penalty.<sup>79</sup> Underpayments occur where an individual taxpayer pays less than the tax required through withholdings or estimated tax payments.<sup>80</sup> An undisclosed foreign financial asset is an asset that should have been reported or disclosed on Forms required under Section 6038 (interests in foreign corporations or partnerships), 6038B (transfers of property to foreign corporations or partnerships), 6038D (specified foreign financial assets), 6046A (interests in foreign partnerships), or 6048 (interests or assets in foreign trusts).<sup>81</sup> Under Section 6662(j), the penalty is 40% of the tax understatement.<sup>82</sup>

## **The IRS Rejects the Defense of “Substantial Compliance” in Foreign Asset Reporting Cases.**

A taxpayer complies with section 6038D’s reporting requirements by attaching Form 8938 to his or her income tax return.<sup>83</sup> The IRS contends that the Form 8938 is not considered filed until a complete Form 8938 is filed.<sup>84</sup> Thus, the IRS contends that the failure to file penalty can apply to failing to disclose completely the information required by section 6038D.<sup>85</sup>

In traditional income tax examinations, the doctrine of substantial compliance excuses the consequences of noncompliance (e.g., penalties and loss of a tax benefit) if the taxpayers show that they have done all that can reasonably be expected of them but have nonetheless failed to comply with a procedural statute.<sup>86</sup> Regarding foreign asset reporting, the IRS generally rejects the doctrine of substantial compliance.<sup>87</sup> The IRS training materials essentially direct examiners to reject the substantial compliance doctrine.<sup>88</sup> There are currently no reported opinions that analyze the application of the substantial compliance doctrine to section 6038D.

Notwithstanding the IRS position,<sup>89</sup> some tax professionals advocate that tax professionals without complete information file a “best efforts return,” also sometimes known as a *Beard* filing.<sup>90</sup> *Beard* filings disclose the information within the taxpayer's control and explain why the taxpayer could not obtain the other required information.<sup>91</sup> While the IRS views *Beard* filings as not complying with the filing requirements,<sup>92</sup> some professionals believe that these filings will mitigate penalties.

Another variation of the substantial compliance doctrine applies if a taxpayer neglected to file Form 8938 but reported the foreign income or assets on Schedule B, an FBAR, Form 3520, Form 5471, Form 8621, and/or Form 8865 elsewhere on their annual tax return.<sup>93</sup> This argument seeks to incorporate the duplicative filings exception into the doctrine of substantial compliance.<sup>94</sup> Here, too, there are currently no cases.

## **The IRS is not applying the First Time Penalty Abatement Policy to Form 8938 Penalties.**

Regarding traditional examinations, the IRS has a First Time Abatement policy for delinquency penalties.<sup>95</sup> The IRS has not been applying the First Time Abatements to failing to file international information reporting forms e.g., the Form 8938.<sup>96</sup> The exception to this rule is for a taxpayer that files their Form 1040, late, but correctly attached the Form 8938. In these cases, the IRM may allow the first-time abatement.<sup>97</sup>

### **Challenging the Penalties Resulting from the Failure to Report International Income and Assets**

The reasonable cause defense and the procedures for challenging the penalties resulting from failing to report foreign income or assets on Form 8938 are the same as they are for challenging the other penalties resulting from failing to file an international information return.<sup>98</sup>

#### **Reasonable Cause is a Defense to the Penalty.**

The taxpayer may assert reasonable cause as a defense to penalties if their failure to file was due to reasonable cause and not willful neglect.<sup>99</sup> The IRS will not consider a reasonable cause defense until a taxpayer has filed all open years.<sup>100</sup> Here, a taxpayer must file an amended return filing the Form 8938 with a written explanation of all the facts and circumstances warranting abatement.<sup>101</sup> A taxpayer cannot use a reasonable cause defense in the situation where disclosure subjects the taxpayer to civil or criminal penalties in a foreign jurisdiction.<sup>102</sup>

Section 6038D does not describe “reasonable cause,” but the IRS determines whether a taxpayer acted with reasonable cause and in good faith on a case-by-case basis, considering all facts and circumstances.<sup>103</sup> The reasonable cause defense focuses upon a taxpayer’s exercise of “ordinary care and prudence, [even if the taxpayer was] unable to file the return within the prescribed time.”<sup>104</sup> According to the courts, a reasonable cause defense is a fact-sensitive inquiry that considers:

1. a taxpayer’s reason for failing to file;
2. his or her efforts to comply with the filing requirements; and,
3. in certain circumstances, his or her knowledge or ignorance of the law.<sup>105</sup>

Reasonable cause exists when a taxpayer can show he or she either: (a) made a reasonable and good faith effort to comply with the law, or (b) was unaware of the law’s requirement and could not reasonably be expected to know of the requirement.<sup>106</sup> A taxpayer can assert a reasonable cause defense if they show that they relied on a tax expert. Courts have agreed that a taxpayer’s reliance on an attorney’s or an accountant’s mistaken advice establishes reasonable cause when the advice concerns three issues: when the taxpayer should file; should a taxpayer file a form; or an actual tax liability.<sup>107</sup> A taxpayer’s reliance must have been in good faith based on the advice.<sup>108</sup> If the IRS does not accept the reasonable cause defense, then the taxpayer must pay the penalty unless they want to appeal or litigate the penalty.

#### **Challenges to Determinations Based on the Failure to File an International Information Return**

Under section § 6038D, the IRS may assess penalties for a failure to file Form 8938 without sending a statutory notice of deficiency.<sup>109</sup> After assessing the penalty, the IRS sends a CP 15 or 215, *Notice of Penalty Charge*, to the taxpayer.<sup>110</sup> Form 8938 penalties have post-assessment pre-payment penalty appeal rights.<sup>111</sup>

In lieu of a post-assessment penalty appeal, the taxpayer can pay the penalty, file a Form 843,<sup>112</sup> *Claim for Refund and Request for Abatement*, and, if denied, file a refund suit in the U.S. District Court or the U.S. Court of Federal Claims.<sup>113</sup>

By contrast, the IRS sends the taxpayer a Revenue Agent's Report for income adjustments resulting from failing to report or disclose the accurate value of a foreign financial asset. The taxpayer has 30-days to protest the examiner's findings to the IRS Appeals Office. If the taxpayer does not file a protest, the IRS sends a statutory notice of deficiency to the taxpayer.<sup>114</sup> The taxpayer has 90 days from the notice of deficiency to file a petition with the Tax Court requesting a redetermination of the deficiency determined by the IRS.<sup>115</sup>

### **Collection Due Process and Tax Litigation**

If a taxpayer does not pay the penalty on the Letter CP15 or CP 215, the IRS will eventually send the taxpayer, (a) Letter L-1058, *Notice of Intent to Levy and Notice of Your Right to a Hearing*; (b) LT11, *Final Notice of Intent to Levy and Notice of Your Right to a Hearing*; or (c) Letter 3172, *Notice of Federal Tax Lien Filing and Your Right to a Hearing under IRC 6320*. Sections §§ 6320 and 6330 allow a Taxpayer to file IRS Form 12153, *Request for a Collection Due Process ("CDP") or Equivalent Hearing*, to challenge their liability before the Appeals Office. By filing Form 12153, this action preserves a taxpayer's ability to seek pre-payment relief in the United States Tax Court. If the Appeals Office rules unfavorably, a taxpayer may appeal to the U.S. Tax Court within 30 days prior to the lien or levy for collection.<sup>116</sup>

### **Conclusion**

More than one in five New Jersey residents is an immigrant while nearly one in six is a native-born U.S. citizen with at least one immigrant parent.<sup>117</sup> The IRS campaigns to detect and penalize taxpayers that fail to report their foreign financial assets have already begun. Tax professionals representing individuals should review their client's obligations and, if necessary, take the steps necessary to mitigate penalties resulting from any past noncompliance with FATCA and IRS Form 8938.

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<sup>2</sup> Large Business and International Launches Compliance Campaigns, Internal Revenue Service (2017), <https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns> (last visited Jul 16, 2018).

<sup>3</sup> See I.R.C. 6038D(a).

<sup>4</sup> *Id.* at (d).

<sup>5</sup> Treas. Reg. § 1.6038D-2(a)(1).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*; See I.R.C. § 6072(a).

<sup>8</sup> Treas. Reg. § 1.6038D-2(a)(1).

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<sup>9</sup> *Id.* at (a)(7).

<sup>10</sup> Treas. Reg. § 1.6038D-1(a)(2).

<sup>11</sup> *Id.* at (b).

<sup>12</sup> I.R.C. § 6038D(b); Treas. Reg. §§ 1.6038D-3(a)(1), (b)(1).

<sup>13</sup> *See* Treas. Reg. § 1.6038D-3(d).

<sup>14</sup> *Id.*

<sup>15</sup> *See* Treas. Reg. § 1.6038D-5(f)(3) (noting that pension and deferred compensation plans are measured under the fair market value method).

<sup>16</sup> Basic Questions and Answers on Form 8938, Internal Revenue Service, <https://www.irs.gov/businesses/corporations/basic-questions-and-answers-on-form-8938> (last visited Jul 13, 2018).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> Treas. Reg. § 1.6038D-3(a)(3)(i) (2018); Basic Questions and Answers on Form 8938, *supra* note 16.

<sup>22</sup> Basic Questions and Answers on Form 8938, *supra* note 16.

<sup>23</sup> Treas. Reg. § 1.6038D-2(a)(1).

<sup>24</sup> *Id.* at (a)(2).

<sup>25</sup> *Id.* at (a)(1).

<sup>26</sup> *Id.* at (a)(3).

<sup>27</sup> *Id.* at (a)(4).

<sup>28</sup> *See* Frequently Asked Questions About International Individual Tax Matters, Internal Revenue Service, <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-about-international-individual-tax-matters#ForeignEarnedIncomeExclusion> (last visited Jul 19, 2018); Foreign Earned Income Exclusion Physical Presence Test, Internal Revenue Service, <https://www.irs.gov/individuals/international-taxpayers/foreign-earned-income-exclusion-physical-presence-test> (last visited Jul 19, 2018).

<sup>29</sup> Treas. Reg. § 1.6038D-5(b)(1) (emphasis added).

<sup>30</sup> *Id.* at (a); *see* Treas. Reg. §§ 1.897-1(a)(1)-(2).

<sup>31</sup> *Id.* at (b)(2).

<sup>32</sup> *Id.* at (c).

<sup>33</sup> *Id.* at (a).

<sup>34</sup> *Id.* at (e).

<sup>35</sup> *Id.* at (f)(1).

<sup>36</sup> Basic Questions and Answers on Form 8938, *supra* note 16.

<sup>37</sup> I.R.C. § 6038D(e).

<sup>38</sup> *Id.* (explaining that \$50,000 or \$75,000 is the threshold requirements as outlined above).

<sup>39</sup> Treas. Reg. § 1.6038D-7(a)(1).

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> *See e.g.*, I.R.C. 6048(c); Treas. Reg. §§ 1.1298-1(b), 1.6038-2(a), & 1.6038-3(a).

<sup>43</sup> Report of Foreign Bank and Financial Accounts FBAR, Internal Revenue Service, <https://www.irs.gov/businesses/small-businesses-self-employed/report-of-foreign-bank-and-financial-accounts-fbar> (last visited Jul 13, 2018).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> Treasury Inspector General For Tax Administration, Despite Spending Nearly \$380 Million, The Internal Revenue Service Is Still Not Prepared to Enforce Compliance With The Foreign Account Tax Compliance Act 13-7 (U.S. Dep't of Treasury 2018), *available at* <https://www.oversight.gov/sites/default/files/oig-reports/201830040fr.pdf>.

<sup>48</sup> *Id.* at 3.

<sup>49</sup> *Id.* at 16.

<sup>50</sup> *Id.* at 17.

<sup>51</sup> *Id.*

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<sup>52</sup> Streamlined Filing Compliance Procedures, Internal Revenue Service, <https://www.irs.gov/individuals/international-taxpayers/streamlined-filing-compliance-procedures> (last visited Jul 18, 2018).

<sup>53</sup> *Id.*

<sup>54</sup> See Delinquent International Information Return Submission Procedures, Internal Revenue Service, <https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures> (last visited Jul 13, 2018).

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> I.R.C. § 6501(a).

<sup>59</sup> *Id.* at § (c)(8).

<sup>60</sup> Treas. Reg. § 1.6038D-8(a).

<sup>61</sup> *Id.* at (c)(8).

<sup>62</sup> *Id.* at (e)(1)(A).

<sup>63</sup> *Id.*

<sup>64</sup> I.R.M., pt. 4.10.3.2.1 (Feb. 26, 2016)

<sup>65</sup> I.R.M., pt. 4.10.9.6.2 (Aug 11, 2014).

<sup>66</sup> I.R.M., pt. 4.10.9.1 (Aug 11, 2014).

<sup>67</sup> *Id.* at (3)-(4).

<sup>68</sup> Treasury Inspector General For Tax Administration, *supra* note 47, at 15.

<sup>69</sup> *Id.*

<sup>70</sup> See Steven Toscher, International Reporting Penalties- The Doctrine of Substantial Compliance (2017), <http://www.taxlitigator.com/international-reporting-penalties-the-doctrine-of-substantial-compliance-by-steven-toscher/> (last visited Jul 13, 2018).

<sup>71</sup> I.R.C. § 982 (c)(1); I.R.M. Ex. 4.61.4-1 (05-01-06).

<sup>72</sup> I.R.C. § 982 (c)(2).

<sup>73</sup> *Flying Tigers Oil Co. v. Comm’r*, 92 T.C. No. 82 (1989).

<sup>74</sup> I.R.C. § 6038D(d)(1).

<sup>75</sup> I.R.C. § 6038D(e).

<sup>76</sup> I.R.M. 20.1.9.22.2(1) (07-08-2015).

<sup>77</sup> Treas. Reg. § 1.6038D-8(c).

<sup>78</sup> *Id.* at (e).

<sup>79</sup> I.R.M., pt. 20.1.5.2.2(10) (Dec. 13, 2016).

<sup>80</sup> I.R.C. § 6664(a).

<sup>81</sup> I.R.M., pt. 20.1.5.13(2) (Dec. 13, 2016).

<sup>82</sup> Treas. Reg. § 1.6038D-8(f); I.R.C. § 6662(j).

<sup>83</sup> I.R.C. § 6038D(a).

<sup>84</sup> *Id.* at § 6501(c)(8).

<sup>85</sup> Treas. Reg. § 1.6038D-8(d)(2). The regulation states that if a taxpayer does not comply with the requirements of “Section 6038D(c) and Treas. Reg. § 1.6038D-4,” then the \$10,000 penalty “will apply to that [taxpayer].” *Id.* at (a).

<sup>86</sup> See *Estate of Chamberlain v. Comm’r*, T.C. Memo. 1999-181.

<sup>87</sup> See LB&I International Practice Service Process Unit, Internal Revenue Service, *available at* [https://www.irs.gov/pub/int\\_practice\\_units/FEN9434\\_02\\_05R.pdf](https://www.irs.gov/pub/int_practice_units/FEN9434_02_05R.pdf).

<sup>88</sup> *Id.*

<sup>89</sup> See e.g., LB&I International Practice Service Process Unit, *supra* note 87. See also I.R.S. Chief Counsel Advice 20429007 (explaining when a Form 5472 can be substantially complete).

<sup>90</sup> *Beard v. Comm’r*, 82 T.C. 766, 777 (1984).

<sup>91</sup> *Id.*

<sup>92</sup> I.R.M., pt. 20.1.9.13.1(2) (Mar. 21, 2013); see LB&I International Practice Service Process Unit, *supra* note 87.

<sup>93</sup> Treas. Reg. § 1.6038D-7(a)(1).

<sup>94</sup> See e.g., *Beard v. Comm’r*, 82 T.C. 766, 777 (1984).

<sup>95</sup> I.R.M., pt. 20.1.1.3.3.2.1 (4) (Nov. 21, 2017).

<sup>96</sup> *Id.* at (7).

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<sup>97</sup> See e.g., I.R.M., pt. 21.8.1.25.1 (Oct. 1, 2013).

<sup>98</sup> See National Taxpayer Advocate, Annual Report to Congress—2017 315, n.4 (I.R.S. Vol. 1 2017), available at [https://taxpayeradvocate.irs.gov/Media/Default/Documents/2017-ARC/ARC17\\_Volume1.pdf](https://taxpayeradvocate.irs.gov/Media/Default/Documents/2017-ARC/ARC17_Volume1.pdf).

<sup>99</sup> I.R.C. § 6038D(g).

<sup>100</sup> I.R.M., pt. 20.1.9.22.5(1) (Mar. 21, 2013).

<sup>101</sup> Treas. Reg. § 1.6038D-8(e)(2).

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> See e.g., *U.S. v. Boyle*, 469 U.S. 241, 246 (1985).

<sup>105</sup> See I.R.M., pt. 20.1.1.3.2 (Nov. 21, 2017).

<sup>106</sup> *Id.*

<sup>107</sup> See *U.S. v. Boyle*, 469 U.S. 241, 250-51 (1985).

<sup>108</sup> See e.g., *Estate of La Meres v. Comm’r*, 98 T.C. 294, 318-19 (1992).

<sup>109</sup> I.R.M., pt. 20.1.9.2(4) (Nov. 30, 2015).

<sup>110</sup> I.R.M., pt. Exh. 20.1.9-7 (Aug. 8, 2015).

<sup>111</sup> I.R.M., pt. 8.11.5.13 (Dec. 18, 2015).

<sup>112</sup> I.R.C. § 7422(a).

<sup>113</sup> 28 U.S.C. § 1346(a)(1) (2018).

<sup>114</sup> See National Taxpayer Advocate, Annual Report to Congress—2013 341, n.20 (I.R.S. Vol. 1 2013), available at <https://taxpayeradvocate.irs.gov/2013-Annual-Report/downloads/Accuracy-Related-Penalty-Under-IRC-6662-b-1-and-2.pdf>.

<sup>115</sup> See I.R.C. §§ 6212, 6213.

<sup>116</sup> I.R.C. § 6330(a).

<sup>117</sup> Immigrants in New Jersey, American Immigration Council (2018),

<https://www.americanimmigrationcouncil.org/research/immigrants-in-new-jersey> (last visited Jul 16, 2018).

**NEW YORK STATE  
CRIMINAL TAX UPDATE**

**LIU Civil and Criminal Tax  
Controversy Forum  
August 16, 2018**

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## NEW YORK STATE CRIMINAL TAX PENALTIES

### A. CRIMINAL ENFORCEMENT PROVISIONS

Almost ten years ago, Part V-1, Subpart I, of Chapter 57 of the New York Laws of 2009 revised the criminal tax law and created a new crime, criminal tax fraud, which replaced many of the criminal provisions in the former tax law. The law introduced the ways in which tax fraud can be committed and is applicable to all taxes administered by the New York State Tax Department. It also created a new series of felony classifications for tax fraud that elevate the criminal tax penalties for tax evasion as the amount of tax fraud increases. Depending on the degree of Criminal Tax Fraud charged, an accused can face not only a mandatory minimum sentence of one to three years in prison, but a maximum sentence of up to eight and one third to twenty-five years.

The law now treats all tax fraud the same, regardless of type of tax evaded and regardless of how the fraud was accomplished. The new structure recognizes that every form of tax evasion - whether occasioned by non-filing, false filing or by some other fraudulent scheme - causes the same harm to the State and thus warrants the same punishment.

New York Tax Law 1801 defines a "tax fraud act" and explains the basis of all Criminal Tax Fraud offenses. These tax fraud acts are usually enhanced depending on the monetary value of the fraud. The law does not differentiate monetary value between under reporting or receiving an excessive refund. Generally, if a person willfully acts (or causes another to act) as set forth below, then one has perpetrated a "tax fraud act." The law also recognizes that the severity of

these crimes against the public pocketbook should be measured by the amount of harm suffered by the State and local governments.

Although there are several crimes that prosecutors can pursue for an alleged theft of State money, including Grand Larceny and Criminal Possession of Stolen Property, Assistant District Attorneys, and/or Assistant Attorneys General often seek to charge offenders with other white collar crimes relating to the falsification of documents. These crimes can include such felonies as Offering a False Instrument for Filing, Falsifying Business Records and Forgery. Whatever the degree of Criminal Tax Fraud alleged, it is rare that this offense is the only crime presented to a New York Grand Jury. Possible additional crimes include:

- Grand Larceny: New York Penal Law Article 155
- Criminal Possession of Stolen Property: New York Penal Law Article 165
- Offering a False Instrument for Filing: New York Penal Law Article 175
- Falsifying Business Records: New York Penal Law Article 175
- Forgery: New York Penal Law Article 170

Further, a related investigation for Federal Tax Fraud and Tax Evasion is also possible.

## **B. ELEMENTS OF THE CRIME**

There are three elements of the felony offenses that the People must prove beyond a reasonable doubt. The elements are:

- the commission of a “tax fraud act”;
- the requisite mens rea; and

- a monetary threshold.

The misdemeanor level requires the first two elements, but does not require a monetary threshold.

The new Tax Law defines eight ways in which tax fraud can be committed when the defendant has acted “willfully” (defined below).

### C. TAX FRAUD ACTS

#### 1. Tax Law §1801(a)(1) Willful Failure to File a Return or Other Required Document

Under former law the failure to file income or corporate tax returns constituted a felony only if the taxpayer failed to file for three (3) consecutive years. Since 2009, felony liability arises if the taxpayer (i) fails to file (even for a single year); (ii) intends to evade tax; and (iii) underpays in an amount that meets the monetary threshold.

#### 2. Tax Law §1801(a)(2),(3) Willfully and Knowingly Making or Filing a False Return or Report or Supplying False Information

Tax Law §1801(a)(2), concerns the filing of false documents, and provides that tax fraud occurs when a person willfully, while knowing that a return, report, statement or other document under this chapter contains any materially false or fraudulent information, or omits any material information, files or submits that return, report, statement or document with the state or any political subdivision of the state.

Tax Law §1801(a)(3) deals with the submission of false information to the Department of Taxation and Finance. It applies if a person willfully and knowingly supplies or submits materially false or fraudulent information in connection with any return, audit, investigation, or

proceeding or fails to supply information within the time required by or under the provisions of [the tax law or regulations].

Section 1801(a)(3), which addresses submissions to the Department, include oral submissions made in connection with an audit or investigation. Thus, the intentional submission of false documentation by the taxpayer or by his representative in order to justify a position would constitute a false submission.

Under former law, knowingly filing a false income or corporate tax return with intent to evade tax constituted a class E felony if the filing resulted in a “substantial understatement” of tax. Under the current tax law, the threshold for a substantial understatement was increased from \$1,500 to \$3,000. Under the current law, felony liability will arise in all cases where a materially false submission has been made with an intent to evade a tax or to defraud where the false submission results in a tax evasion of more than \$3,000.

It should be noted that the current provisions of the Tax Law complement, but do not supersede, existing Penal Law provisions. Under the Penal Law, knowingly filing a false document with any public office or public servant constitutes a misdemeanor, which rises to felony status if the false filing is made with an intent to defraud the state or any political subdivision. No minimum monetary threshold applies to the Penal Law statute. Thus, a taxpayer who files a false income tax return which defrauds New York of less than \$3,000 would be exposed to misdemeanor liability under the new tax law, but felony liability under the Penal Law.

3. **Tax Law §1801(a)(4)**  
**Willfully Engaging in a Scheme to Defraud the State**  
**in Connection With Any Matter Under the Tax Law**

§1801(a)(4) provides that a person (not necessarily a taxpayer) commits tax fraud when he willfully engages in any scheme to defraud the state or a political subdivision . . . by false or fraudulent pretense, representations or promises as to any material matter, in connection with any tax imposed. . .

Although similar to language in Penal Law statutes, the Tax Law is more strict than its Penal Law counterpart in that it does not require a “systemic ongoing course or conduct”, as does the Penal Law. However, the Tax Law is less strict than the Penal Law in that false representations must be with respect to a “material” matter.

4. **Tax Law §1801(a)(5)**  
**Willfully Failing to Remit Taxes Collected in Behalf of the State**

Withholding taxes collected from employees and sales taxes collected from customers constitute trust fund taxes. Fiduciaries who misappropriate these funds have always been subject to prosecution under the Penal Law for larceny, whereas under the Tax Law prosecution for employers who failed to remit employment taxes was limited to a misdemeanor regardless of the amount of payroll taxes collected and not remitted, and the failure of a tax vendor to remit collected sales tax was not a criminal act under the Tax Law. Under Tax Law §1801(a)(5), tax fraud occurs when a person willfully “fails to remit any tax collected in the name of the state or on behalf of the State . . . when such collection is required under this chapter.” Therefore, the Penal Law and Tax Law are both available to prosecutors to seek filing charges for crimes involving failure to remit sales or withholding taxes.

5. **Tax Law §1801(a)(6)**  
**Willfully Failing to Collect a Sales, Excise or**  
**Withholding Tax That is Required to be Collected**

Under former Tax Law §1817(c), the failure of employers to collect employment tax, and the failure of vendors to collect sales tax, constituted a misdemeanor. Tax Law §1817(c)(2) provided that the failure to collect \$10,000 in sales tax or the failure to collect \$100 in sales tax on ten or more occasions constituted a class E felony. Under revised Tax Law §1801(a)(6), the willful failure to collect tax when required constitutes tax fraud. If taxes not collected exceed \$3,000 in one year, felony liability attaches; otherwise, the tax fraud constitutes a misdemeanor.

6. **Tax Law §1801(a)(7)**  
**Willfully and With an Intent to Evade any Tax,**  
**Failing to Pay a Tax Due**

Under new Tax Law §1801(a)(7), the taxpayer who willfully and with intent to evade tax fails to pay such tax commits tax fraud. The current law imposes a stricter standard for prosecution than the former law in that the failure to pay must be both willful and with an intent to evade tax. Thus, those taxpayers who file but cannot pay the tax will not be subject to criminal liability. However, for those taxpayers whose failure to file does meet the more exacting standard, felony liability may attach if the amount of the underpayment meets the monetary limits in the felony tax fraud sections.

7. **Tax Law §1801(a)(8)**  
**Issuing False Exemption Certificates**

Tax Law §1801(a)(8) provides that a tax fraud act includes one where a party willfully issues an exemption certificate, inter distributor sales certificate, resale certificate or any other document capable of evidencing a claim that taxes do not apply to a transaction, which he or she does not believe to be true and correct as to any material matter, which omits any material information, or which is false, fraudulent, or counterfeit.

#### D. THE DEGREE OF THE TAX CRIME (MONETARY THRESHOLDS)

If one commits a tax fraud act, as defined by the statute, then he or she is guilty of a crime. The lowest level criminal Tax Fraud crime, NY Tax Law § 1802 is a misdemeanor punishable by up to one year in jail. Although it is distinct crime from the other degrees of criminal Tax Fraud, it is the basis of those greater offenses. Generally speaking, it is relatively rare that Criminal Tax Fraud in the Fifth Degree is the top or most serious count in a criminal complaint.

A person is guilty of Criminal Tax Fraud in the Fourth Degree under NY Tax Law § 1803 if he or she commits a “tax fraud act” with the intent to evade certain taxes. Additionally, one must defraud the State during a time frame not exceeding one year out of more than \$3,000, but not great than \$10,000, less than the tax liability that is due.

A person is guilty of criminal Tax Fraud in the Third Degree under NY Tax Law § 1804 if he or she commits a “tax fraud act” with the intent to defraud. Assuming the conduct has established these elements, one must have defrauded New York during a one year period in an amount greater than \$10,000, but less than \$50,000.

Criminal Tax Fraud in the Second Degree under NY Tax Law § 1805 is the more common New York Tax crime that results in incarceration for those convicted. This “C” felony, punishable by up to **fifteen years in prison** for an individual with absolutely no criminal history. Criminal Tax Fraud in the Second Degree is similar, in part, to Grand Larceny in the Second Degree (NY PL 155.40) in that the theft or value of the tax fraud, must be **greater than \$50,000**, but no more

than \$1,000,000. Beyond this, however, one is guilty of Criminal Tax Fraud in the Second Degree if he or she commits one of the “tax fraud acts” noted above.

There is no more debilitating and onerous white collar crime one can face, in terms of potential sentences and collateral consequences, than Criminal Tax Fraud in the First Degree. A “B” felony, New York Penal Law 1806, is punishable by a **mandatory prison sentence**. Without a prior criminal history, if convicted of NY Tax Law 1806, one would face a minimum of one to three years in prison and a maximum of eight and third to twenty-five years. Alternatively, if one has a prior felony in the past ten years, then he or she would face a minimum of four and one half to nine years in prison and a maximum of twelve and one half to twenty-five years. The distinction between NY Tax Law 1806 and the lesser degree offenses is that the value or amount either underpaid to or overpaid from the State must be in excess of \$1,000,000.

#### **E. TAX LAW FELONY FACTORS (*Mens Rea*)**

To elevate a tax fraud act to a felony, two facts must be established. First, the defendant must act with the intent to evade a tax due or to defraud the state or a political subdivision. With the addition of this *mens rea*, tax law felonies can be committed only when the defendant acts both **willfully and with the intent** to evade or defraud. The additional mental element of intent is designed to ensure that felony liability under the Tax Law applies only to those who deliberately evade their responsibilities and not to those who may have failed to comply with a tax obligation (and who may owe substantial taxes as a result) but who have not acted with criminal intent to evade paying those taxes.

Second, a tax fraud act is a felony only when the tax evaded reaches the monetary thresholds set out in new Tax Law §§1803 (tax fraud in the fourth degree) to 1806 (tax fraud in the first degree). Under the current law, the felony grades of tax fraud are defined in monetary terms where the degree of the crimes and the severity of punishment turn on the amount of loss to the state.

#### **F. VENUE**

The current law expands the county venue provisions for false filing tax offenses by creating a new subsection (m) to N.Y. Criminal Procedure Law §20.40(4). The new provision recognizes that taxpayers are often involved in economic activity in one county that gives rise to a tax liability reflected in a tax return that happens to be filed in a different county. The new provision enables the prosecutor in the county where the economic activity **took place** to prosecute the resultant tax crimes. That new section provides the following:

(m) An offense under the tax law or the penal law of filing a false or fraudulent return, report, document, declaration, statement, or filing, or of tax evasion, fraud, or larceny resulting from the filing of a false or fraudulent return, report, document, declaration, or filing in connection with the payment of taxes to the state or a political subdivision of the state, may be prosecuted in any county in which an underlying transaction reflected, reported or required to be reflected or reported, in whole or part, on such return, report, document, declaration, statement, or filing occurred.

#### **G. CRIMINAL TAX OFFENSE – STATUE OF LIMITATIONS**

The Statute of Limitations on criminal liability begins to run from the date the offense was committed. Similar to larceny crimes, the current Tax Law provides for a five-year Statute of Limitations.

## **H. NYS CRIMES AGAINST REVENUE PROGRAM**

The New York State Crimes Against Revenue Program (CARP), first established in 2004, provides grants to Das offices across the State to fund investigations and prosecutions of tax crimes. The CARP program is funded by the proceeds from investigations that result in tax revenues, fines and restitution being returned to the State resulting in an incentive for local DAs to investigate and prosecute tax crimes. The CARP program currently supports investigation and prosecution of tax crimes in 28 countries including New York City, Nassau and Suffolk.

## **I. ATTACHMENTS**

A. Form Kovel Letter

B. Recent Press Releases

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*Regular Mail*  
*Copy via e-mail:*

Dear Mr. \_\_\_\_\_:

This letter confirms our agreement whereby we have engaged you and your firm to render professional services directly to us on behalf of \_\_\_\_\_, or any entity of which they have an interest (the "clients"), under the conditions prescribed herein, in order to enable us to provide legal advice to the same.

In connection with the retainer of our firm to render legal services to the clients, we have express authority to retain an accountant who shall work under our direction and report directly to us. This work contemplates services of character and quality which would be necessarily adjunct to our services as lawyers. The accountant is authorized to bill us for his services and we, in turn, will charge the client therefore as our necessary out-of-pocket disbursements.

In connection with said employment, all communications between you and the client, as well as communications between you and any attorney, agent, or employee acting in his behalf, shall be regarded as confidential and made solely for the purpose of assisting counsel in giving legal advice to the client. You will not disclose to anyone, without our written permission, the nature or content of any oral or written communication, nor any information gained from the inspection of any record or document submitted to you, including information obtained from corporate records or documents; and you will not permit inspection of any papers or documents without our permission in advance.

All work papers, records or other documents, regardless of their nature and the source from which they emanate, shall be held by you solely for our convenience and subject to our unqualified right to instruct you with respect to possession and control. Work papers prepared by you, or under your direction, belong to this law firm.

As part of the agreement to provide accounting services in this matter, you will immediately notify this law firm of the happening of any one of the following events: (a) the exhibition or surrender of any documents or records prepared by or submitted to you or someone under your direction, in

KESTENBAUM & MARK LLP

a manner not expressly authorized by this law firm; (b) a request by anyone to examine, inspect, or copy such documents or records; (c) any attempt to serve, or the actual service of, any court order, subpoena, or summons upon you which requires the production of any documents or records. You will immediately return all documents, records and work papers to us at our request.

In connection with the foregoing, we agree to pay you at your per diem rates, plus out-of-pocket expenses as a disbursement on behalf of our client. In this regard, invoices should be rendered to us and will be payable upon payment to us by our clients.

If this letter describes our agreement to your satisfaction, please sign and date the enclosed copy of this letter and return it to me. If you wish to modify this letter in any way, please advise me of your wishes.

Sincerely,

AGREED AND ACCEPTED:

\_\_\_\_\_

Dated: \_\_\_\_\_

## **A.G. Schneiderman And Acting Tax Commissioner Manion Announce Guilty Plea Of Steuben County Restaurateur For Failing To Pay Over \$175K In Sales Tax**

*Christopher Klee, Former Owner of Sonora's Mexican Restaurants in Bath and Corning, Failed to Pay Over \$175,000 in Sales Tax Owed to New York State*

*Defendant Will Pay Over \$350,000 In Unpaid Sales Tax and Penalties*

STEUBEN COUNTY - Attorney General Eric T. Schneiderman and Acting Commissioner of Taxation and Finance Nonie Manion today announced the guilty plea and conviction of Christopher Klee, 56, and his business CKP Holdings, LLC, for failing to file numerous sales tax returns and remit over \$175,000 in sales tax that was collected at two Sonora's Mexican Restaurant locations in Bath and Corning, New York. Klee will be required to pay over \$350,000 to the Department of Taxation and Finance for unpaid sales tax, penalties, and interest.

"When New Yorkers spend their hard-earned money, they expect the business is following the rules," said **Attorney General Schneiderman**. "My office will continue to hold accountable those who seek to steal from taxpayers to line their own pockets."

"By blatantly disregarding his tax obligations, this defendant violated the trust of his customers, deprived the communities where he operated of revenue needed for vital services, and put similar businesses at a competitive disadvantage," said **Acting Commissioner of Taxation and Finance Nonie Manion**. "We'll continue to work with the Attorney General and all our law enforcement partners to bring tax criminals to justice."

The Bath restaurant, formerly located at 330 W. Morris Street, opened in September 2004 under the name Sonora's Mexican Restaurant. An investigation and audit conducted by the Department of Taxation and Finance ("DTF") revealed that from September 1, 2006 through August 1, 2011, the Bath restaurant failed to file sales tax returns and made over \$1,850,000 in total sales and collected over \$140,000 in sales tax that was not remitted to New York State.

The Corning restaurant, formerly located at 84 E. Market Street, opened in February 2010 under the name CKP Holdings, LLC. The DTF audit revealed that from December 1, 2009 through November 30, 2011, no sales tax returns were filed for the Corning restaurant during which it made over \$480,000 in total sales and collected over \$38,000 in sales tax that was not remitted to New York State.

In November 2011, one year after the DTF began their investigation, Klee submitted seven sales tax returns and remitted approximately \$35,000 in collected sales tax to New York State covering the period from December 1, 2009 through August 31, 2011. However, Klee failed to file a sales tax return for the last quarter ending November 30, 2011, and still owed over \$3,500 in collected sales tax for that quarter alone.

On February 5, 2018, Klee, 56, pleaded guilty before the Honorable Peter C. Bradstreet in Steuben County Court to Petit Larceny, a Class A misdemeanor.

CKP Holdings, LLC, pleaded guilty to Grand Larceny in the Third Degree, a Class D felony, and was sentenced to an unconditional discharge.

Pursuant to his plea, Klee paid \$225,000 to the New York State Department of Taxation and Finance for the unpaid sales tax, related penalties, and interest. Klee will be sentenced to a period of supervised release on March 26, 2018 and will pay the remaining \$129,380.40 to the Department of Taxation and Finance as a condition of his sentence.

The case was initially investigated by the Department of Taxation and Finance's Criminal Investigations Division, and then referred to the Attorney General's Office for further investigation and prosecution. The Attorney General thanks the New York State Department of Taxation and Finance for their valuable assistance in this investigation.

The Attorney General's investigation was conducted by Investigator Joel Cordone under the supervision of Supervising Investigator Richard Doyle and Deputy Chief Antione Karam. The Investigations Bureau is led by Chief Dominick Zarrella.

The case is being prosecuted by Assistant Attorney General Andrew Tarkowski of the Criminal Enforcement and Financial Crimes Bureau. The Criminal Enforcement and Financial Crimes Bureau is led by Bureau Chief Stephanie Swenton and Deputy Bureau Chief Joseph G. D'Arrigo. The Division of Criminal Justice is led by Executive Deputy Attorney General Margaret Garnett.

**Attorney General's Press Office: (212) 416-8060**

**[nyag.pressoffice@ag.ny.gov](mailto:nyag.pressoffice@ag.ny.gov)**

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# Syracuse Cycle Shop Owner Sentenced to Prison for Tax Fraud

***Defendant failed to remit \$37K in sales tax collected***

**For Release:** Immediate, Thursday, February 15, 2018

**For press inquiries only, contact:** James Gazzale, 518-457-7377

The New York State Department of Taxation and Finance today announced that a Syracuse businessman has been sentenced to a prison term of three to six years for failing to pay New York State the sales tax he collected from customers.

Robert Woodward, 45, of 4510 Quamby Rd., Clay, NY, pleaded guilty to 2nd degree criminal possession of a forged instrument and 3rd degree criminal tax fraud, both felonies. He was sentenced on February 8 in Onondaga County Court.

"Business owners who disregard their obligations to collect and remit sales tax violate the trust of their customers, deprive the communities where they operate of revenue needed for vital services, and put similar businesses at a competitive disadvantage," said Acting Commissioner Nonie Manion. "I thank the Onondaga County District Attorney's office for prosecuting this case."

Woodward was the owner of Rob's Cycle Supply, Inc., 613 Wolf Street, Syracuse, NY. He was charged with collecting \$37,323 in sales tax from customers between March 2012 and August 2013, that he failed to remit to the New York State Tax Department as required by law.

The defendant also tried to pay several tax assessments, including the sales tax owed, with a forged check. However, since his guilty plea, Woodward has made a partial payment for his combined tax liabilities.

The case was prosecuted by the Onondaga County District Attorney's office.

In New York State, 96% of taxes are paid by businesses and individuals who voluntarily meet their tax responsibilities. The remaining 4% is collected through the Tax Department's audit, collections, and criminal investigation programs. Through its enforcement programs, the Tax Department ensures fair tax administration for all New Yorkers.

## **Report fraud**

You can [report tax evasion and fraud](#) online at the Tax Department's website or by calling 518-457-0578. The information is kept confidential.

## **Related news**

[A.G. Schneiderman And Acting Tax Commissioner Manion Announce Guilty Plea of Steuben County Man for Failing to Pay Over \\$175K In Sales Tax](#)

###

Updated: February 15, 2018

## **A.G. Schneiderman And Acting Tax Commissioner Manion Announce Conviction Of Former Broome County Restaurant Owner For Failing To Pay Over \$59K In Sales Tax**

*Robert Niederriter, Former Owner of Buffalo Head Bar & Grill in Conklin, Failed to File 16 Sales Tax Returns and Pay Sales Tax Owed to New York State*

*Defendant Paid \$59,789; Sentenced to One-Year Conditional Discharge*

BROOME COUNTY – Attorney General Eric T. Schneiderman and Acting Commissioner of Taxation and Finance Nonie Manion today announced the guilty plea and conviction of Robert Niederriter, 52, of Kirkwood, and his business, Buffalo Head Bar & Grill, Inc., for failing to file numerous sales tax returns and remit over \$59,000 in sales tax that was collected at Buffalo Head Bar & Grill. Pursuant to his plea, Niederriter paid \$59,789.01 to the New York State Department of Taxation and Finance for the unpaid sales tax and was sentenced to a one-year conditional discharge.

“New Yorkers trust businesses to follow the rules and pay their fair share of taxes,” said **Attorney General Schneiderman**. “Our office will continue to root out and prosecute those who seek to steal from taxpayers to line their own pockets.”

“As this conviction clearly shows, the NYS Tax Department dedicates significant resources to finding business owners who commit sales tax fraud,” **Acting Commissioner Manion** said. “We’ll continue to work with the AG’s office and all our law enforcement partners to bring criminals to justice, and make sure honest merchants do not face a competitive disadvantage.”

From June 2011 through December 2015, Niederriter owned and operated Buffalo Head Bar & Grill (“Buffalo Head”), a bar and restaurant located at 1577 Conklin Road in Broome County. Niederriter, the sole person responsible for sales tax at Buffalo Head, was legally required to report all taxable sales, including food and beverage sales, and to file sales tax returns on a quarterly basis. However, during the time he owned Buffalo Head, Niederriter only filed two quarterly sales tax returns when he should have filed eighteen. According to an audit conducted by the New York State Department of Taxation and Finance, between June 1, 2011 and November 30, 2015, Niederriter underreported Buffalo Head’s total sales by \$747,362.56 and failed to remit \$59,789.01 in sales tax due.

On March 14, 2018, Buffalo Head pleaded guilty before the Honorable Joseph F. Cawley in Broome County Court to Grand Larceny in the Second Degree, a Class C felony. Buffalo Head is scheduled to be sentenced to an unconditional discharge on June 4, 2018.

Today, Niederriter pleaded guilty before the Honorable Beth L. Marshall in Conklin Town Court to Petit Larceny, a Class A misdemeanor. Pursuant to his plea, Niederriter paid \$59,789.01 to the New York State Department of Taxation and Finance for the unpaid sales tax and was sentenced to a one-year conditional discharge.

The case is a result of a joint prosecution was initially investigated by the Department of Taxation and Finance's Criminal Investigations Division, and then referred to the Attorney General's Office for further investigation and prosecution. The Attorney General thanks the New York State Department of Taxation and Finance for their valuable assistance in this investigation.

The Attorney General's investigation was conducted by Investigator Joel Cordone under the supervision of Supervising Investigator Richard Doyle and Deputy Chief Antoine Karam. The Investigations Bureau is led by Chief Dominick Zarrella.

The case is being prosecuted by Assistant Attorney General Andrew J. Tarkowski of the Criminal Enforcement and Financial Crimes Bureau. The Criminal Enforcement and Financial Crimes Bureau is led by Bureau Chief Stephanie Swenton and Deputy Bureau Chief Joseph G. D'Arrigo. The Division of Criminal Justice is led by Executive Deputy Attorney General Margaret Garnett.

**Attorney General's Press Office: (212) 416-8060**

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# Buffalo Tax Preparer Charged with Filing Fraudulent Tax Returns

*Defendant faces two felonies in case investigated by the New York State Tax Department*

**For Release:** Immediate, Tuesday, March 27, 2018

**For press inquiries only, contact:** James Gazzale, 518-457-7377



The New York State Department of Taxation and Finance today announced the arrest of a Buffalo tax preparer on felony charges of preparing and filing fraudulent income tax returns.

Dorothea Fleming, 54, of 78 Sanford Street, was employed as a tax preparer at Pro-File Tax and Insurance Coalition, formerly known as Capital Tax Service, 1220 Hertel Avenue, also in Buffalo. She was arraigned before Buffalo City Court Judge Betty Calvo-Torres and charged with third-degree criminal tax fraud and first-degree offering a false instrument for filing, both felonies.

The defendant, released on her own recognizance, is alleged to have fraudulently inflated wages on returns she filed to increase the earned income tax credit paid to the taxpayer.

Fleming pleaded guilty to two misdemeanor counts of offering a false instrument for filing on October 22, 2014. After violating the terms of her sentence in that case, she was resentenced on March 4, 2016. That sentence included a prohibition against preparing returns for one year.

If convicted on the latest charges, Fleming could face a sentence of up to seven years in prison. Her next court date has not been scheduled.

“We work diligently to protect taxpayers from unscrupulous tax preparers,” said Acting Commissioner Nonie Manion. “Filers, though, need to do their homework before hiring a tax professional and should carefully review their returns before signing them.”

## **Tax preparer checklist**

To help consumers screen potential tax preparers, the Tax Department has published a [checklist](#) at [Tips for hiring a tax preparer](#). Use the checklist as a guide before you hire a preparer.

If you're aware of a tax preparer who has engaged in illegal or improper conduct, you can [file a tax preparer complaint](#) online or contact the New York State Tax Department at 518-530-HELP (option #2). The information is kept confidential. The Tax Department promptly reviews each complaint and takes corrective action when appropriate.

A criminal complaint is only an accusation; the defendant is presumed innocent until proven guilty. The case will be prosecuted by the Erie County District Attorney.

###

*Updated: March 27, 2018*

# Buffalo Tax Preparer Pleads Guilty a Second Time to Filing Fraudulent Tax Returns

*She's ordered to pay more than \$10,000 and could face seven-year sentence after ignoring the terms of her previous sentencing*

**For Release:** Immediate, Friday, May 25, 2018

**For press inquiries only, contact:** James Gazzale, 518-457-7377

The New York State Department of Taxation and Finance today announced the guilty plea of a Buffalo tax preparer for preparing and filing fraudulent income tax returns.

Dorothea Fleming, 54, of 78 Sanford Street, pleaded guilty to 4th degree criminal tax fraud, a felony, in an appearance before Erie County Court Judge John L. Michalski. She admitted that she fraudulently inflated wages on returns she filed to increase the earned income tax credit paid to the taxpayer.

Fleming, who was employed as a tax preparer at Pro-File Tax and Insurance Coalition, formerly known as Capital Tax Service, also agreed to pay New York State \$10,618. She could face a sentence of up to seven years in prison at her sentencing on July 31.

Fleming previously pleaded guilty on October 22, 2014 to two misdemeanor counts of offering a false instrument for filing. After violating the terms of her sentence in that case, she was resentenced on March 4, 2016. She then ignored that sentence's prohibition against preparing returns for one year.

"This tax preparer had every opportunity to do the right thing, but it appears that she purposely decided to again violate the law," said Acting Commissioner Nonie Manion. "I thank the Erie County District Attorney's Office for its diligence in prosecuting this case."

New York is one of just four states that regulate the tax preparer industry. Taxpayers who use the services of paid tax preparers are entitled to protection from unfair treatment. The [Consumer Bill of Rights Regarding Tax Preparers](#) describes your rights and contains important information about how to protect yourself from unfair practices.

If you're aware of a tax preparer who has engaged in illegal or improper conduct, you can [file a tax preparer complaint](#) online or contact the NYS Tax Department at 518-530-HELP (option #2). The information is kept confidential. The Tax Department promptly reviews each complaint, and takes corrective action when appropriate.

###

Updated: May 25, 2018

LIU's Civil and Criminal Tax Controversy Forum

**NEW YORK STATE COLLECTION ENFORCEMENT:  
DRIVER'S LICENSE SUSPENSION**

August 16, 2018

Speaker: Yvonne R. Cort, Esq.

Capell Barnett Matalon & Schoenfeld LLP

100 Jericho Quadrangle, Suite 233

Jericho, NY 11753

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Yvonne R. Cort

[ycort@cbmslaw.com](mailto:ycort@cbmslaw.com)

Yvonne R. Cort is a Partner at Capell Barnett Matalon & Schoenfeld LLP, where she focuses her practice on resolving Federal and New York State tax controversies.

For over eighteen years, Yvonne has assisted individuals and businesses with IRS and NYS tax matters including New York State and New York City residency audits, unfiled returns, income tax, sales tax, withholding tax, responsible person assessments, liens and levies, innocent spouse, voluntary disclosure, installment agreements and offers in compromise.

Yvonne has been selected to New York Metro SuperLawyers, a designation given to only 5% of the lawyers in the state. She is the current Chair of the IRS Downstate New York Practitioner Liaison Group and previously served as Chair of the Tax Law Committee of the Nassau County Bar Association. She is a member of the New York State Bar Association Tax Section, where she has contributed to policy papers. Yvonne is a recipient of the Long Island Power Women in Business award from Long Island Press.

Yvonne's numerous articles on tax topics have been featured in accounting and legal publications such as the Journal of Multistate Taxation and Incentives, and the Tax Stringer, published by the New York State Society of Certified Public Accountants. She is a regular speaker for many professional groups in New York and Florida. Yvonne has been interviewed by various media outlets, and she has been quoted in several leading publications including Bloomberg BNA and Newsday.

Yvonne received her B. A. magna cum laude from the University of Rochester, and her J.D. from the University of Pennsylvania Law School. Yvonne is admitted to the Bar in New York and Pennsylvania, and admitted to practice before the United States Tax Court.

Yvonne can be reached at: [ycort@cbmslaw.com](mailto:ycort@cbmslaw.com), 516.931.8100 ext. 370

Capell Barnett Matalon & Schoenfeld, LLP

Long Island office:  
100 Jericho Quadrangle, Suite 233  
Jericho, NY 11753

New York City office:  
225 West 35th Street, 16th Floor  
New York, NY 10001

LIU’s Civil and Criminal Tax Controversy Forum

**NEW YORK STATE COLLECTION ENFORCEMENT:  
DRIVER’S LICENSE SUSPENSION**

August 16, 2018

Speaker: Yvonne R. Cort

Capell Barnett Matalon & Schoenfeld LLP  
100 Jericho Quadrangle, Suite 233, Jericho, NY 11753  
516.931.8100  
www.cbmslaw.com  
ycort@cbmslaw.com

**Capell Barnett  
Matalon & Schoenfeld** LLP

## What are collateral consequences?

- Nonmonetary sanctions for individuals who do not comply with the tax laws
- Goal is to encourage voluntary compliance
  - Federal: passport; deportation
  - States: licenses; permits

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Yvonne R. Cort, Capell Barnett Matalon &  
Schoenfeld LLP

August 16, 2018

## NYS Driver’s Licenses

- Suspension for \$10,000 or more of tax, interest and penalties
- Exceptions
  - commercial driver’s license
  - bankruptcy
  - innocent spouse
  - wage garnishment already in place
    - for unpaid taxes
    - for past-due child support



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**Yvonne R. Cort, Capell Barnett Matalon & Schoenfeld LLP**

**August 16, 2018**

## NYS Driver’s Licenses

- Sixty-day letter sent to the taxpayer from the NYS Dept. of Taxation and Finance
  - Includes notice of the past-due liabilities
  - Includes info on how to avoid suspension
- Fifteen-day letter sent from the DMV
  - Contact NYS DTF to resolve liability
  - Contact DMV for restricted license if no other resolution

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**Yvonne R. Cort, Capell Barnett Matalon & Schoenfeld LLP**

**August 16, 2018**

## Pertinent Cases



- ***Matter of Balkin***, TAT Feb. 10, 2016: New collection vehicle for old taxes is “merely a ministerial administrative act” and does not violate due process standards.
- ***Matter of Jacobi***, TAT May 12, 2016, *aff’d*, 156 A.D.3d 1154 (3rd Dep’t 2017): Pending OIC does not avoid suspension of DL, and rejected OIC is not reviewable by the Tribunal.

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Yvonne R. Cort, Capell Barnett Matalon &  
Schoenfeld LLP

August 16, 2018

## NYSBA Report

### Proposals:

- Hardship exemption
  - automatic exemption for low income taxpayers
  - hardship exemption for any taxpayer who can demonstrate undue economic hardship
- Increase threshold to \$50,000; adjust for inflation
- No threshold if taxpayer affirmatively seeks to evade or avoid collection
- Discretion to waive suspension based on equity

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Yvonne R. Cort, Capell Barnett Matalon &  
Schoenfeld LLP

August 16, 2018

## Proposed Budget 2018-2019

- Intended to limit the effect of driver’s license law on those suffering economic hardship
- Increase threshold to \$20,000; adjust for inflation
  - No threshold if affirmatively evade or avoid collection
- Low income? No suspension!
- Discretion to waive suspension based on equity
  
- Not passed!

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**Yvonne R. Cort, Capell Barnett Matalon & Schoenfeld LLP**

**August 16, 2018**

## NYS Alternatives

- Installment Payment Agreement
  - Must pay in full
  - Direct debit preferred
  - Interest continues to accrue
  - Financial info may be required
  
- No NYS Partial Pay Installment Agreements
- No Currently Not Collectible designation



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**Yvonne R. Cort, Capell Barnett Matalon & Schoenfeld LLP**

**August 16, 2018**

## NYS Alternatives

- Income Execution
  - First Service
  - Second Service
  - 10% wage garnishment
  - No warrant needed
- Offer in Compromise



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**Yvonne R. Cort**  
**Capell Barnett Matalon & Schoenfeld LLP**

**August 16, 2018**

## NYS Voluntary Disclosure & Compliance Program

- For nonfilers – individuals and businesses
  - No penalties assessed
  - No referral for criminal charges
  - May be eligible for 3 or 6 year limited lookback
- NOT eligible:
  - Under audit or rec’d a bill
  - Under criminal investigation by NY
  - Tax Shelters
- Must pay in full – but can pay over time
- Must stay current, or VDA may become void

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**Yvonne R. Cort, Capell Barnett Matalon & Schoenfeld LLP**

**August 16, 2018**

## Questions?

Yvonne R. Cort, Esq.  
Partner

Capell Barnett Matalon & Schoenfeld LLP  
[www.cbmslaw.com](http://www.cbmslaw.com)

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Capell Barnett  
Matalon & Schoenfeld LLP

August 16, 2018



**Notice of Proposed  
Driver's License Suspension Referral**

March 3, 2017

Collection case ID: E-1

**You must pay your New York State tax debts or your driver's license may be suspended.**

New legislation allows New York State to suspend the driver's licenses of persons who have delinquent unpaid tax debts. Our records indicate you owe the amounts listed on the enclosed *Consolidated Statement of Tax Liabilities*.

Unless you respond within **60 days** from the date this notice was mailed, we will provide the New York State Department of Motor Vehicles with your name, social security number, and other identifying information, and your driver's license will be suspended.

This suspension will remain in effect until you pay the amount due or make arrangements with the Tax Department for payment.

**Exemptions**

Certain drivers are **not** subject to suspension for unpaid tax debts, including:

- drivers holding commercial driver's licenses, and
- persons making certain child or combined child and spousal support payments.

See the back for more information about these and other exemptions and for instructions on contacting the Tax Department if any of the exemptions apply to you.

**How to avoid suspension of your license**

If none of the exemptions listed on the back apply to you, you must pay the amount due or set up a payment plan to avoid suspension of your license. You can pay in any of these ways:

**Online:** Follow the prompts on our website for making an online payment.

**Phone:** Call us at (518) 862-6000.

**Mail:** Follow the instructions on the enclosed *Payment Document*. Be sure to use the address on the *Payment Document*. Do not send payment to any other address.

**If you disagree**

See the back for instructions on how to respond.

**Questions?**

- Call (518) 862-6000
- Visit our website

## How to respond to this notice

If any of the following apply, call the Tax Department at (518) 862-6000. We may ask you to provide proof supporting your claim.

### Child support exemption

Your license will not be suspended based on this notice if:

- Your wages are being garnished for the payment of child support or combined child and spousal support from this state or any other state.
- You have made a satisfactory payment arrangement with a support collection unit for payment of child support or combined child and spousal support to avoid the suspension of your driver's license.

### Commercial driver's license exemption

Drivers with commercial driver's licenses are not subject to suspension based on this notice.

### Other grounds

Your license will not be suspended based on this notice if any of the following apply:

- You are not the taxpayer named in the notice.
- The tax debts have been paid.
- The Tax Department is already garnishing your wages to pay these debts.
- Your license was previously selected for suspension for unpaid tax debts and:
  - you set up a payment plan with the Tax Department, and
  - the Tax Department erroneously found you failed to comply with that payment plan on at least two occasions in a twelve-month period.

You may also contact the department by calling (518) 862-6000 if:

- You are eligible for innocent spouse relief under section 654 of the Tax Law for certain New York State income tax debts. See Publication 89, *Innocent Spouse Relief*, available on our website.
- Enforcement of the underlying tax debts has been stayed by the filing of a bankruptcy petition.
- You are interested in learning about other options that may be available to you to resolve your debt.

### Protests and legal actions

The legislation limits the grounds for challenging the suspension of your license. Whether you are filing a protest with the Tax Department, or bringing a legal action, you may only raise the grounds listed above.

- Contacting the Tax Department to ask questions or to resolve any of these issues will not extend your time to protest.

### If you do not respond within 60 days

Unless you do one of the following within 60 days, we will provide your name, social security number, and other identifying information to the Department of Motor Vehicles for the purpose of suspending your driver's license:

- resolve your tax debts or set up a payment plan,
- notify the Tax Department of your eligibility for an exemption, or
- protest the proposed suspension of your license by:
  - filing a *Request for Conciliation Conference* (Form CMS-1-MN, available on our website), with the Tax Department; or
  - filing a petition (Form TA-10) with the Division of Tax Appeals, available at [www.dta.ny.gov](http://www.dta.ny.gov).



March 3, 2017

## List of unpaid bills

This document lists the bills we've issued to the taxpayer named above that haven't been paid. If you've used more than one taxpayer identification number to report your taxes, there may be other unpaid bills that aren't listed here.

**Interest and penalties continue to accrue on unpaid bills.**

- To avoid additional charges, pay these bills immediately.
- Pay online at [www.tax.ny.gov](http://www.tax.ny.gov) or use the coupon.

### Recent payments

The amounts due listed below may not include any recent payments that you've made. For an up-to-date statement, visit our website at [www.tax.ny.gov](http://www.tax.ny.gov).

### Bills subject to collection action

The following unpaid bills are subject to collection action. This means we may collect the unpaid amounts by garnishing your wages, seizing your property, or filing warrants against you.

Tax type	Assessment ID	Tax Period Ended	Tax Amount Assessed	(+) Interest Amount Assessed	(+) Penalty Amount Assessed	(-) Assessment Payments/ Credits	(=) Current Balance Due
INCOME	I	12/31/11	\$ 9,545.00	\$ 4,266.54	\$ 4,935.01	\$ 0.00	\$ 18,746.55
<b>Total</b>							<b>\$ 18,746.55</b>

### Bills not yet subject to collection action

The Tax Department may not yet take collection action against you to collect these bills. If you don't pay these bills, however, we will have the right to take collection action.

Tax type	Assessment ID	Tax Period Ended	Tax Amount Assessed	(+) Interest Amount Assessed	(+) Penalty Amount Assessed	(-) Assessment Payments/ Credits	(=) Current Balance Due
INCOME	L	12/31/13	\$ 5,934.00	\$ 1,428.73	\$ 2,497.71	\$ 0.00	\$ 9,860.44
INCOME	L	12/31/12	2,794.00	942.68	1,317.33	0.00	5,054.01
<b>Total</b>							<b>\$ 14,914.45</b>

### Questions?

- Visit our website at [www.tax.ny.gov](http://www.tax.ny.gov)
- Call (518) 457-5434



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### Payment Document

If name or address shown is incorrect or has changed, enter correct information and return this entire payment document.

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

### Instructions

If you entered a name or address change above, return this entire document. Otherwise, detach the payment coupon below and include it with your payment. Be sure to:

- Mark an **X** in the appropriate box and enter the amount you are paying in the space provided.
- Make your check or money order payable in U.S. funds to **Commissioner of Taxation and Finance**.
- Write the Collection case ID number on your payment.

### Pay online

If you prefer, you can pay online through our Web site at [www.tax.ny.gov](http://www.tax.ny.gov).

DTF-968.4 (9/13)

- Payment for tax debts included in Collection case ID E-
- Payment for any other unpaid tax debts.

Amount to be applied

\$ \_\_\_\_\_

Enter Taxpayer ID: \_\_\_\_\_

\$ \_\_\_\_\_

Enter amount enclosed ➡	\$ _____
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<i>For office use only</i>	
Form track number	• _____
Amount received	• _____
Payment effect/rec'd dates	• _____

Mail to the address below



NYS ASSESSMENT RECEIVABLES  
PO BOX 4127  
BINGHAMTON NY 13902-4127

DTF-968.4 (9/13)



Department of Motor Vehicles

ORDER OF SUSPENSION OR REVOCATION

dmv.ny.gov

POSTAL ID:

COMPLIANCE DATE \_\_\_\_\_
ITEM
AFFIDAVIT
MV REP SIGNATURE

III

COURT

BROOKLYN NY

05/02/2017 KINGS COUNTY, BROOKLYN D.O.
ORDFP NUMBER IDENTIFICATION NUMBER DATE OF BIRTH SEX CLIENT NUMBER

YOUR NEW YORK STATE DRIVER LICENSE WILL BE SUSPENDED EFFECTIVE 05/16/2017. THIS ACTION IS TAKEN UNDER SECTION 510 OF THE VEHICLE AND TRAFFIC LAW.

CAUSE: DELINQUENT UNPAID TAX DEBT WITH THE NYS DEPARTMENT OF TAXATION AND FINANCE. CASE NUMBER E

IF YOU HAVE ANY QUESTIONS REGARDING WHY THIS SUSPENSION WAS ISSUED OR ABOUT CLEARING THIS SUSPENSION, CONTACT:

THE NEW YORK STATE DEPARTMENT OF TAXATION AND FINANCE
518-862-6000
www.tax.ny.gov

YOU ARE ELIGIBLE FOR A RESTRICTED USE LICENSE. CONTACT THE MOTOR VEHICLES OFFICE LISTED BELOW. THE FEE FOR A RESTRICTED USE LICENSE IS \$75. THERE MAY BE ADDITIONAL FEES.

YOU MAY NOT DRIVE A MOTOR VEHICLE IN NEW YORK STATE FOR ANY REASON WHILE THIS ORDER IS IN EFFECT, UNLESS YOU RECEIVE A RESTRICTED USE LICENSE/PRIVILEGE FROM DMV. IF YOU DO DRIVE, YOU MAY BE SUBJECT TO ARREST AND THE PENALTIES PROVIDED BY LAW.

IF YOU HAVE NOT ALREADY DONE SO, TURN IN YOUR NYS DRIVER LICENSE (INCLUDING ANY DUPLICATES) TO THE DEPARTMENT OF MOTOR VEHICLES AT THE OFFICE LISTED BELOW.

DEPARTMENT OF MOTOR VEHICLES
2875 WEST 8TH STREET, CONEY ISLAND, NY 11224

DEPARTMENT OF MOTOR VEHICLES
625 ATLANTIC AVE, BROOKLYN, NY 11217

## Private Debt Collection

The Internal Revenue Service recently implemented a new private debt collection program and will assign certain overdue federal tax debts to private collection agencies.



### [Sample Letter Do Not Contact](#)

**Video:**  
[NTA Message to Private Collection Agencies on Protecting taxpayer Rights](#)

**Information on Private Debt Collection**  
on [www.irs.gov](http://www.irs.gov)

**IRS Publications – Publication 4518 - What You Can Expect When the IRS Assigns Your Account to a Private Collection Agency**

### **Why am I getting letters or calls from a private company about a tax debt?**

A federal law enacted by Congress in 2015 requires the IRS to assign certain tax debts to private collection agencies (PCAs). The IRS has entered into contracts with four PCAs: Conserve (NY), Pioneer (NY), Performant (CA), and CBE Group (IA) to collect outstanding tax debts.

### **How do I know if the company contacting me is a scam?**

Before a PCA contacts you, you should receive a Notice CP40 from the IRS with the name of the PCA, the PCA's toll-free telephone number, and a ten-digit Taxpayer Authentication Number (TAN). The PCA should also first send you a letter explaining that your tax debt has been assigned to it and listing the same TAN. At the beginning of every phone contact, the PCA must ask you to provide the first five digits of the TAN and must respond by reading you the last five digits of the TAN. This allows the PCA to verify your identity and allows you to verify that the caller works for the PCA. The PCA cannot continue the conversation with you until your identity has been verified.

### **What if I can't find my Taxpayer Authentication Number?**

You can request that the PCA re-send the letter with the TAN. Alternatively, **if you agree**, the PCA may verify your identity by using your Social Security Number instead of the TAN, as long as you first provide your full name, address, and date of birth. However, the use of your Social Security Number instead of the TAN does not allow you to verify that the caller works for the PCA, so you should consider carefully before agreeing to this.

### **Do I have to work with the private collection agency?**

No. You can send the PCA a written request to stop further communication with you. We recommend your request be sent using certified mail (See "[No Contact Letter](#)").

### **What can (and can't) a private collection agency do?**

The PCA can ask if you can full pay your tax debt within 120 days. If you can't, the statute allows the PCA to offer you a plan known as an "installment agreement" under which you may pay your tax debt in full over 5 years or less. If the PCA obtains IRS approval, it may set up an installment agreement for 6 or 7 years. A PCA may not take collection action (such as file a lien, levy your bank account, or garnish your wages), nor may it issue a summons or report your IRS tax debt to the credit rating agencies.

### **What if I want to explore other alternatives with the IRS?**

You can call the IRS and explain that you do not want to pay in installments, or can't afford to do so. If you orally advise the PCA you plan to contact IRS about collection alternatives, the PCA will place a 60-day hold on your account. If you have not reached an agreement with IRS within those 60 days, the PCA may resume collection activity on your account. Because many actions take longer than 60 days, you may wish to write to the PCA to request that it stop contacting you (See "[No Contact Letter](#)").

### **Can I work with the Taxpayer Advocate Service?**

Yes. The Taxpayer Advocate Service will work with you on private debt collection issues related to your IRS tax debt. You can find contact information for your Local Taxpayer Advocate in IRS Publication 1546, *Taxpayer Advocate Service*, and at <https://www.irs.gov/advocate/local-taxpayer-advocate>.

# **Nuts and Bolts of Tax Collection and CDP**

LIU Civil and Criminal Tax Controversy Forum  
Presented at Long Island University CW Post (Brookville, N.Y.)

August 16, 2018

Presented by Frank Agostino, Jim Caligure, and Monica Koch

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**Appendix A:** Sample Attachment to Form 12153

**Appendix B:** FOIA Letter for Alter Ego Determination

I. Administrative Collection

A. How A Tax Debt Arises – The Assessment Process

1. In General: Before we discuss the collection of tax debts, it is important to first understand the tax assessment process. Professor Steve Jonson has aptly described the process as follows:

The IRS lacks legal authority to assess and collect certain major taxes—income, estate, gift, and some excise taxes—until the taxpayer has had the opportunity to contest the liabilities in Tax Court. In brief, the process is as follows: First, the taxpayer files a return. Second, the IRS selects the return for examination. Third, if the IRS agent believes that correct liability exceeds liability reported on the return (that is, that a deficiency exists), the agent issues to the taxpayer a preliminary document (the Revenue Agent’s Report or thirty-day letter) setting out proposed adjustments. Fourth, if the taxpayer disagrees, she can obtain administrative review by filing a protest with the IRS Appeals Office. Fifth, if Appeals Office consideration is not requested or no resolution is reached at Appeals, the IRS issues a notice of deficiency (also called a ninety-day letter). Sixth, the taxpayer may contest the determinations in the notice of deficiency by filing a timely petition with the Tax Court. Seventh, if the taxpayer fails to file a timely petition or if the Tax Court holds against the taxpayer in whole or part, the IRS may then assess and collect the deficiency (and interest and penalties, if any).

Steve R. Johnson, *Reasoned Explanation and IRS Adjudication*, 63 DUKE L.J. 1771, 1794 (Oct. 2013) (footnotes omitted).

2. The Assessment Process: In order for the IRS to begin collections, the tax must first be assessed by any of the following means:
- a. Self-assessment (*i.e.*, pursuant to a filed original or amended tax return showing tax due). (I.R.C. § 6201(a)(1));
  - b. Through the deficiency procedures of I.R.C. § 6212, et seq.;
    - (1) Traditional Audits: Subject to the limitations discussed below, the IRS may propose to assess additional tax in a notice of deficiency that is issued in connection with an audit;
    - (2) Automated Underreporter Program: Subject to the limitations discussed below, the IRS is increasingly relying upon third-party matching. The IRS matches information returns with a taxpayer’s tax identification number and discovers income that was not included on a return and issues a notice of deficiency determining additional tax; and
    - (3) Substitute Returns: Subject to the limitations discussed

below, where the taxpayer fails to file a return and the IRS matches information returns with taxpayer's tax identification, the IRS can prepare a substitute return under I.R.C. § 6020(b) and issues a notice of deficiency to assess additional tax assessing the tax;

- c. Through the jeopardy assessment process of I.R.C. § 6861 and 6862 or through the termination assessment processes of I.R.C. § 6851; or
- d. Through the TFRP assessment process (discussed below).

3. Limitations on Assessment:

a. Period of Limitations:

(1) General Rule: Pursuant to I.R.C. § 6501, tax must be assessed within three years after a return is filed or the due date for filing the return, whichever is later. This is to say that an assessment is valid only if it is made before the expiration of the period of limitations on assessment.

(2) Exceptions: There are a number of exceptions to this general rule, the most important of which in a collection context are:

(a) Extension by Agreement: Pursuant to I.R.C. § 6501(c)(4), the three-year statute of limitations may be enlarged if the taxpayer and the IRS agree to do so. Note the following:

(1) Must Be Agreed to Before Expiration of Statute: The extension is not effective unless both parties agree before the statute expires.

(2) Burden of Proof on IRS: The IRS has the burden of proving that the agreement extended the statute. The IRS must produce direct proof of signed extensions or circumstantial evidence establishing the extension.

(3) Types of Extensions: The IRS may use various forms to extend the statute of limitations. Among the more common forms are:

(i) Form 872 extends the statute of limitations to a particular date.

(ii) Form 872-A extends the statute of limitations indefinitely, until 90 days after the IRS or the taxpayer receives a notice of termination from the other party (Form 872-T) or until the IRS sends a notice of deficiency.

(iii) Form 872-P extends the time to

assess the tax attributable to partnership items.

- (b) False or Fraudulent Returns: The IRS may assess the tax, or a court proceeding for the collection of such tax may be brought at any time in the case of:
    - (1) A false or fraudulent return with the intent to evade tax, see I.R.C. § 6501(c)(1);<sup>1</sup>
    - (2) A willful attempt to evade tax, see I.R.C. § 6501(c)(2); or
    - (3) The failure to file a return, see I.R.C. § 6501(c)(3).
  - (c) 25% Omission and Foreign Financial Assets: Pursuant to I.R.C. § 6501(e) and Treas. Reg. § 301.6501(e)-1, the period of limitations on assessment is extended to six years if:
    - (1) The taxpayer omits additional gross income in excess of 25% of the amount of gross income stated in the tax return filed with the IRS, *or*
    - (2) The taxpayer omits in excess of \$5,000 from gross income that is foreign-sourced and required to be reported, see I.R.C. § 6038D (reporting requirements).
- b. The Notice of Deficiency:
- (1) In General: If the IRS determines there is a deficiency in tax, he is authorized to send a notice of the deficiency to the taxpayer by registered or certified mail. I.R.C. § 6212(a).
    - (a) Effect on Validity of Assessment: As a general rule, a notice of deficiency is valid only if it is issued before expiration of the appropriate statute of limitations.
    - (b) Effect on Collections: Except in the case of certain jeopardy or termination assessments, the IRS may not assess a deficiency until:
      - (1) A notice of deficiency has been mailed to the taxpayer; and
      - (2) The time for filing a petition with the Tax Court has expired (*i.e.*, 90 days generally or 150 days if addressed to a person outside the United States). I.R.C. § 6503(a)(1).
    - (c) Effect of Tax Court Petition on Assessment and Collection: If a petition with the Tax Court is filed,

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<sup>1</sup> Where a taxpayer files a fraudulent return but later files a nonfraudulent amended return, the tax may be assessed at any time, even more than three years after the nonfraudulent amended return was filed. Badaracco v. Commissioner, 464 U.S. 386 (1984).

then the IRS may not assess the deficiency until 60 days after the Tax Court decision has become final. (*i.e.*, for 150 days if no petition has been filed). I.R.C. § 6213(a).

- (2) Effect of Tax Court Case on Statute of Limitations: I.R.C. § 6503 provides that the statute of limitations for a tax year is tolled (suspended) during any time that the Service is prohibited from making an assessment (*i.e.*, during the time a notice of deficiency is outstanding). No exception is made in I.R.C. § 6503 for an invalidly issued notice of deficiency. Thus, the statute of limitations is not suspended for an invalidly issued notice of deficiency.

4. Collection Follows Assessment: Once the tax is assessed and the taxpayer fails to pay the tax liability, the IRS will begin collections (the types of notices the IRS typically issues are discussed below).

B. Collection Devices (With Recent Developments)

1. Authority to Collect: The Code directs the Commissioner to collect the taxes imposed by the internal revenue laws. I.R.C. § 6301.

- a. Liens and Levies as Primary Means of Collection: In furtherance of the Commissioner's collection authority, Congress has authorized the Commissioner to effect the collection of tax by, in addition to other methods, liens and levies.

2. Liens: The Code imposes a lien in favor of the United States on all property and property rights of a taxpayer who is liable for taxes after a demand for the payment of the tax has been made and the taxpayer fails to pay the taxes. I.R.C. § 6321. The lien arises at the time the assessment is made and continues until the assessed amount is satisfied or is unenforceable by lapse of time. I.R.C. § 6322.

3. Levies: The Code also authorizes the Commissioner to levy upon all property or property rights of any taxpayer who is liable for any tax and neglects or refuses to pay that liability within 10 days after notice and demand for payment was made. I.R.C. § 6331.

- a. Statutory Prohibition on Levies: The IRS is prohibited from levying under certain circumstances:

- (1) During the period that an offer for an installment agreement under I.R.C. § 6159 is made or if such offer is rejected, during the 30 days thereafter (and, if an appeal of such rejection is filed within such 30 days, during the period that such appeal is pending);
- (2) During the period that an offer-in-compromise is pending and if such offer is rejected by the IRS, during the 30 days thereafter (and, if an appeal of such rejection is filed within such 30 days, during the period that such appeal is pending);
- (3) During the period after a request for relief from joint and several liability (*i.e.*, an innocent spouse claim is made).

I.R.C. §§ 6015(e)(1)(B)(i); 6331(k).

- b. Practical Prohibition on Levies: Levy action is not suspended by law, but is generally suspended by policy in the following instances:
  - (1) During a timely CDP lien hearing;
  - (2) During a timely CDP levy hearing; or
  - (3) During an Equivalent Hearing (“EH”).
- c. When Levy May Proceed Despite CDP Request: The IRS collection division may deem levy action appropriate even though a CDP or EH hearing is pending if:
  - (1) Collection is at risk (*e.g.*, the collection statute expiration date is imminent and the taxpayer is dissipating assets or pyramiding additional liabilities);
  - (2) The taxpayer raises only frivolous issues; or
  - (3) The taxpayer is solely seeking to delay the collection process.
- 4. Other Collection Devices: The IRS has available other collection tools, including but not limited to jeopardy levies, seizures, forced sales, wage garnishment, and the writ of *ne exeat republica*. A detailed discussion of these collection devices is outside the scope of this Outline.
- 5. IRS Notices:
  - a. Overview: As noted, after the IRS assesses the tax, if the taxpayer fails to pay the tax liability within ten days thereof, then the IRS will begin enforced collection action by typically issuing three notices.<sup>2</sup> The IRS issues many types of collection notices, and we summarize below the notices the taxpayer may receive in connection with a collection case. The taxpayer should respond to every notice received from the IRS.
  - b. Notice CP501:
    - (1) In General: The Notice CP501, *You have unpaid taxes*, is the taxpayer’s first notice that there is a tax balance due and owing.
    - (2) Response: The tax practitioner should first determine whether or not the tax amount is correct or still due.
      - (a) Grounds for Abating or Reducing Tax: The grounds on which the tax may be challenged include, but are not limited to:
        - (1) The underlying tax liability is incorrect;
        - (i) If the taxpayer did not receive a notice of deficiency and has not had a prior administrative or judicial opportunity to challenge the amounts assessed, then the taxpayer may

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<sup>2</sup> The IRS used to issue five collection notices, but has recent limited that practice to issuing three notices before beginning enforced collection action. As discussed, the IRS sometimes issues more than three notices before seeking enforced collection. Practitioners and taxpayers should read *all* notices that the IRS sends.

challenge the liability in connection with the CDP hearing. Montgomery v. Commissioner, 122 T.C. 1 (2004).<sup>3</sup>

- (ii) Penalties are included in the underlying tax liability. Id. at 8-9.
  - (iii) A self-assessed tax liability on a tax return may be reviewed *de novo*. Id.
  - (iv) The United States Tax Court (“Tax Court”) reviews the underlying liability *de novo*. Id.
- (2) The additions to tax for failure to file or to pay may be abated based on an administrative waiver, see I.R.M., pt. 20.1.1.3.3 (Nov. 25, 2011), or reasonable cause, see I.R.C. § 6651(a)(2), (3).
  - (3) The taxes were discharged in bankruptcy. See 11 U.S.C. §§ 727, 1141;
  - (4) The taxpayer is entitled to relief from joint and several liability for the taxes (*i.e.*, the taxpayer may be an innocent spouse). See I.R.C. § 6015. In these cases, a Form 8857, *Request for Innocent Spouse*, should be filed at the earliest possible time.
  - (5) The period of limitations on assessment under I.R.C. § 6501 has expired:
    - (i) General Rule for Assessments: In general, a tax assessment is invalid if not made within 3 years of the filing of the tax return. See I.R.C. § 6501(a).
    - (ii) Exceptions: There are a number of situations, the most common which may arise in connection with a collection case are:
      - i. 25% Omission and Foreign Financial Assets: Pursuant to I.R.C. § 6501(e) and Treas. Reg. § 301.6501(e)-1, the period of limitations on assessment is extended to six years if:
        - (1) The taxpayer omits

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<sup>3</sup> For recent litigation concerning the prior opportunity to dispute an underlying liability, see discussion of Keller Tank Servs. II, Inc. v. Commissioner, 854 F.3d 1178 (10th Cir. 2017), James v. Commissioner, 850 F.3d 160 (4th Cir. 2017), and Flume v. Commissioner, T.C. Memo. 2017-21.

additional gross income in excess of 25% of the amount of gross income stated in the tax return filed with the IRS,  
*or*

(2) The taxpayer omits in excess of \$5,000 from gross income that is foreign-sourced and required to be reported, see I.R.C. § 6038D (reporting requirements).

- (6) The period of limitations on collection under I.R.C. § 6502 has expired; and
  - (i) As a general rule, the IRS has 10 years from the date of a timely assessment to collect the tax by levy or to begin a proceeding in court. See I.R.C. § 6502.
- (7) In trust fund recovery penalty (“TFRP”) cases, the taxpayer is not the Responsible Person for the failure to remit employment taxes and the IRS failed to notify the taxpayer in writing by mail to his/ her “last known address.” (IRC § 6672(b)(1)). Mason v. Commissioner, 132 T.C. 301 (2009); Barry v. Commissioner, T.C. Memo. 2010-57.
- (3) Tools to Confirm Validity of Assessment: The tools a practitioner will need to ascertain the validity of the assessment include:
  - (a) Power of Attorney: Prepare and file Form 2848, *Power of Attorney and Declaration of Representative*;
  - (b) Transcripts: Request IRS account and wage and income transcripts through IRS e-services (<https://www.irs.gov/Individuals/Get-Transcript>), or through the Practitioner’s Priority Service hotline ((866) 860-4259).
  - (c) Administrative Requests for Information: Request the IRS’s administrative file through a Freedom of Information Act Request, 5 U.S.C. § 552, as amended (“FOIA”). Also, request third party contacts under I.R.C. § 7602(c).
- c. Notice CP503: The Notice CP503, *Second Reminder*, may be a second notice to the taxpayer that there is a tax due and owing.
  - (1) Issuance Less Common Than In the Past: The IRS has

been issuing the Notice CP503 less frequently than in past years (it is instead proceeding directly to issue Notice CP504 (discussed below)). However, in some instances, especially for older liabilities that may arise from partnership action, the IRS is still issuing the Notice CP503.

(2) Response: Once the tax practitioner determines that the tax is valid and owing, the tax practitioner will need to determine the appropriate collection alternative.

(a) Collection Alternatives: The taxpayer has the right to propose a collection alternative at any time.

(1) Consider Requesting an Installment Agreement if the Taxpayer is Able to Pay the Tax in Full: If an installment agreement is appropriate because the taxpayer is fully collectible, a response to the second notice is an ideal time to have the taxpayer enter into an installment agreement and avoid the additional costs associated with a prolonged collection case.

(2) Voluntary Payments: The taxpayer may want to make voluntary tax payments to reduce the tax and interest until a formal installment agreement is granted.

(b) Penalty Abatements: If penalties or additions to tax or imposed, and they were not challenged in response to the first notice, then practitioners may want to challenge the penalties and additions to tax in response to the second notice.

d. Notice CP504: The Notice CP504, *Notice of intent to seize (levy) your state tax refund or other property*, is the next notice to the taxpayer that there is a tax balance due and owing, and it usually signals that enforced collection (*i.e.*, the filing of a lien or the issuance of a levy is forthcoming).

(1) Contents of Notice: In the Notice CP 504, the taxpayer is given notice that unless the tax is paid in full, the IRS will soon issue a Notice of Federal Tax Lien (“NFTL”) and file a related lien;

(a) The Lien: The lien is public, and has detrimental effects on the taxpayer’s credit, business reputation, ability to secure bonding, or ability to sell or transfer property.

(b) Requests to Withdraw the Lien: Once the lien is filed, pursuant to I.R.C. § 6323(j), the taxpayer may seek to have the lien withdrawn for any of the following reasons:

- (1) Notice was filed prematurely;
  - (2) The taxpayer entered into an installment agreement and the tax liability is less than \$50,000;
  - (3) Withdrawal may facilitate tax collection; or
  - (4) Best interest of taxpayer and government. See also I.R.M., pt. 5.12.9 (Dec. 7, 2015) (discussing the grounds under which a lien may be withdrawn).
- (2) Response: How to respond to the CP504 depends upon how the taxpayer intends to resolve the taxes due.
- (a) Full-Pay Taxpayers: If the taxpayer is in a full-pay situation (*i.e.*, he or she does not qualify for an offer in compromise (“OIC” or “offer”) or currently not collectible status), then the taxpayer may want to respond to the Notice CP504 by filing with the IRS a Form 9423, *Collection Appeal Request*, and proposing collection alternatives.
    - (1) Other Reasons to File Form 9423: Some taxpayers may desire to file Form 9423 in response to the Notice CP504 to (i) resolve the liabilities at the earliest possible stage, or (ii) to show a willingness to resolve the liabilities so as to reduce the likelihood of a criminal case being brought. We discuss the collection appeal proceedings (sometimes, “CAP”) more fully below.
- e. The Final Notice:
- (1) In General: In addition to the IRS issuing to the taxpayer a notice and demand for payment, the IRS must provide notice to the taxpayer concerning his/her right to a collection due process (“CDP”) hearing under I.R.C. § 6330 or 6320 after it has:
    - (a) Filed the first lien; or
    - (b) Before its first intended levy for the particular tax and tax period.
  - (2) The Forms of Final Notices: Traditionally, the Final Notice took one of two forms: (a) “Final Notice, Notice of Intent to Levy and Notice of Your Right to a Hearing”; or (b) “Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320”. However, the IRS has recently started issuing automated collection notices, which also inconspicuously provides taxpayers with the opportunity for a hearing.
    - (a) BEWARE OF AUTOMATED FINAL NOTICES: In automated collection cases, the IRS now issues

Letter 11 (LT 11), in which it advises taxpayers of a balance due and owing, and offers to taxpayers the opportunity to request a hearing. This letter takes a different format than has previously been used, and does not advise taxpayers of the right to a hearing until the second page of the letter. Practitioners should request a CDP hearing in response to a LT 11, the same way as done for traditional final notices.

- (3) Requirements of the Notice: The final notice must comply with the following requirements:
  - (a) Sent to taxpayer's last known address (Graham v. Comm'r, T.C. Memo. 2008-129);
  - (b) By certified mail, return receipt requested;
  - (c) For a NFTL filing, the IRS notice must be sent not more than five business days after the day of filing the lien notice. I.R.C. § 6320(a)(2); and
  - (d) For levy notices, the IRS notice must be issued at least thirty days before the day of the proposed levy. I.R.C. § 6330(a)(2).
- (4) Opportunity for a Hearing: If a taxpayer desires to request a CDP hearing in response to the issuance of a final notice, no later than 30 days after the date of the final notice, the Taxpayer must submit to the IRS a Form 12153, *Request for a Collection Due Process or Equivalent Hearing*. The Form 12153 is discussed below.

C. Collection Alternatives (With Recent Developments)

1. In General: Enforced collection by the IRS is an extraordinary measure. Depending upon the specific facts of a case, taxpayers may have available various collection alternatives to payment in full.
2. Offers in Compromise:
  - a. In General: I.R.C. § 7122 authorizes the IRS to compromise a taxpayer's Federal tax liabilities. Pursuant to I.R.C. § 7122(d), the Commissioner has developed guidelines for evaluating whether an OIC is adequate and should be accepted to resolve a civil tax dispute.
    - (1) Grounds for an Offer: Under existing guidelines, grounds for compromise include doubt as to collectibility (sometimes, "DATC"), doubt as to liability (sometimes, "DATL"), and to promote effective tax administration. See Treas. Reg. § 301.7122-1; see also I.R.M., pt. 5.8.11.1 (Aug. 5, 2015).
    - (2) Policy Statement: The Service's policy towards taxpayer offers is expressed in Policy Statement P-5-100:

The Service will accept an offer in compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. An OIC is a legitimate alternative to declaring a case currently not collectible or a protracted installment agreement.

The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the Government.

I.R.M., pt. 5.8.1.2.3 (May 5, 2017).

b. TIPRA and Deemed Acceptances:

(1) Background on TIPRA: The Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (“TIPRA”) was enacted on May 17, 2006. TIPRA made major changes to the OIC program effective for all offers received by the IRS on or after July 16, 2006.

(2) Deemed Acceptance: Under TIPRA, if the IRS does not make a determination on an offer within 24 months, the offer will be deemed accepted. I.R.M., pt. 5.8.1.11 (May 5, 2017).

(a) If a liability included in the offer amount is disputed in any court proceeding, that time period is omitted from the calculation of the two-year period.

(b) Once a determination letter is issued by the offer examiner or offer specialist, the 24-month time frame will be considered stopped.

c. Withdrawal: Any failure to make an installment (other than the first installment) due under an OIC during the period such offer is being evaluated by the Secretary may be treated by the Secretary as a withdrawal of the offer. I.R.C. § 7122(c)(1)(B)(ii).

d. DATL:

(1) When Allowed: The IRS may compromise a tax liability based on doubt as to liability where there is a genuine dispute as to the existence or amount of the correct tax liability under the law. I.R.M., pt. 4.18.2.2 (Dec. 9, 2008). Doubt as to liability does not exist where the liability has been established by a final court decision or judgment concerning the existence or amount of the tax liability. Treas. Reg. § 301.7122-1(b)(1); I.R.M., pt. 4.18.2.2 (Dec. 9, 2008).

(2) When Acceptable: Whether the amount offered by the taxpayer is adequate for a DATL offer to be accepted will depend upon the degree of doubt established by the taxpayer. I.R.M., pt. 4.18.2.6 (Dec. 9, 2008).

- (3) Application Fee: There is no filing fee for submitting an OIC on the ground of DATL.
- (4) Jurisdiction Over Offers:
  - (a) Jurisdiction for Offers Not Related to the TFRP or Excise Taxes: The IRS's Examination Division has jurisdiction over DATL offers other than those related to the TFRP or personal liability for excise taxes. I.R.M., pt. 4.18.2.3 (Dec. 9, 2008).
  - (b) Jurisdiction for Offers Related to the TFRP or Excise Taxes: The IRS's Collection Division has jurisdiction over DATL offers involving the TFRP and personal liability for excise tax. I.R.M., pt. 4.18.2.3 (Dec. 9, 2008). Liability offers concerning assessments made during bankruptcy proceedings may also fall under the jurisdiction of Collection Division.
  - (c) Counsel Approval for Liabilities of \$50,000 or More: Under I.R.C. § 7122(b), if the total liability for an offer is \$50,000 or more the IRS Office of Chief Counsel must provide an opinion to ensure that the offer meets the legal requirements for compromise and conforms to the Service's policy and procedure. I.R.M., pt. 4.18.2.6 (Dec. 9, 2008).
- (5) DATL Offer Examinations: An DATL offer examination is conducted in a manner similar to an audit reconsideration examination (discussed below). I.R.M., pt. 4.18.2.4 (Feb. 28, 2017). Thus, the DATL offer should be examined and additional documents requested from the taxpayer, if necessary. Id.
- (6) Payment in Full Not Required: If the offer is accepted, then payment will be in accordance with the terms listed on the Form 656. I.R.M., pt. 4.18.2.6 (Feb. 28, 2017). If the taxpayer cannot full pay the amount agreed upon in the accepted DATL offer, consider other payment options such as an installment agreement or advise the taxpayer of his option to file an offer on the basis of doubt as to collectibility. Id.
- (7) Judicial Review: Neither the IRS Office of Appeals ("Appeals") nor the Tax Court will review a DATL offer if the Taxpayer has had a prior opportunity to contest the underlying tax.
  - (a) Recent Litigation: For recent litigation concerning the prior opportunity to dispute an underlying liability, see discussion of Keller Tank Servs. II, Inc. v. Commissioner, 854 F.3d 1178 (10th Cir. 2017), James v. Commissioner, 850 F.3d 160 (4th

Cir. 2017), and Flume v. Commissioner, T.C. Memo. 2017-21.

e. DATC:

- (1) When Allowed: The IRS may compromise a tax liability based on doubt as to collectibility where the taxpayer's assets and income are less than the full amount of the unpaid tax liability. Treas. Reg. § 301.7122-1(b)(2).
- (2) When Acceptable: An offer to compromise based on doubt as to collectibility should be considered as acceptable where (1) it is unlikely that the unpaid tax liability can be collected in full, and (2) the offer reflects the taxpayer's total reasonable collection potential. Rev. Proc. 2003-71, sec. 4.02(2), 2003-2 C.B. 517.
- (3) Application Fee: There is a \$186 application fee for filing an offer on the ground of DATC.
- (4) IRS Policy Objectives: Consistent with this principle, the I.R.M. provides as follows:

The Service will accept an Offer in Compromise when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential. An OIC is a legitimate alternative to declaring a case as currently not collectible, or to a protracted installment agreement. The goal is to achieve collection of what is potentially collectible at the earliest possible time and at the least cost to the government. The ultimate goal is a compromise, which is in the best interest of the taxpayer and the Service. Acceptance of an adequate offer will also result in creating, for the taxpayer, an expectation of and a fresh start toward compliance with all future filing and payment requirements.

(Policy Statement P-5-100).

- (5) Reasonable Collection Potential: As noted, to determine whether an offer is adequate, the taxpayer's reasonable collection potential must be evaluated. In accordance with I.R.M., pt. 5.8.4.3.1 (Apr. 30, 2015), the IRS must ordinarily include the following four components to calculate the reasonable collection potential for offer purposes:
  - (a) The amount collectible from the taxpayer's net realizable equity in assets;
  - (b) The amount collectible from the taxpayer's expected future income;
  - (c) The amount collectible from third parties; and

- (d) The amount that the taxpayer should reasonably be expected to raise from assets in which the taxpayer has an interest but which is beyond the reach of the government.
- f. Effective Tax Administration: The IRS may compromise a tax liability for promotion of effective tax administration where: (i) collection in full, while achievable, would cause the taxpayer economic hardship; or (ii) compelling public policy or equity considerations provide a basis for compromising the liability. Speltz v. Commissioner, 124 T.C. 165, 172-173 (2005), aff'd, 454 F.3d 782 (8th Cir. 2006).
- (1) Jurisdiction: The IRS's collection division generally has jurisdiction over offers based on effective tax administration. I.R.M., pt. 4.18.3.3 (Feb. 28, 2017).
  - (2) Application Fee: There is a \$186 application fee for filing an offer on the ground of effective tax administration.
  - (3) Factors Considered: In determining whether or not an offer should be accepted on the ground of effective tax administration, the IRS typically considers whether not granting the offer would result in:
    - (a) A determination that the taxpayer is incapable of earning a living because of a long-term illness, medical condition, or disability, and it is reasonably foreseeable that taxpayer's financial resources will be exhausted providing for care and support during the course of the condition. Treas. Reg. § 301.7122-1(c)(3);
    - (b) A determination that although the taxpayer has certain monthly income, that income is exhausted each month in providing for the care of dependents with no other means of support. Treas. Reg. § 301.7122-1(c)(3);
    - (c) A determination that although the taxpayer has certain assets, the taxpayer is unable to borrow against the equity in those assets and liquidation of those assets to pay outstanding tax liabilities would render the taxpayer unable to meet basic living expenses. Treas. Reg. § 301.7122-1(c)(3); and
    - (d) A determination that compromise would not undermine compliance with the tax laws, including (i) the taxpayer does not have a history of noncompliance with the filing and payment requirements of the Code, (ii) the taxpayer has not taken deliberate actions to avoid the payment of taxes, and (iii) the taxpayer has not encouraged others to refuse to comply with the tax laws. Treas.

Reg. § 301.7122-1(c)(3); see also I.R.M., pt. 4.18.3.2 (Dec. 23, 2010).

g. Types of Offers:

(1) In General: When submitting an offer, taxpayers are expected to pay the entire amount offered in as short a time as reasonably possible. I.R.M., pt. 5.8.1.13.4 (May. 5, 2017). There are two types of payment terms offered on the Form 656 to which the IRS and taxpayer may agree:

- (a) Lump sum offers; or
- (b) Periodic payment offers. I.R.M., pt. 5.8.1.13.4 (May. 5, 2017).

(2) Lump Sum Offers:

(a) Defined: A lump sum offer is defined as one payable in five or fewer installments within five months of the offer acceptance. I.R.M., pt. 5.8.1.13.4 (May 5, 2017).

(b) Treatment of Lump Sum Offers: Taxpayers submitting requests for lump sum cash offers must include with the offer a payment equal to 20% of the offer amount. I.R.M., pt. 5.8.1.7 (May 5, 2017). The payment is treated as a payment of tax and is nonrefundable, which means that it will not be returned even if the offer is deemed to be not processable, later returned, withdrawn, terminated, or rejected. Id. A lump sum cash offer means any offer of payments made in five or fewer installments within five months of offer acceptance

(3) Periodic Payment Offers:

(a) Defined: A period payment offer is defined as one payable in six or more installments. I.R.M., pt. 5.8.1.13.4 (May 5, 2017).

(b) Treatment of Periodic Payment Offers: Taxpayers submitting requests for periodic payment offers must include the first proposed installment payment with their offer. I.R.M., pt. 5.8.1.11 (May. 5, 2017). A periodic payment offer is any offer of payments made in six or more installments. Id. The taxpayer is required to pay additional installments while the offer is being evaluated by the IRS. Id. All installment payments are nonrefundable, even if the offer is deemed not processable, later returned or rejected. Id.

h. Recent Updates:

(1) Renewed Emphasis on Compliance: The IRS recently announced that: “Beginning with Offer applications received on or after March 27, 2017: The IRS will return

any newly filed Offer in Compromise application if you have not filed all required tax returns. Any application fee included with the OIC will also be returned. Any initial payment required with the returned application will be applied to reduce your balance due. This policy does not apply to current year tax returns if there is a valid extension on file.” IRS, *Offer in Compromise*, available at <https://www.irs.gov/individuals/offer-in-compromise-1> (last visited Aug. 9, 2018).

3. Installment Agreements:

a. Overview:

- (1) In General: I.R.C. § 6159(a) authorizes the IRS to enter into written agreements which allow taxpayers to pay tax in installment payments if the IRS determines that the “agreement will facilitate full or partial collection of such liability.”
- (2) Check for Guaranteed, Streamlined, or In-Business Trust Fund Express Agreements: If the taxpayer is unable to pay in full, then the IRS is to first determine if the taxpayer qualified for a guaranteed, streamlined, or in-business trust fund express agreement (discussed below). I.R.M., pt. 5.14.1.2 (Jul. 16, 2018).
- (3) Financial Statement Otherwise Required: If the taxpayer does not qualify for a guaranteed, streamlined, or in-business trust fund express agreement, then the IRS will request a Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, or a Form 433-B, *Collection Information Statement for Businesses*, as appropriate. I.R.M., pt. 5.14.1.2 (Jul 16, 2018).
- (4) Methods of Payment: There are various means of paying installment agreements. The automated methods are usually advisable to avoid an inadvertent default of the installment agreement. The various methods of payment for an installment agreement are set forth as follows in I.R.M., pt. 5.14.1.2 (Jul. 16, 2018):
  - (a) Electronic Federal Tax Payment System (EFTPS), under which taxpayers will select the “payment-due with IRS notice” payment type for posting to Masterfile with a TC 670. EFTPS has the ability to schedule payments up to 12 months in advance for individual taxpayers and up to 4 months in advance for business taxpayers. The taxpayer must initiate payments by sending instructions to EFTPS. See I.R.M., pt. 21.7.1.4.8.1 (Aug. 20, 2015) for instructions.

- (b) Direct Debit installment agreements, under which, if taxpayers maintain a checking account, they can arrange make direct debit installment agreement payments. See I.R.M., pts. 5.14.10.4 and 5.14.10.5 (Dec. 14, 2017) for instructions.
- (c) Payroll Deduction installment agreements, under which, if taxpayers will not agree to a direct debit installment agreement, they can enter into a payroll deduction agreement. See I.R.M., pt. 5.14.10.2 (Dec. 14, 2017) for instructions.
- (d) Credit card installment agreement payment, under which taxpayers can pay by credit card. See I.R.M., pt. 21.2.1.48.4 (Oct 1, 2007) for procedures.
- (e) Payment by check or money order, under which payments are made by check and should be made payable to: “U.S. Treasury”. Checks made out to “Internal Revenue Service” or “IRS” will also be processed.
- (f) Direct pay, which is a free service that allows taxpayers to make electronic payments directly to the IRS from their checking or savings accounts. See I.R.M., pt. 21.2.1.48.1 (Oct. 1, 2017) for further information.

b. Streamlined Installment Agreements:

- (1) In General: Under the IRS’s Fresh Start Program, launched in 2008, the IRS made it easier for taxpayers to qualify for installment agreements.
- (2) Qualification: Streamlined installment agreements may be approved for taxpayers under the following circumstances:
  - (a) The aggregate unpaid balance of assessments is \$50,000 or less (*i.e.*, the “Summary Balance”). The unpaid balance of assessments includes tax, assessed penalties, and interest, and all other assessments on the tax modules. It does not include accrued penalty and interest. I.R.M., pt. 5.14.5.2 (Dec. 23, 2015)
    - (1) If pre-assessed taxes are included, the pre-assessed liability plus unpaid balance of assessments must be \$50,000 or less.
- (3) Computing the Minimum Payment: The minimum payment amount is determined by dividing the Summary Balance by 72. The installment agreement must resolve all balances due prior to the expiration of the collection statute expiration date. I.R.M., pt. 5.14.5.2 (Dec. 23, 2015).
- (4) Financial Information Unnecessary: A Form 433-A or 433-B is not required for streamlined installment agreements.

I.R.M., pt. 5.14.5.1 (May 23, 2014).

- (5) Liens: Historically, the IRS filed a lien when a balance was owed to the IRS. Under the Fresh Start Program, a lien determination is not required for a streamlined installment agreement but may be made at the discretion of the revenue officer and liens may be filed. I.R.M., pt. 5.14.5.2 (Dec. 23, 2015).

c. Guaranteed Installment Agreements:

- (1) Right to Installment Agreement Secured by Statute: I.R.C. § 6159(c) requires the IRS to accept proposals of installment agreements under certain circumstances. In accordance with I.R.C. § 6159(c), the IRS must accept proposals to pay in installments if taxpayers are individuals who:

- (a) Owe income tax only of \$10,000 or less (excluding penalties and interest);
  - (b) Have not failed to file any income tax returns or to pay any tax shown on such returns during any of the preceding five taxable years;
  - (c) Cannot pay the tax immediately (see (2) below);
  - (d) Agree to fully pay the tax liability within 3 years;
  - (e) Agree to file and pay all tax returns during the term of the agreement; and
  - (f) Have not entered into an installment agreement during any of the preceding five taxable years.
- I.R.M., pt. 5.14.5.3 (Dec. 23, 2015).

- (2) Full Payment Inconsequential: As a matter of policy, the IRS grants guaranteed agreements even if taxpayers are able to fully pay their accounts. I.R.M., pt. 5.14.5.3 (Dec. 23, 2015).

- (3) Financial Information Unnecessary: A Form 433-A or 433-B is not required for guaranteed installment agreements. I.R.M., pt. 5.14.5.1 (May 23, 2014).

d. In-Business Trust Fund Express Agreements:

- (1) Qualification: In-business trust fund express installment agreements may be granted if the aggregate unpaid balance of assessments (*i.e.*, the Summary Balance) is \$25,000 or less. I.R.M., pt. 5.14.5.4 (Dec. 23, 2015).

- (a) The unpaid balance of assessments includes tax, assessed penalty and interest, and all other assessments on the tax modules. It does not include accrued penalty and interest. I.R.M., pt. 5.14.5.4 (Dec. 23, 2015).

- (2) Limitations: In-business trust fund express installment agreements may not be granted where the first payment on the agreement is a lump sum payment to be made in order

to pay down the balance to meet the \$25,000 criteria. That is, taxpayers must meet the dollar criteria at the time the in-business trust fund express installment agreement is granted. However, taxpayers with a liability greater than \$25,000, can be considered for an in-business trust fund express installment agreements if they pay down the liability to \$25,000 or less prior to the agreement being granted. I.R.M., pt. 5.14.5.4 (Dec. 23, 2015).

- (3) Full Payment Required Within 24 Months: Taxes must be fully paid in 24 months, or before the collection statute expiration date, whichever is earlier. I.R.M., pt. 5.14.5.4 (Dec. 23, 2015).
- (4) Field Visit and Financial Statement Not Required: If the taxpayer qualifies for an in-business trust fund express installment agreement, then neither a field visit nor a financial statement is required. I.R.M., pt. 5.14.5.4 (Dec. 23, 2015).
- (5) Lien Filing: Per I.R.M., pt. 5.12.2.3.1 (Oct. 14, 2013), a lien notice filing determination decision is not required for in-business trust fund express agreements. If the case cannot be closed as an in-business trust fund express installment agreement on or before the lien notice filing determination requirement date, a lien notice filing determination decision must be made based on the facts of the case. The revenue officer has the latitude to make a non-filing deferral determination decision then finish the negotiation and grant the in-business trust fund express installment agreement. Liens may be filed if they will protect the government's interests, such as whether the entity has defaulted on an installment agreement in the current year or prior calendar year periods. I.R.M., pt. 5.14.5.4 (Dec. 23, 2015).
- (6) TFRP Determinations: If the taxpayer qualifies for an in-business trust fund express installment agreement, then a TFRP determination is not required if:
  - (a) The unpaid balance of assessment is \$25,000 or less;
  - (b) The outstanding liabilities only include current year or prior calendar year periods; and
  - (c) The entire liability will be paid in 24 months. I.R.M., pt. 5.14.5.4 (Dec. 23, 2015).

e. Recent Developments:

- (1) Streamlined Processing of Installment Agreements: The IRS is continuing to test expanded criteria for streamlined processing of taxpayer requests for installment agreements. The test which was scheduled to run through September 30,

2017 has been extended to run through September 30, 2018.

- (2) The IRS’s SBSE collection division will test new streamlined processing criteria as follows:
- (a) For individual taxpayers who have filed all required returns and have an assessed balance of tax, penalties and interest of \$50,000 or less:

<b><u>Current Streamlined Criteria</u></b>	<b><u>Test [Expanded] Criteria</u></b>
<b>Payment Terms</b> Up to 72 months – or – the number of months necessary to satisfy the liability in full by the Collection Statute Expiration date, whichever is less	<b>Payment Terms</b> None. This criteria is unchanged.
<b>Collection Information Statement</b> Verification of ability to pay required in event of an earlier default for assessed balances of \$25,001 to \$50,000	<b>Collection Information Statement</b> Not required.
<b>Payment Method</b> Direct debit payments or payroll deduction required for assessed balances of \$25,001 to \$50,000	<b>Payment Method</b> Direct debit payments or payroll deduction is preferred, but not required.
<b>NFTL</b>  Determination not required for assessed balances up to \$25,000.  Determination is not required for assessed balances of \$25,001 - \$50,000 with mandatory use of direct debit or payroll deduction agreement.  Note: If taxpayer does not agree to direct debit or payroll deduction, then they do not qualify for Streamlined Installment Agreement over \$25,000.	<b>NFTL</b> No change in criteria for assessed balances up to \$25,000. Determination is not required for assessed balances of \$25,001 - \$50,000 with the use of direct debit or payroll deduction agreement. Note: If taxpayer does not agree to direct debit or payroll deduction, then they do qualify for Streamlined Installment Agreement over \$25,000, but a NFTL determination will be made.

See IRS, *Streamlined Processing of Installment Agreements*, <https://www.irs.gov/businesses/small-businesses-self-employed/streamlined-processing-of-installment-agreements> (last visited Aug. 9, 2018).

- (b) For individual taxpayers who have filed all required returns and have an assessed balance of tax, penalties and interest between \$50,001 and \$100,000:

<b><u>Current Criteria</u></b>	<b><u>Test [Expanded] Criteria</u></b>
None - Streamlined processing criteria currently does not apply to assessed balances of tax between \$50,001 and \$100,000	<p data-bbox="821 235 1430 411"><b>Payment Terms</b> Up to 84 months – or – the number of months necessary to satisfy the liability in full by the Collection Statute Expiration date, whichever is less</p> <p data-bbox="821 453 1430 558"><b>Collection Information Statement</b> Not required if the taxpayer agrees to make payment by direct debit or payroll deduction</p> <p data-bbox="821 600 1430 777"><b>Payment Method</b> Direct debit payments or payroll deduction is not required; however, if one of these methods is not used, then a Collection Information Statement is required.</p> <p data-bbox="821 819 1430 877"><b>NFTL</b> Determination is required.</p>

See IRS, *Streamlined Processing of Installment Agreements*, <https://www.irs.gov/businesses/small-businesses-self-employed/streamlined-processing-of-installment-agreements> (last visited Aug. 9, 2018).

4. **Currently Not Collectible:**
  - a. **Uncollectible Accounts:** Accounts will be reported as currently not collectible when the taxpayer has no assets or income which are, by law, subject to levy. I.R.M., pt. 1.2.14.1.14 (Nov. 19, 1980).
    - (1) **Assets Exempt From Levy:** Pursuant to I.R.C. § 6334, the following assets are generally exempt from levy:
      - (a) **Wearing apparel and school books:** Such items of wearing apparel and such school books as are necessary for the taxpayer or for members of his family;
      - (b) **Fuel, provisions, furniture, and personal effects:** So much of the fuel, provisions, furniture, and personal effects in the taxpayer’s household, and of the arms for personal use, livestock, and poultry of the taxpayer, as does not exceed \$6,250 in value;
      - (c) **Books and tools of a trade, business, or profession:** So many of the books and tools necessary for the trade, business, or profession of the taxpayer as do not exceed in the aggregate \$3,125 in value.
      - (d) **Unemployment benefits:** Any amount payable to an individual with respect to his or her unemployment,

including any portion thereof payable with respect to dependents, under an unemployment compensation law of the United States, of any State, or of the District of Columbia or of the Commonwealth of Puerto Rico;

- (e) Undelivered Mail: Mail, addressed to any person, which has not been delivered to the addressee.
- (f) Certain annuity and pension payments: Annuity or pension payments under the Railroad Retirement Act, benefits under the Railroad Unemployment Insurance Act, special pension payments received by a person whose name has been entered on the Army, Navy, Air Force, and Coast Guard Medal of Honor roll (38 U.S.C. § 1562), and annuities based on retired or retainer pay under chapter 73 of title 10 of the United States Code.
- (g) Workers' compensation: Any amount payable to an individual as workers' compensation, including any portion thereof payable with respect to dependents, under a workers' compensation law of the United States, any State, the District of Columbia, or the Commonwealth of Puerto Rico.
- (h) Judgments for support of minor children: If the taxpayer is required by judgment of a court of competent jurisdiction, entered prior to the date of levy, to contribute to the support of his minor children, so much of his salary, wages, or other income as is necessary to comply with such judgment.
- (i) Minimum exemption for wages, salary, and other income: Any amount payable to or received by an individual as wages or salary for personal services, or as income derived from other sources, during any period, to the extent that the total of such amounts payable to or received by him during such period does not exceed the applicable exempt amount determined under subsection (d).
- (j) Certain service-connected disability payments: Any amount payable to an individual as a service-connected (within the meaning of section 101(16) of title 38, United States Code) disability benefit under (A) subchapter II, III, IV, V, or VI of chapter 11 of such title 38, or (B) chapter 13, 21, 23, 31, 32, 34, 35, 37, or 39 of such title 38.
- (k) Certain public assistance payments: Any amount payable to an individual as a recipient of public

assistance under (A) title IV or title XVI (relating to supplemental security income for the aged, blind, and disabled) of the Social Security Act, or (B) State or local government public assistance or public welfare programs for which eligibility is determined by a needs or income test.

(l) Assistance under Job Training Partnership Act: Any amount payable to a participant under the Job Training Partnership Act (29 U.S.C. § 1501, et seq.) from funds appropriated pursuant to such Act.

(m) Certain Residences in Certain Cases: Any real property of the taxpayer used as a residence is exempt from levy if the levy amount does not exceed \$5,000.

(1) Court Approval Required: To the extent the IRS seeks to administratively seize a residence, the IRS needs to obtain a court order with respect to the principal residence of:

- (i) The taxpayer;
- (ii) The taxpayer's spouse;
- (iii) The taxpayer's former spouse; or
- (iv) The taxpayer's minor child.

b. Economic Hardship: An account should be declared as currently not collectible if collecting the tax will cause an economic hardship to the taxpayer (*i.e.*, cause him or her to be unable to meet his or her basic living expenses). See I.R.M., pt. 5.16.1.2.9 (Aug. 25, 2014).

c. Defunct Businesses: Accounts may be reported as currently not collectible when an operating business entity cannot pay its back taxes and enforcement cannot be taken because the business has no distrainable accounts receivable or other receipts or equity in assets. I.R.M., pt. 5.16.1.2.7 (Aug. 25, 2014).

5. Bankruptcy: The IRS reports taxes properly discharged in bankruptcy as currently not collectible.

6. Audit Reconsideration:

a. Defined: Audit reconsideration is the process the IRS uses to reevaluate the results of a prior audit if the taxpayer disagrees with the original determination and there is new information that was not considered during the original examination. It is also the process the IRS uses when the taxpayer contests a substitute return determination by filing an original delinquent return or when there is an IRS computational or processing error in assessing the tax. I.R.M., pt. 4.13.1.2 (Dec. 16, 2015).

b. When Granted: The IRS will grant an audit reconsideration request when:

- (1) The taxpayer did not appear for the audit;
- (2) The taxpayer moved and did not receive IRS correspondence; or
- (3) The taxpayer has new documentation that is pertinent to audit the issues presented. I.R.M., pt. 4.13.1.3 (Dec. 16, 2015).

c. When Denied: The IRS will deny an audit reconsideration request when:

- (1) The taxpayer has already been afforded an audit reconsideration request and did not provide any additional information with his/her current request that would change the audit results;
- (2) The assessment was made as a result of a closing agreement entered into under I.R.C. § 7121 using Form 906, *Closing Agreements on Final Determination Covering Specific Matters*, or Form 866, *Agreement as to Final Determination of Tax Liability*, or some combination of the two forms;
- (3) The assessment was made as a result of a compromise under I.R.C. § 7122 because such agreements are final and conclusive;
- (4) The assessment was made as the result of final TEFRA administrative proceedings;
- (5) The assessment was made as a result of the taxpayer entering into an agreement on Form 870-AD, *Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment*;
- (6) The Tax Court has entered a decision that has become final, or a U.S. district court or the United States Court of Federal Claims has rendered a judgment on the merits that has become final; or
- (7) The Tax Court dismissed a case for lack of prosecution. I.R.M., pt. 4.13.1.8 (Dec. 16, 2015).

d. Criteria for Reconsideration: To request the audit reconsideration, the following items must be present:

- (1) The taxpayer filed the tax return for the disputed item;
- (2) The assessment remains unpaid or the IRS reserved credits that the taxpayer is disputing;
- (3) The taxpayer must identify the adjustments that are in dispute;
- (4) The taxpayer must provide new information that was not considered during the original audit; and
- (5) There was a computational or processing error in assessing the tax.

D. Passport Revocation

1. Background: On December 4, 2015, Congress granted to the Service

authority to deny, revoke, or limit the passport of any person who the Service certifies has a seriously delinquent tax debt (*i.e.*, an assessed tax greater than \$50,000 with respect to which formal collection action has been taken). See Fixing America’s Surface Transportation Act (sometimes, “FAST Act”), Pub. L. No. 114-94, § 32101. Included in the FAST Act is a provision which allows for judicial review of the Service’s certification that a person’s passport should be denied, revoked, or limited.

2. Statute: This provision, which is now codified in I.R.C. § 7345(e) provides as follows:

(e) JUDICIAL REVIEW OF CERTIFICATION.—

(1) IN GENERAL.—After the Commissioner notifies an individual under subsection (d), the taxpayer may bring a civil action against the United States in a district court of the United States or the Tax Court to determine whether the certification was erroneous or whether the Commissioner has failed to reverse the certification.

(2) DETERMINATION.—If the court determines that such certification was erroneous, then the court may order the Secretary to notify the Secretary of State that such certification was erroneous.

3. Certification Actions (Tax Court Rules 351 Through 354): The Tax Court proposed rules concerning I.R.C. § 7345(e) at Tax Court Rules 351 through 354. See Press Release, Tax Court, *Interim Amendments to the Tax Court Rules of Practice and Procedure Relating to the Bipartisan Budget Act of 2015, the Fixing America’s Surface Transportation Act, and the Protecting Americans From Tax Hikes Act of 2015* (Mar. 28, 2016), available at <http://www.ustaxcourt.gov/press/032816.pdf>.

4. Commencement of Action (Tax Court Rule 351): A certification action under I.R.C. § 7345(e) is commenced in the Tax Court by filing with the Court a petition entitled “Petition for Certification or Failure to Reverse Certification Action Under Code Section 7345(e)”. The requirements of such a petition are set forth in proposed Tax Court Rule 351. See Press Release, Tax Court, *Interim Amendments to the Tax Court Rules of Practice and Procedure Relating to the Bipartisan Budget Act of 2015, the Fixing America’s Surface Transportation Act, and the Protecting Americans From Tax Hikes Act of 2015* (Mar. 28, 2016), available at <http://www.ustaxcourt.gov/press/032816.pdf>.

a. Time Within Which to File Unclear: Neither I.R.C. § 7345(e) nor the Tax Court’s recently proposed rules set forth the time within which a certification action must be commenced. Treasury Regulations have not yet been issued on the topic, but when such regulations are issued, they will hopefully address this issue

(among others).

E. Private Debt Collection

1. Background: On December 4, 2015, Congress amended I.R.C. § 6306 to require the IRS to collect certain inactive tax receivables pursuant to “qualified tax collection contracts”. See FAST Act, Pub. L. No. 114-94, § 32102.
2. The Statute: I.R.C. § 6306, entitled “Qualified tax collection contracts, now provides, in pertinent part, as follows:

(a) In general

Nothing in any provision of law shall be construed to prevent the Secretary from entering into a qualified tax collection contract.

(b) Qualified tax collection contract. For purposes of this section, the term “qualified tax collection contract” means any contract which—

- (1) is for the services of any person (other than an officer or employee of the Treasury Department)—
  - (A) to locate and contact any taxpayer specified by the Secretary,
  - (B) to request full payment from such taxpayer of an amount of Federal tax specified by the Secretary and, if such request cannot be met by the taxpayer, to offer the taxpayer an installment agreement providing for full payment of such amount during a period not to exceed 5 years, and
  - (C) to obtain financial information specified by the Secretary with respect to such taxpayer,
- (2) prohibits each person providing such services under such contract from committing any act or omission which employees of the Internal Revenue Service are prohibited from committing in the performance of similar services,
- (3) prohibits subcontractors from—
  - (A) having contacts with taxpayers,
  - (B) providing quality assurance services, and
  - (C) composing debt collection notices, and
- (4) permits subcontractors to perform other services only with the approval of the Secretary.

(c) Collection of inactive tax receivables

(1) In general

Notwithstanding any other provision of law, the Secretary shall enter into one or more qualified tax collection contracts for the collection of all outstanding inactive tax receivables.

(2) Inactive tax receivables. For purposes of this section—

(A) In general. The term “inactive tax receivable” means any tax receivable if—

- (i) at any time after assessment, the Internal Revenue Service removes such receivable from the active inventory for lack of resources or inability to locate the taxpayer,
- (ii) more than  $\frac{1}{3}$  of the period of the applicable statute of limitation has lapsed and such receivable has not been assigned for collection to any employee of the Internal Revenue Service, or
- (iii) in the case of a receivable which has been assigned for collection, more than 365 days have passed without interaction with the taxpayer or a third party for purposes of furthering the collection of such receivable.

(B) Tax receivable

The term “tax receivable” means any outstanding assessment which the Internal Revenue Service includes in potentially collectible inventory.

(d) Certain tax receivables not eligible for collection under qualified tax collections contracts. A tax receivable shall not be eligible for collection pursuant to a qualified tax collection contract if such receivable—

- (1) is subject to a pending or active offer-in-compromise or installment agreement,
- (2) is classified as an innocent spouse case,
- (3) involves a taxpayer identified by the Secretary as being—

- (A) deceased,
  - (B) under the age of 18,
  - (C) in a designated combat zone, or
  - (D) a victim of tax-related identity theft,
- (4) is currently under examination, litigation, criminal investigation, or levy, or
- (5) is currently subject to a proper exercise of a right of appeal under this title.
3. Expected Launch Date: The IRS began a private collection of certain overdue federal tax debts. IRS, *Private Debt Collection*, <https://www.irs.gov/businesses/small-businesses-self-employed/private-debt-collection> (last visited Aug. 9, 2018).
4. Contractors Selected: The IRS assigned these cases to the following private collection agencies:
- a. Conserve, Fairport, New York;
  - b. Pioneer, Horseheads, New York;
  - c. Performant, Pleasanton, California; and
  - d. CBE Group, Waterloo, Iowa. Id.
5. Taxpayer Rights Protected? As a condition of receiving a contract, these agencies must respect taxpayer rights including, among other things, abiding by the consumer protection provisions of the Fair Debt Collection Practices Act. Id.
6. What to Expect:
- a. Stale Debts: The private collection agencies will work on accounts where taxpayers owe money to the government, but the IRS is no longer actively working the case. Several factors contribute to the IRS assigning these so-called stale debts to private collection agencies, including older, overdue tax accounts or lack of resources preventing the IRS from working the cases. Id.
  - b. Cases That Will Not Be Transferred to the Collection Agency: The following accounts will not be transferred to the collection agency:
    - (1) Deceased taxpayers;
    - (2) Taxpayers under 18 years of age;
    - (3) Taxpayers in designated combat zones;
    - (4) Victims of tax-related identity theft;
    - (5) Taxpayers currently under civil examination, litigation, criminal investigation, or levy;
    - (6) Taxpayers with pending or active offers in compromise;

- (7) Taxpayers with installment agreements;
  - (8) Taxpayers who have a right to appeal their tax cases;
  - (9) Taxpayers whose cases are classified as innocent spouse cases; and
  - (10) Taxpayers in presidentially declared disaster areas who are requesting relief from collection. I.R.C. § 6306(d).
- c. Notices: The IRS will give taxpayers and their representative written notice that the accounts are being transferred to the private collection agency. The agency will send a second, separate letter to the taxpayer and their representative confirming this transfer. IRS, *Private Debt Collection*, <https://www.irs.gov/businesses/small-businesses-self-employed/private-debt-collection> (last visited Aug. 9, 2018).
- d. Challenging Liabilities and Submitting Collection Alternatives: The details of what happens when a taxpayer wants to challenge a liability or submit a collection alternative have not yet been detailed, but details should be coming soon.
7. The Teachings of New Jersey Private Tax Debt Collection: The New Jersey Division of Taxation has long-used Pioneer to collect underpaid and unfiled State taxes. In New Jersey, the process works as follows:
- a. Process: The collection process with Pioneer currently works as follows:
    - (1) The collection agency will review the debt and assign the account to a caseworker;
    - (2) The caseworker then mails an initial contact letter along with an updated Schedule of Liabilities (the New Jersey-equivalent of an account transcript) detailing the current balance due;
    - (3) The collection agency attempts to contact the taxpayer in an effort to resolve the matter;
      - (a) Note: Although the Division of Taxation states that the collection agency observes powers of attorney on file with the tax authority, this is rarely the case, and instead, the collection agency usually contacts the taxpayer direct.
    - (4) If the debt remains unresolved after 30 days, the collection agency will issue a “Notice of Demand for Payment” via certified mail. This official notification allows taxpayers either 30 days (for deficient items) or 90 days (for delinquent items) to resolve the issue. It is important that taxpayers with delinquent returns be aware that penalty and fees are assessed on delinquencies that are higher than if a return was filed timely.
    - (5) If the debt is still outstanding, a Certificate of Debt (“COD”, which is the New Jersey-equivalent of a NFTL filing) is entered with the Clerk of the New Jersey Superior

Court. In New Jersey, a COD has the same force and effect as a docketed judgment adjudicated in any court of law.

- (a) If a COD is issued for the outstanding liability, a cost of collection fee is added to the docketed judgment and becomes part of the outstanding liability. Not surprisingly, this causes the collection agency to move towards issuance of the COD more quickly than the IRS moves to issue the NFTL.
  - (6) Once the COD is in place, the case is returned to the tax authority for further collection action.
  - (7) All cases with CODs are assessed a cost of collection, which is in addition to the recovery fee. State of New Jersey, *The Collection Process*, <https://www.state.nj.us/treasury/taxation/collectionprocess.shtml> (last visited Aug. 9, 2018).
- b. Referral Cost Recovery Fee: In New Jersey, the collection agency is entitled to a recovery fee rate of 10.7%. *Id.* The recovery fee to which the collection agency would be entitled under federal law has not yet been fixed.
- c. Observations: Pioneer is effective at its job. Deadlines are short, cases are closed fast, and there is not much flexibility in approach. Practitioners will need to get used to a less kind, less gentle, and less informed tax collection agency.
- (1) Private Causes of Action: The Fair Debt Collection Practices Act applies to private collectors, which means that taxpayers can within one year of the violation bring suit against the collection agency in an appropriate U.S. district court. *See* 15 U.S.C. § 1692k(d) (“An action to enforce any liability created by this subchapter may be brought in any appropriate United States district court without regard to the amount in controversy, or in any other court of competent jurisdiction, within one year from the date on which the violation occurs.”)
  - (2) Complaints to TIGTA: The IRS advises that, to make a complaint about a private collection agency or report misconduct by its employee, call the TIGTA hotline at (800) 366-4484, visit [www.tigta.gov](http://www.tigta.gov), or write to:

Treasury Inspector General for Tax Administration  
Hotline  
Post Office Box 589  
Ben Franklin Station  
Washington, DC 20044-0589

## II. Administrative & Judicial Review – Appeals & the Tax Court

### A. Administrative Review in Collection Cases

1. CDP Rights Generally: In addition to issuing the notice and demand for payment (discussed above), the Commissioner must also notify the affected taxpayer in writing of his or her right to a hearing with an impartial officer of the IRS Office of Appeals (“Appeals”) either:
  - a. Before the Commissioner may pursue collection by levy, or
  - b. Within five business days after the date of the filing of a NFTL filing. See I.R.C. §§ 6320(a) and (b) (relating to liens) and 6330(a), (b) (relating to levies).
2. Final CDP Notices & Administrative Appeal Rights: The Commissioner typically advises taxpayers of the IRS’s intended collection efforts by sending to the affected taxpayer, with respect to a lien filing, the Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC 6320, or with respect to a proposed levy, a Final Notice of Intent to Levy and Notice of Your Right to a Hearing.
  - a. Notices Which Trigger CDP Rights: A CDP hearing may be requested in response to any of the following notices:
    - (1) “Notice of Federal Tax Lien Filing and Your Right to a Hearing Under IRC § 6320”;
    - (2) “Notice of Intent to Levy and Notice of Your Right to a Hearing”;
    - (3) “Notice of Jeopardy Levy and Right of Appeal”;
    - (4) “Notice of Levy on Your State Tax Refund - Notice of Your Right to a Hearing”;
    - (5) “Final Notice, Notice of Levy and Notice of Your Right to a Hearing” (collectively, sometimes, “Final Notices”).
  - b. One Hearing Per Period: I.R.C. §§ 6320 and 6330 provide for one hearing per type of tax and tax period for the tax debt listed on the Final Notices.
    - (1) Multiple NFTLs or Proposed Levy Notices: The right to request a CDP hearing applies to the first NFTL filed or the first proposed levy notice issued for a particular tax debt.
  - c. Coordination of Collection Review: To the extent practical, a CDP lien hearing will be held in conjunction with a CDP levy hearing whenever a NFTL and proposed levy notice are issued.
3. The Form 12153:
  - a. Exercising CDP Rights: A taxpayer invokes his or her rights to receive a CDP hearing by filing with the IRS no later than 30 days after the date of the final notice a Form 12153, *Request for a Collection Due Process or Equivalent Hearing*, with the IRS office and address as directed on the CDP notice.
    - (1) Importance of the Form 12153: It is important to fully develop the Form 12153 vis-à-vis an attachment and supporting documents. Even if the issues raised in the Form 12153 are not discussed during the CDP hearing (as

sometimes occurs), if the matters are in the Form 12153, Appeals should consider those items when issuing its determination as to whether the IRS's collection action is sustained.

(2) Items to Include With Form 12153 Package: The Form 12153 package should be sent by certified mail or fax and include the following items:

- (a) Cover letter;
- (b) Complete Form 12153 (may be signed by an authorized representative pursuant to a Form 2848);
- (c) A copy of the Form 2848; and
- (d) An attachment to the Form 12153 that should include, but is not limited to, the following items:
  - (1) A request for a face-to-face transcribed conference request at the local IRS Appeals Office pursuant to I.R.C. §§ 6330 and 7521 (more on I.R.C. § 7521 below);
  - (2) A request for *de novo* review of the tax, penalty and interest, if applicable;
  - (3) A request that Appeals verify that the applicable requirements of law have been met, including but not limited to:
    - (i) Record of assessment (I.R.C. § 6203);
    - (ii) Issuance of a notice of deficiency if the assessment is for more than the tax shown on the return (I.R.C. § 6212);
    - (iii) Notice and demand of payment (I.R.C. §§ 6303, 6321, 6331(a));
    - (iv) SOL on assessment has not expired (I.R.C. § 6501);
    - (v) SOL on collection has not expired (I.R.C. § 6502);
    - (vi) Document demonstrating compliance with I.R.C. § 6751(b)(1) if a non-automatic penalty is to be collected; and
    - (vii) Verification of contacts required by I.R.C. § 6404(g) for non-suspension of interest.
  - (4) A request for penalty abatement request, if applicable;
  - (5) A statement of relevant background facts;
  - (6) A statement of all pertinent and potential issues;

- (7) A request for the right to amend the request;
- (8) A request for the right to supplement the CDP request;
- (9) A request for no ex-parte communication between IRS employees working on the same or related cases unless it is beneficial for resolution of the case to allow such ex parte communications; and
- (10) If applicable, the taxpayer's proposed collection alternative(s).

Attached as **Appendix A** is a sample attachment to a Form 12153.

- (3) Equivalent Hearings Allowed: A taxpayer who fails to make a timely request for a CDP hearing may request an equivalent hearing with Appeals. But, the determination by Appeals in connection with the equivalent hearing is NOT subject to Tax Court review.
- b. Supplementing the Form 12153: As the window in which to file a Form 12153 is a relatively short 30-day window, practitioners may want to supplement the Form 12153 as new facts are discovered. It is okay to supplement the Form 12153, and as noted above, it is generally advisable to reserve the right to supplement the Form 12153 when it is first submitted to Appeals. The Supplement may include:
  - (1) Additional facts and arguments Appeals should consider;
  - (2) Proof of compliance with payment and filing obligations;
  - (3) Requests for penalty abatements or audit reconsideration, as appropriate;
  - (4) The collection information statement (*i.e.*, the Form 433-A or Form 433-B, as appropriate); and
  - (5) Forms required to obtain collection alternatives (*e.g.*, Form 9465, *Installment Agreement Request* (for installment agreement requests), Form 656 (for OIC requests), and Form 8857, *Request for Innocent Spouse Relief* (for innocent spouse requests)).
- 4. Securing Face-to-Face Hearings in a Resource-Challenged Environment:
  - a. Elimination of Face-to-Face Conferences? The extent to which a taxpayer is entitled to a face-to-face conference in connection with a CDP hearing has long been the subject of debate. On October 1, 2016, the IRS amended the I.R.M. to instruct AOs and SOs: "[e]xcept as set forth below, hold conferences by telephone." I.R.M., pt. 8.6.1.4.1 (Oct. 1, 2016).
    - (1) The Issue With Eliminating Face-to-Face Conferences: Face-to-face conferences contribute to amicable resolution

of many tax cases, especially CDP cases. The elimination of face-to-face conferences is troubling for many reasons which are outside the scope of this Outline. That said, we reject the premise that Appeals can unilaterally eliminate face-to-face conferences, provided that the request is made under I.R.C. § 7521.

- b. Using I.R.C. § 7521 to Force Face-to-Face Conferences:
- (1) Taxpayers' Right to Record: Under the plain language of I.R.C. § 7521, first enacted with the original Taxpayer Bill of Rights as part of the Technical and Miscellaneous Revenue Act of 1988, any IRS officer or employee “in connection with any in-person interview with any taxpayer relating to the determination or collection of any tax” must allow the taxpayer to audio record an interview if the taxpayer requests it in advance, pays for it, and supplies the equipment. I.R.C. § 7521(a)(1).
  - (2) IRS's Right to Record: IRS officers or employees may also record any such interview with advanced notice to the taxpayer, and if they provide the taxpayer a transcript or copy of the recording upon the taxpayer's request. (The taxpayer would pay for his or her personal copy of the IRS's recording or transcript.) I.R.C. § 7521(a)(2).
  - (3) When Granted: Requests to record an in-person interview will be granted by the IRS under the following conditions:
    - (a) The taxpayer or representative supplies the equipment;
    - (b) The IRS may produce its own recording;
    - (c) The recording takes place in a “suitable location, ordinarily in an Internal Revenue Service office where equipment is available to produce the Service's recording”; and
    - (d) All non-IRS participants consent to the recording, and they identify themselves and their roles in the proceeding. Notice 89-51, 1989-1 CB 691.
  - (4) How to Request: A taxpayer or tax representative must request a recording in writing addressed to the IRS employee conducting the interview, who must receive it at least ten days prior to the interview date. If such notice is not given, the IRS may use its discretion to conduct the interview or schedule a new date. Id.
  - (5) In-Person Interviews Include CDP Hearings: I.R.C. § 7521 applies to not only in-person interviews with the examination division, but also to face-to-face Appeals hearings. Keene v. Commissioner, 121 T.C. 8 (2003); I.R.M., pt. 8.6.1.5.2 (Oct. 1, 2016).
    - (a) Keene v. Commissioner: In the landmark case of

Keene v. Commissioner, 121 T.C. 8 (2003), the Tax Court held that a taxpayer who declined to participate in a CDP hearing because the Appeals Officer refused to let him record the hearing was denied due process rights.<sup>4</sup> The majority of the Tax Court decided on several grounds that Appeals conferences could be recorded or transcribed. First, the Court determined that language in Notice 89-51, 1989-1 C.B. 691, and internal memorandum<sup>5</sup> which deliberately excluded Appeals hearings as “interviews” was invalid; “hearing” and an “interview” were basically synonymous, and any other interpretation would lead to an anomalous result. Keene, 121 T.C. at 16-18.

(1) Benefits of Transcribed Hearings in CDP Cases: In his concurring opinion in Keene, Judge Vasquez aptly described the benefits of a transcribed CDP hearing as follows:

Having a transcript of the section 6330 hearing will allow us to perform better the review provided to taxpayer by section 6330(d). Until now, in order to determine what issues taxpayers raised at the Section 6330 hearing, the Court was faced with “he said-she said” situations—needless “credibility contests” between the taxpayer and the Appeals Officer. [Keene, 121 T.C. at 23 (J. Vasquez, concurring).]

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<sup>4</sup> Note that the taxpayer in Keene raised all frivolous arguments in his request for a CDP hearing. The general consensus in case law, the Treasury Regulations, and I.R.M. directives post-Keene is that AOs need not grant face-to-face conferences for “taxpayers who only raise frivolous issues and/or arguments, or other issues such as those concerning moral, constitutional, religious, conscientious, political, or similar grounds.” I.R.M., pt. 8.6.1.5(2) (Oct. 1, 2016). Because the taxpayer must raise all issues before the hearing, the I.R.M. implies that Appeals will determine whether it deems an issue frivolous before a face-to-face hearing can be scheduled. I.R.M., pt. 8.6.1.5(2), (3), Note (Oct. 1, 2016); see also Treas. Reg. § 301.6330-1(d)(2), Q&A-D8 (“A face-to-face CDP conference concerning a taxpayer’s underlying liability will not be granted if the request for a hearing or other taxpayer communication indicates that the taxpayer wishes only to raise irrelevant or frivolous issues concerning that liability.”). According to the I.R.M., taxpayers who are denied a face-to-face hearing because their issues are deemed frivolous “are allowed an opportunity to raise specific relevant issues in response to the Appeals letter advising them they do not qualify for a face-to-face conference.” I.R.M., pt. 8.6.1.5(3) (Oct. 1, 2016). If the taxpayer succeeds to raise such specific relevant issues before the Appeals conference, but discusses only frivolous issues during a face-to-face conference, the Appeals officer may terminate the conference. I.R.M., pt. 8.6.1.5.1(2) (Oct. 1, 2016). Indeed, the IRS’s policy is now that frivolous arguments may not be audio recorded. I.R.M., pt. 8.6.1.5.2(3) (Oct. 1, 2016). See also Le Doux v. United States, 375 F. Supp.2d 1242 (D.N.M. 2005) (ruling that the IRS’s refusal to let a taxpayer raising frivolous arguments record a CDP hearing constituted “harmless error”).

<sup>5</sup> For full text of the 2002 memorandum, see Keene, 121 T.C. at 12-13.

- (b) What Must Be Done to Obtain the Face-to-Face Conference: Pursuant to the I.R.M., a taxpayer who wishes for a stenographic record of a CDP hearing, in addition to notifying the IRS ten days in advance, must also otherwise qualify for a face-to-face conference, and must work with a court reporter who is either qualified to take depositions for a U.S. district court or who is licensed or certified by any State to be a court reporter or to take depositions. I.R.M., pt. 8.6.1.5.2 (Oct. 1, 2016).

5. Collection Forms With Which Practitioners Should Be Familiar:

- a. In General: A number of forms arise with regularity in collection cases. A summary of the forms practitioners are most likely to encounter, and their relevance to the collection process, are discussed below.
- b. Form 433-A: The IRS uses Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, to obtain current financial information to determine how a wage earner or self-employed individual can satisfy an outstanding tax liability. Income from a Schedule C, *Profit or Loss From Business*, should be reported on Form 433-A.
- c. Form 433-B: The IRS uses Form 433-B, *Collection Information Statement for Businesses*, to obtain current financial information with respect to income derived from an active trade or business or with respect to income received from an entity (*e.g.*, from a corporation, partnership, or limited liability company (“LLC”), regardless of whether the LLC has a single member or multiple members).
- d. Form 433-F: The IRS uses Form 433-F, *Collection Information Statement*, to obtain current financial information to determine how a wage earner or self-employed individual can satisfy an outstanding TFRP liability. Form 433-F may be used in lieu of Form 433-A if the individual is a wage earner and the potential TFRP liability is less than \$100,000.
- e. Form 656: Offers in compromise requests are submitted on Form 656, *Offer in Compromise*, using the most current version.
  - (1) The Form 656 Booklet: The Form 656-B (Booklet), *Offer in Compromise*, provides detailed instructions for completing an offer and includes all of the necessary financial forms. When submitting Form 656, unless the taxpayer qualified for the low-income certification or is filing a DATL offer, the taxpayer must include an application fee and the required TIPRA payment (*i.e.*, the payments established in accordance with the Tax Increase and Reconciliation Act of 2005). I.R.M., pt. 5.8.1.13 (May. 5, 2017).

- (2) When Are Financial Statements Required for an Offer: Offers submitted on the basis of DATC or ETA should include a current version of the collection information statement (*i.e.*, Form 433-A (OIC)). For offers based solely on DATL, no collection information statement is required. However, the taxpayer must include a written statement explaining why the liability is incorrect and must include a statement addressing the validity of the actual assessment(s) or a portion of the assessment(s). I.R.M., pt. 5.8.1.13 (May 5, 2017).
- f. Form 656-L: To apply for an offer on the basis of doubt as to liability, a taxpayer should submit Form 656-L, *Doubt as to Liability*.
- g. Form 433-A (OIC): The IRS uses Form 433-A (OIC), *Collection Information Statement for Wage Earners and Self-Employed Individuals*, to obtain current financial information for wage earners and self-employed individuals to determine a taxpayer's reasonable collection potential and to compute the minimum offer amount that the IRS would accept in connection with an OIC. Income from a Schedule C should be reported on Form 433-A.
- h. Form 433-B (OIC): The IRS uses Form 433-B (OIC), *Collection Information Statement for Businesses*, to obtain current financial information with respect to businesses or entities (*e.g.*, from a corporation, partnership, or LLC of any type). The IRS uses the Form 433-B (OIC) to determine a taxpayer's reasonable collection potential and to compute the minimum offer amount that the IRS would accept in connection with an OIC.
- i. Form 8857: The Form 8857, *Request for Innocent Spouse*, is filed to request relief from joint and several liability with respect to a joint tax return.
- j. Form 9465: The Form 9465, *Installment Agreement Request*, is used to request an installment agreement where the taxpayer cannot pay the amount due in one payment, but can pay it over time.
- k. Form 911: The Form 911, *Request for Taxpayer Advocate Service Assistance*, is used to request assistance from the Taxpayer Advocate Service ("TAS") if the taxpayer is facing difficulty with the IRS. The Form 911 is appropriate if:
- (1) The taxpayer's problem with the IRS is causing financial difficulties for the taxpayer, his or her family, or his or her business;
  - (2) The Taxpayer (or his or her business) is facing an immediate threat of adverse action;
  - (3) The Taxpayer has tried repeatedly to contact the IRS, but no one has responded, or the IRS has not responded by the date promised; or

- (4) If an IRS office will not give the taxpayer the help you've requested.

Note: TAS is an incredible resource for taxpayers where the IRS is not doing what it should be doing. TAS is overloaded, and as a practical matter, will sometimes seek to reject cases where there is no economic hardship. However, to the extent there is a violation of the Taxpayer Bill of Rights, explaining that to the case advocate, will often result in TAS interceding on the taxpayer's behalf.

- l. Form 12153: Form 12153, *Request for a Collection Due Process or Equivalent Hearing*, is the form by which a CDP hearing is requested. CDP hearings are discussed *in passim* throughout this outline.
  - m. Form 9423: Form 9423, *Collection Appeal Request*, is the form by which a CAP hearing is requested. CAP hearings are discussed *in passim* throughout this outline.
6. Appeals' Function in CDP Cases:
- a. Appeals Handles CDP Cases: Collection cases are reviewed by the Appeals. This is to say that the Commissioner takes a collection action (as is the case in issuing the NFTL) or proposes to levy property. Then, that collection action is subject to administrative review by Appeals and, if an agreement is not able to be reached and a petition is timely filed, judicial review by the Tax Court. Within Appeals, readers must understand a distinction between to whom their clients cases may be assigned:
    - (1) AOs v. SOs: Within Appeals, there are Appeals Officers ("AOs") and Settlement Officers ("SOs").
    - (2) AOs: AOs have the ability to determine underlying tax liability; SOs generally do not.
    - (3) SOs: SOs usually handle CDP cases where the underlying liability is not at issue.
  - b. The Welcome to Appeals Letter: Once the case is assigned to an officer in Appeals, the assigned officer will send a letter introducing himself or herself, scheduling a CDP conference, and requesting certain documents to support the collection alternative requested.
    - (1) Documents Typically Requested: The documents typically requested include: (1) an amended tax return (if the underlying liability is challenged in connection with a filed tax return for which a notice of deficiency has not been issued); (2) Form 8857, *Request for Innocent Spouse* (if relief from joint and several liability is requested); (3) Forms 433-A and 433-B (Collection Information Statements); and (4) proof of current compliance (*e.g.*, proof that tax filings are current and that current tax

deposits have been made).

- (a) Exception to Current Compliance: If a proposed levy will cause an undue hardship and must be immediately released, the taxpayer is not required to prove compliance as a pre-requisite for a hearing. See Vinatieri v. Commissioner, 133 T.C. 392 (2009).
- (2) What to Do When the Case is Not Assigned to a Local Office: More frequently, despite the request for a face-to-face conference, the IRS is assigning CDP requests to Service Centers for CDP conferences by telephone. The assigned office will be learned in the Welcome to Appeals Letter. In response to the Welcome to Appeals Letters to a Service Center, assuming the practitioner still desires a face-to-face conference, submit a request to have the case transferred to a local Appeals office and renew the request that the CDP conference be recorded. Traditionally, Appeals will transfer the case to a local Appeals office, provided that the Taxpayer is in compliance and has submitted all required documents (*e.g.*, the Form 433-A, Form 433-B, and proof of current compliance). Practitioners should expect resistance from Appeals with respect to these requests in light of the recent changes to the I.R.M. providing the default rule that conferences with Appeals should be held by telephone.

7. The CDP Hearing:

- a. Generally: As noted, I.R.C. §§ 6320(b) (relating to liens) and 6330(b) relating to levies allows a taxpayer to request a hearing with Appeals to review the propriety of the collection action. This hearing is known as a “CDP hearing”.
- b. Preparing the CDP Hearing: It is important to prepare for the CDP hearing by taking the following steps:
  - (1) Explore and Be Prepared to Discuss All Potential Arguments: Any issue not raised during the CDP hearing is waived, so it is important to raise all arguments. See Giamelli v. Commissioner, 129 T.C. 107, 111 (2007).
  - (2) Review All Information About the Taxpayer’s Case:
    - (a) Request updated IRS account transcripts;
    - (b) Review the IRS’ administrative file pursuant to the FOIA Request; and
    - (c) Conduct searches for taxpayer’s assets, liabilities, and background via Google, credit reports, public record searches, lawsuits, liens, etc.
  - (3) Determine and Discuss Which Collection Alternatives Are Being Requested and Which Apply: It is important to fully think through (and discuss during the CDP hearing)

possible collection alternatives:

- (a) Challenges to the underlying liability;
- (b) Offers in compromise;
- (c) Audit reconsideration;
- (d) Innocent spouse;
- (e) Currently not collectible; and
- (f) Installment agreements and full-pay offers.

c. Issues Which May Be Raised During Hearing: CDP hearings allow taxpayers to raise issues relating to the collection of the tax liability, including:

- (1) Appropriateness of the collection action;
- (2) Collection alternatives (*e.g.*, installment agreement, OIC, request for “currently not collectible” status, relief from joint and several liability, and any other item the taxpayer wishes to propose);
- (3) Spouse defenses under I.R.C. § 6015;
- (4) The existence or amount of the underlying liability, but only if the taxpayer did not receive a notice of deficiency or otherwise have an opportunity to dispute the tax (I.R.C. § 6330(c)(2)(B)); and

(a) Refusal of Delivery of Notice of Deficiency: A taxpayer who receives notification from the U.S. Post Office that a notice of deficiency is ready to be picked up, but refuses to collect the notice, had a meaningful opportunity to challenge the underlying tax liability and is not entitled to challenge the notice at the CDP hearing. See Onyango v. Commissioner, 142 T.C. 425 (2014), *aff’d*, 638 Fed. Appx. 5 (D. C. Cir. 2016).

(b) Proving the Notice of Deficiency Was Not Received: Self serving testimony alone is generally insufficient to demonstrate that a notice of deficiency was not received. See Klingenberg v. Commissioner, T.C. Memo. 2012-292, *aff’d* 551 Fed. Appx. 354 (9th Cir. 2014). But, some of the authors have recently had success on this front with credible taxpayers. When challenging receipt of a notice of deficiency, to the extent possible, it is advisable to buttress the witness’ testimony with a lack of records by the IRS (*e.g.*, no proof of certified mailing, notice not issued to the taxpayer’s last known address, or the IRS is unable to produce a copy of the notice of deficiency).

(c) Recent Litigation: For recent litigation concerning the prior opportunity to dispute an underlying liability, see discussion of Keller Tank Servs. II,

Inc. v. Commissioner, 854 F.3d 1178 (10th Cir. 2017), James v. Commissioner, 850 F.3d 160 (4th Cir. 2017), and Flume v. Commissioner, T.C. Memo. 2017-21.

- (5) Any other relevant issue relating to the unpaid tax, the lien, or the proposed levy.
- d. Issues Which May Not Be Raised at the Hearing: Pursuant to I.R.C. § 6330(c)(4), an issue may *not* be raised at the CDP hearing if:
- (1) The issue was raised and considered at a previous hearing under I.R.C. § 6320 (notice and opportunity for hearing upon filing of notice of lien) or in any other previous administrative or judicial proceeding *and* the person seeking to raise the issue participated meaningfully in such hearing or proceeding; or
  - (2) The issue meets the requirements of a “specified frivolous submission” (i.e. based on a position which the IRS has identified as frivolous, or a position which reflects a desire to delay or impede the administration of federal tax laws). See I.R.C. § 6702(b)(2)(A).
- e. Items to be Raised and Considered at Hearing: Where a hearing is requested, either in response to a lien filing or a proposed levy, the Appeals officer must comply with the requirements set forth in I.R.C. § 6330(c). That is, the Appeals officer must:
- (1) Obtain verification from the IRS that the requirements of applicable law or administration procedure were met;
    - (a) Thus, to the extent the IRS did not comply with the applicable law or administrative procedures, then this should be discussed and documented during the CDP hearing.
  - (2) Consider any relevant issue relating to the unpaid tax, the filing of the NFTL or the proposed levy, including but not limited to appropriate spousal defenses, challenges to the appropriateness of the collection actions, and collection alternatives; and
    - (a) As noted, the taxpayer should raise during the hearing all challenges to the underlying liability and all collection alternatives, as well as any other relevant issue the taxpayer wants considered.
  - (3) Consider whether the action taken or proposed balances the government’s need for the efficiency collection of taxes with the taxpayer’s legitimate concern that any collection action be no more intrusive than necessary. See I.R.C. § 6330(c); see also I.R.M., pt. 8.22.9.6.7 (Nov. 13, 2013).
    - (a) As discussed more fully *infra* at Section II.B.3.2, some Appeals officers fail to properly balance these

two competing interests. Practitioners should detail the reasons that the taxpayer's concern that the collection action be no more intrusive than necessary outweighs the government's need to efficiently collect taxes.

8. The Notice of Determination:

a. In General: Following the CDP hearing, Appeals issues its determination by mailing to the taxpayer a notice of determination that sets forth its findings and decision, resolves the tax liability, sustains or rejects the IRS's proposed (or actual) collection action, or accepts or rejects the taxpayer's proposed collection alternative. I.R.C. § 6330(c)(3); Treas. Reg. §§ 301.6320-1(e)(3), Q&A-E8 (relating to liens); 301.6330-1(e)(3), Q&A-E8 (relating to levies). As explained below, the taxpayer is entitled to judicial review of the notice of determination.

b. Items to Be Considered in Issuing the Notice of Determination: I.R.C. § 6330(c)(3) requires an Appeals officer to take into account the following items in making a determination in connection with a CDP case:

(1) Verification from the Secretary that the requirements of applicable law or administration procedure were met;

(a) Requirements of Applicable Law: The requirements of applicable law may include any of the following:

(1) Record of assessment (I.R.C. § 6203);

(2) Issuance of a notice of deficiency if the assessment is for more than the tax shown on the return (I.R.C. § 6212);

(3) Notice and demand of payment (I.R.C. §§ 6303, 6321, 6331(a));

(4) SOL on assessment has not expired (I.R.C. § 6501);

(5) SOL on collection has not expired (I.R.C. § 6502);

(6) Document demonstrating compliance with I.R.C. § 6751(b)(1) if a non-automatic penalty is to be collected; and

(7) Verification of contacts required by I.R.C. § 6404(g) for non-suspension of interest.

(2) Any relevant issue relating to the unpaid tax, the filing of the NFTL or the proposed levy, including but not limited to appropriate spousal defenses, challenges to the appropriateness of the collection actions, and collection alternatives; and

(3) Whether the action taken or proposed balances the government's need for the efficiency collection of taxes

with the taxpayer's legitimate concern that any collection action be no more intrusive than necessary. See I.R.C. § 6330(c)(3).

9. CAP & Equivalent Hearings: A taxpayer who fails to make a timely request for a CDP hearing may request an equivalent hearing with Appeals. But, the determination by Appeals in connection with the equivalent hearing is NOT subject to Tax Court review.

B. Judicial Review in CDP Cases

1. Jurisdiction and Filing the Petition:

- a. Jurisdiction: I.R.C. §§ 6320(c) (relating to liens) and 6330(d)(1) (relating to levies, and by incorporation, to liens) grants the Tax Court jurisdiction to review lien and levy collection actions undertaken by the IRS.

- (1) Purpose of Judicial Review: A lien and levy action seeks judicial review of the Service's determination to proceed with respect to certain collection actions; namely, liens and levies.

- (2) Ability to Restrain: The Tax Court may restrain collection actions where the IRS did not comply with certain procedural due process requirements. I.R.C. § 6330.

- b. Prerequisites to Jurisdiction – The Notice of Determination and the Petition: Following the issuance of the notice of determination, the taxpayers has the right to judicial review of Appeal's determinations provided that the taxpayer *timely*:

- (1) Filed the CDP request;

- (a) What if a taxpayer fails to request a CDP hearing within 30 days because the notice was not sent to the most recent address or was not sent at all?

- (1) The Tax Court has no jurisdiction without a Notice of Determination which comes after a CDP hearing.

- (2) Many Tax Court decisions invalidated levies in such situations before dismissing the case for lack of jurisdiction.

- (3) One recent appellate decision stated that, without jurisdiction, the Tax Court cannot invalidate levies in such cases. See Adolphson v. Comm'r, 842 F.3d 478, 486 (7th Cir. 2016) (citing Boyd v. Commissioner, 451 F.3d 8, 10 (1st Cir. 2006)).

- (4) The Court stated such wronged taxpayers can still sue for a refund in the U.S. Court of Federal Claims and in U.S. District Courts.

and

- (2) Petitions the Tax Court.

- (a) Time for Filing Petition: A taxpayer has 30 days from the date the notice of determination *is placed in the mail* to file a petition.
  - (1) Note: The operative date is not the date of the notice of determination, but the date the notice is placed into the mail. In Weiss v. Commissioner, 147 T.C. 179 (2016), the Tax Court held that when the date appearing on a levy notice is earlier than the date of mailing, the 30-day period to file a Tax Court petition is calculated by reference to the date of mailing, not the date of the notice. This logic easily extends to the 90-day period to file a Tax Court petition in response to a notice of deficiency (though in practice it is less of an issue because of the longer period).
  - (b) Lien Action Petitions: A petition initiating a lien action shall be entitled “Petition for Lien Action Under Section 6320(c)”.
  - (c) Levy Action Petitions: A petition initiating a levy action is to be entitled “Petition for Levy Action Under Section 6330(d). The contents are discussed below.
  - (d) Petition Requirements: The requirements of the respective petitions are set forth in Tax Court Rule 331(b). The contents are discussed below.
- c. Tax Court’s Two-Fold Function in a CDP Case: In Dalton v. Commissioner, 682 F.3d 149 (1st Cir. 2012), the Court of Appeals for the First Circuit reversed the Tax Court and held that the Tax Court’s job is two-fold:
  - (1) To decide whether the IRS’s subsidiary factual and legal determinations are reasonable; and
  - (2) Whether the ultimate outcome of the CDP proceeding constitutes an abuse of the IRS’s wide discretion. In other words, subsidiary legal determination, even if incorrect, will not be an abuse of discretion, if the determination was reasonably reached.
- d. Record Rule: Under the administrative record rule, judicial review of nonliability issues under I.R.C. § 6330 is limited to the administrative record (*i.e.*, the administrative record developed during the agency proceeding). See, e.g., Boulware v. Commissioner, T.C. Memo. 2014-80.
  - (1) Query whether the record rule should necessarily include a transcription of the hearing, which is allowed under I.R.C. § 7521, but not required.

2. Pleadings & Requested Relief:

a. The Petition: As noted, a petition initiating a lien action shall be entitled “Petition for Lien Action Under Section 6320(c)”. A petition initiating a levy action is to be entitled “Petition for Levy Action Under Section 6330(d).” The requirements of the respective petitions are set forth in Tax Court Rule 331(b) and are as follows:

- (1) In the case of a petitioner who is an individual, the petitioner’s name and State of legal residence on the date the petition is filed. In the case of a petitioner that is other than an individual, the petitioner’s name and principal place of business or principal office or agency as of the date the petition is filed;
- (2) The petitioner’s mailing address as of the date of the petition;
- (3) The date of the notice of determination;
- (4) The city and State of the office of the Service which made the determination;
- (5) The amount or amounts and type of underlying tax liability and the year or years or other periods to which the notice of determination relates;
- (6) Clear and concise assignments of each and every error which the petitioner alleges to have been committed by the Service in the notice of determination;
- (7) Clear and concise lettered statements of the facts on which the petitioner bases the assignments of error;
- (8) A prayer setting forth the relief sought by the petitioner;
- (9) The signature, mailing address, and telephone number of each petitioner or each petitioner’s counsel, as well as the counsel’s Tax Court bar number; and
- (10) A COPY OF THE NOTICE OF DETERMINATION.

b. The Answer:

- (1) In General: The Answer is the Service’s responsive pleading, and is required pursuant to Tax Court Rule 36.
- (2) Time to Answer or Move: The Service has 60 days from the date the petition is served within which to file an answer or 45 days from that date within which to move with respect to the petition (*e.g.*, to file a motion to dismiss for lack of jurisdiction). Tax Ct. R. 36(a).
- (3) Form and Content: The answer must be drawn so that it will advise the petitioner and the Court fully of the nature of the Service’s defenses. Tax Ct. R. 36(b). Paragraphs within the answer must be designated to correspond to those of the petition to which they relate. The following general rules apply as to the admission or denial of any matter contained in the answer:

- (a) Admissions and Denials: The answer must contain a specific admission or denial of each material allegation in the petition; but if the Service lacks knowledge or information sufficient to form a belief as to the truth of an allegation, then the Service shall so state, and such statement shall have the effect of a denial.
      - (b) Clear and Concise Statements: The answer must contain a clear and concise statement of every ground, together with the facts in support thereof on which the Commissioner relies and has the burden of proof (*e.g.*, fraud).
    - (4) Effect of Answer: Every material allegation of the petition, not expressly admitted or denied in the answer, is deemed admitted. Tax Ct. R. 36(c).
  - c. Reply: Taxpayers can file a Reply in response to affirmative allegations in the Answer. Affirmative allegations are rarely (if ever) made in a collection case, and as such, we do not discuss the Reply here.
- 3. Standard of Review:
  - a. Standard of Review:
    - (1) Underlying Liability at Issue: Where the validity of an underlying tax liability is properly raised in the taxpayers' CDP hearing, the Court reviews the issue *de novo*. Montgomery v. Commissioner, 122 T.C. 1, 7-10 (2004).
    - (2) Underlying Liability Not at Issue: Where the underlying tax liability is not at issue, and the Court reviews only the appropriateness of the collection action, the standard of review is abuse of discretion.
      - (a) Abuse of Discretion: An abuse of discretion occurs if the Appeals Office exercises its discretion arbitrarily, capriciously, or without sound basis in fact or law. Woodral v. Commissioner, 112 T.C. 19, 23 (1999).
      - (b) Creative Uses of I.R.C. § 7803(a)(3) to Establish an Abuse of Discretion: As noted *supra* at II,G.1., the recent codification of TBOR II through I.R.C. § 7803(a)(3) permits practitioners to argue that Appeals' failure to follow the TBOR II is a violation of the internal revenue laws and a *per se* abuse of discretion. Taxpayers may be able to craft arguments that Appeals abused its discretion in failing to adhere to these rights (*e.g.*, the right to pay no more than the correct of tax and the right to a fair and just tax system).
      - (c) Creative Uses of I.R.C. § 6330(c) to Establish an

Abuse of Discretion: Recall that I.R.C. § 6330(c) requires the Appeals officer to balance the government’s need for the efficiency collection of taxes with the taxpayer’s legitimate concern that any collection action be no more intrusive than necessary. Many Appeals officers are failing to properly balance, if they balance at all, these two factors. Instead, some Appeals officers simply *say* they have balanced the government’s and the taxpayer’s respective interests, but do not cite any specific factors explaining the balancing test performed. Practitioners should evaluate whether the Appeals officer *properly* balanced the two competing interests, and to the extent the Appeals officer did not, to argue that the improper balancing was an abuse of discretion.

- (1) National Taxpayer Advocate’s Concerns: The National Taxpayer Advocate (“NTA”) reported that that “[t]hese issues contribute to the appearance that Appeals is simply ‘rubber stamping’ prior determinations by the Collection function.” 2 NAT’L TAXPAYER ADVOCATE, 2016 Objectives Report to Congress, 66 (2016). In particular, the NTA determined that Appeals often uses *pro forma* or boilerplate statements that the balancing test has been performed yet does not cite any specific factors balanced. Id.
- (2) Proposals for Balancing Test: The NTA proposed the following solution in order to address errors with the balancing test:

To provide the protections that Congress intended, the National Taxpayer Advocate recommends that the Office of Appeals, in collaboration with TAS, formulate a policy statement on the CDP balancing test that reflects congressional intent; develop specific factors for the application of the CDP balancing test based on an analysis of case law and legislative history for use by both Appeals and Collection; revise the IRM to specifically prohibit *pro forma* statements that the balancing test has been performed and instead require a description of which factors were considered and how they apply in the particular taxpayer’s case; integrate any newly developed factors for the application of the CDP balancing test into the Appeals IRM

and train all Appeals Officers, Settlement Officers, and Appeals Account Resolution Specialists on applying the balancing test consistently; incorporate the balancing test analysis into the Collection IRM; and provide necessary training to Collection employees (because if the balancing test were applied at the point of first contact, there would be less rework for TAS and Appeals). [Id.]

4. Scope of Review & the *Chenery* Doctrine:

- a. Underlying Liability at Issue: As noted, where the validity of the tax liability is properly at issue, the standard of review is *de novo*. Montgomery v. Commissioner, 122 T.C. 1 (2004). This means that the Court will consider all relevant evidence introduced at trial. See Hoyle v. Commissioner, 131 T.C. 197 (2008).
- b. Underlying Liability Not at Issue: As noted, where the validity of an underlying tax liability is properly raised in the taxpayers' CDP hearing, the Court reviews the issue *de novo*. Montgomery v. Commissioner, 122 T.C. 1, 7-10 (2004). However, the scope of that review is limited by at least three doctrines.
  - (1) Administrative Record at the Time of the CDP Hearing: The scope of review is limited to the administrative record at the time of the CDP hearing. Giamelli v. Commissioner, 129 T.C. 107 (2007).
    - (a) Exception for Changed Circumstances: There is an exception if there are changed circumstances, in which the Court may remand the case to Appeals to consider the changed circumstances if doing so would be "necessary or productive". See Lunsford v. Commissioner, 117 T.C. 183, 189 (2001); Magana v. Commissioner, 118 T.C. 488 (2002); Churchill v. Commissioner, T.C. Memo. 2011-182.
  - (2) Issues Not Raised During the CDP Hearing Cannot Be Raised: Issues not raised during the CDP hearing cannot be raised by the taxpayer at trial. See Giamelli, 129 T.C. at 107.
  - (3) The *Chenery* Doctrine: Under the *Chenery* doctrine, the IRS should not argue that a determination should be sustained on issues that were not identified in the Notice of Determination. See Antioco v. Commissioner, T.C. Memo. 2013-35. The *Chenery* doctrine provides as follows:

a reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless

to affirm the administrative action by substituting what it considers to be a more adequate or proper basis. To do so would propel the court into the domain which Congress has set aside exclusively for the administrative agency. [SEC v. Chenery, 332 U.S. 194, 196 (1947)]

- (4) Applies in CDP Cases: The *Chenery* doctrine applies in CDP cases. E.g., Meyer v. Commissioner, T.C. Memo. 2013-268, 2013 WL 6169420, at \*9-10 (2013); Antioco v. Commissioner, T.C. Memo. 2013-35, 2013 WL 424787, at \*10 (2013); Jones v. Commissioner, T.C. Memo. 2012-274, 2012 WL 4458210, at \*5-8 (2012); Salahuddin v. Commissioner, T.C. Memo. 2012-141, 2012 WL 1758628, at \*7 (2012).
  - c. How It Arises in Practice: Sometimes, an Appeals officer will fail to consider an issue in a CDP case, and IRS counsel will seek to supplement the administrative record with evidence showing the correctness of the Appeals officer's decision, for example, to sustain a proposed levy or the filing of a NFTL. IRS counsel is generally precluded from doing so under the *Chenery* rule. See, e.g., La. Ass'n of Indep. Producers & Royalty Owners v. F.E.R.C., 958 F.2d 1101, 1123 n.12 (D.C. Cir. 1992) (noting that *Chenery* precludes a court from giving an agency, such as the Service, the benefit of a "post hoc rationale of counsel"); see also Burlington Truck Lines, Inc. v. United States, 371 U.S. 156, 168-169 (1962) ("The courts may not accept ... counsel's post hoc rationalizations for agency action; ... an agency's discretionary order [must] be upheld, if at all, on the same basis articulated in the order by the agency itself").
5. Motion Practice:
- a. The Motion for Summary Judgment:
    - (1) Overview: A motion for summary judgment attempts to bring to a head the legal merits of the case (or a part of the case) on the basis of the pleadings, affidavits, and exhibits, without the need for a trial.
      - (a) Common in CDP Cases: Especially in CDP cases, where the record rule applies, a motion for summary judgment is an appropriate way to dispose of a collection case.
    - (2) Purpose: Summary judgment is a procedure designed to serve judicial economy by avoiding unnecessary and expensive trials of phantom factual questions. Shiosaki v. Commissioner, 61 T.C. 861, 862 (1974).
    - (3) Who May File (Tax Court Rule 121(a)): Either party may move, with or without supporting affidavits or declarations, for a summary adjudication in the moving party's favor

upon all or any part of the legal issues in controversy.

- (4) Time for Filing (Tax Court Rule 121(a)): A motion for summary judgment may be filed at any time commencing 30 days after the pleadings are closed and no later than 60 days before the date the case is calendared for trial. The Court has discretion to allow the filing of a motion for summary judgment after the 60-day deadline.
- (5) Response Will be Required (Tax Court Rule 121(b)): The Court will order a written response.
- (6) When Decision Will be Entered (Tax Court Rule 121(b)): After the motion and response are filed, the Court will render a decision “if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits and declarations, if any, show that there is no genuine dispute as to any material fact and that a decision may be rendered as a matter of law.”
- (7) Partial Summary Judgment Allowed (Tax Court Rule 121(b)): The motion for summary judgment may be filed with respect to one, more than one, or all issues presented in the case.
- (8) Factual Inferences: The facts and inferences drawn therefrom are viewed in the light most favorable to the nonmoving party. See Naftel v. Commissioner, 85 T.C. 527, 529 (1985).
- (9) Opposing Party May Not Rest on Allegations in Pleadings Alone (Tax Court Rule 121(d)): The non-moving party may not simply rest upon the allegations and denials in that party’s pleadings. Instead, the nonmoving party must set forth specific facts showing that there is a genuine issue for trial. Tax Ct. R. 121(d); Dahlstrom v. Commissioner, 85 T.C. 812, 820-821 (1985).

b. The Motion to Remand:

- (1) General: In collection cases, Appeals retains jurisdiction of a case even though judicial review of the collection action is sought in the Tax Court. See I.R.C. § 6330(d)(2).
- (2) Applicability: In collection cases in which the underlying tax liability is not at issue, the Tax Court may make a determination on the basis of the administrative record that the Appeals officer or Settlement officer (collectively, “Appeals officer”) assigned to the taxpayer’s case abused his or her discretion in sustaining a proposed (or actual) collection action. When Appeals has abused its discretion or the taxpayer was not given a proper hearing, the Tax Court will remand the case to Appeals to hold a new hearing if a new hearing is necessary or will be productive.

I.R.M., pt. 35.3.23.7 (Mar. 26, 2015). This type of relief is requested in a Motion to Remand.

- (3) Procedure for the Moving Party: In practice, a Motion to Remand is made much the same way as a Motion for Summary Judgment. The moving party relies upon the administrative record and applicable law to prove that the assigned Appeals officer abused his or her discretion (i.e., acted without a sound basis in fact or law). The Motion to Remand should be supported with a motion, a memorandum of law, and one or more declarations that include all or relevant portions of the administrative record.
- (4) Procedure for the Government Attorney: I.R.M., pt. 35.3.23.7 (Mar. 26, 2015) instructs Government attorneys to proceed as follows on a Motion to Remand:
  - (a) Accordingly, instead of trying to defend an erroneous or insufficient notice of determination at trial, the trial attorney should consider asking the court to remand the case to Appeals for a supplemental determination if:
    - (1) The Appeals officer failed to address a relevant issue;
    - (2) The Appeals officer failed to make necessary findings of fact;
    - (3) The Appeals officer failed to perform an analysis that is necessary in making the determination;
    - (4) The administrative record contains no indication of the documents or evidence the Appeals officer considered in making the determination or the reasons for the determination;
    - (5) The Appeals officer's conduct of the hearing deprived the taxpayer of a procedural right granted by statute or regulation, such as the right to an impartial Appeals officer under I.R.C. §§ 6320(b)(3) or 6330(b)(3); or
    - (6) The Appeals officer did not give the petitioner an adequate opportunity to present evidence or arguments in support of relevant issues raised during the CDP hearing process.
- (5) Time: The Motion to Remand can be made at any time 30 days after the joinder of issues (i.e., the filing of the last responsive pleading) and before trial. Although there is no rule on point, it is generally advisable to file a Motion to Remand at least 60 days before trial, and ideally as early as

possible. Keep in mind that the Service will move for summary judgment in the majority of collection cases.

- (6) Time: The Motion to Remand can be made at any time 30 days after the joinder of issues (i.e., the filing of the last responsive pleading) and before trial. Although there is no rule on point, it is generally advisable to file a Motion to Remand at least 60 days before trial, and ideally as early as possible. Keep in mind that the Service will move for summary judgment in the majority of collection cases.
- (7) Relief Requested: The relief requested in the Motion to Remand is typically as follows: (1) grant the Motion to Remand; (2) strike the case from the calendar (if applicable); (3) continue the case; and (4) remand the case to Appeals to conduct a new (or supplemental) hearing under I.R.C. §§ 6320 and/or 6330 (as the case may be). The Court will provide further instructions to Appeals if you are successful on the Motion to Remand and those deadlines should obviously be adhered to by both the taxpayer and the Service.

6. The Effect of Bankruptcy:

a. Historical Rule for Cases:

- (1) When a bankruptcy petition is filed, an automatic stay is in effect. See 11 U.S.C. 362(a)(8). The stay halts ongoing collection procedures against the debtor, including an ongoing Tax Court case. A case cannot be commenced in the Tax Court while the stay is in effect.
- (2) While the stay is in effect, no Tax Court petition can be filed, whether the deficiency is for a pre-petition or post-petition liability. Halpern v. Commissioner, 96 TC 895 (1991).

b. Recent Developments Concerning Innocent Spouse and Collection Cases:

- (1) Recent Developments: Congress recently amended I.R.C. §§ 6015(e) and 6330(d) to provide that the period for filing a petition for review of a claim for spousal relief or a petition for review of a lien or levy action is suspended during the period that a bankruptcy filing under title 11 of the United States Code prevents a taxpayer from petitioning the Court and for 60 days thereafter. See also Protecting Americans From Tax Hikes Act of 2015, Pub. L. 114-113, § 425, 129 Stat. 2242.
- (2) Effective Date: The effective date for such changes is December 18, 2015.
- (3) Recent Proposed Changes to Tax Court Rules: The Tax Court recently amended Tax Court Rule 13(e) to incorporate the effect of bankruptcy and receivership on

such proceedings. See Press Release, Tax Court, *Interim Amendments to the Tax Court Rules of Practice and Procedure Relating to the Bipartisan Budget Act of 2015, the Fixing America's Surface Transportation Act, and the Protecting Americans From Tax Hikes Act of 2015* (Mar. 28, 2016), available at <http://www.ustaxcourt.gov/press/032816.pdf>.

7. Concurrent Jurisdiction With Appeals: Pursuant to I.R.C. § 6330(d)(3), Appeals retains jurisdiction with respect to any determination made under I.R.C. § 6330, including subsequent hearings requested by the taxpayer or directed by the Tax Court. This means that, even with a docketed Tax Court case, the Tax Court can still remand a case to Appeals for a new or supplemental hearing under I.R.C. § 6330.
8. Changed Circumstance Remands: The Tax Court has the authority to remand CDP cases to Appeals pursuant to I.R.C. § 6330(d). Thus, where an argument can be made that remanding the case to Appeals will be “necessary or productive”, a collection case may be remanded to Appeals.
  - a. The Goal is Orderly and Efficient Disposition of Cases: “Absent limiting statutes, courts generally have the inherent authority to issue such orders as they deem necessary and prudent to achieve the orderly and expeditious disposition of cases.” Churchill v. Commissioner, T.C. Memo. 2011-182 (quoting Williams v. Commissioner, 92 T.C. 920, 932 (1989) (citing Roadway Express, Inc. v. Piper, 447 U.S. 752, 764-765 (1980); Link v. Wabash R.R. Co., 370 U.S. 626, 630-631 (1962))) (internal quotations omitted).
  - b. Necessary or Productive: The Tax Court has the authority to remand this case to Appeals if it believes doing so is “necessary or productive”. Lunsford v. Commissioner, 117 T.C. 183 (2001).

C. Tax Court’s Ability to Restrain Collection in Deficiency Cases

1. Background: Under I.R.C. § 6213(a), the Tax Court may enjoin assessment and collection or may order a refund with respect to taxes for which a timely petition is filed.
2. Motions to Restrain Assessment or Collection: A motion to restrain assessment or collection or to order refund of any amount collected may be filed with the Court where a timely petition has been filed with the Court. Tax Ct. R. 55.
3. Example: Once a petition is filed, premature assessment and/or collection as to that taxable year is prohibited. If the Service seeks to prematurely assess or collect taxes with respect to a year properly before the Court, the taxpayer may move the Court to restrain assessment or collection pursuant to Tax Court Rule 55.
4. Strategy: It is generally advisable, even where a favorable result has been reached in Appeals but a notice of determination is issued, for the taxpayer to file a protective petition so that the Tax Court acquires jurisdiction over the period for which the tax is sought to be collected. This ensures that the taxpayer has an opportunity for judicial review if the Service continues the

collection action despite the agreement reached in Appeals.

D. Tax Court Review of Jeopardy Assessments and Levies:

1. Background: I.R.C. § 7429(b) authorizes the Tax Court to review a jeopardy assessment or jeopardy levy (e.g., an extreme action to prematurely assess or collect taxes if the Service determines that property in question is in jeopardy).
2. Commencement of Review (Tax Court Rule 56(a)): Review of jeopardy assessment or jeopardy levy is commenced by filing a motion with the Court. The petitioner-moving party shall:
  - a. Entitle the document “Motion for Review of Jeopardy Assessment” or “Review of Jeopardy Levy”, as the case may be; and
  - b. Place on the motion the same docket number as that of a then-pending action under I.R.C. § 6213 (deficiency petition).
3. Time for Filing (I.R.C. § 7429(b)(1)): The motion must be filed within 90 days of the earlier of (i) the administrative review determination, or (ii) the 16th day after the request for administrative review.
4. Service of Motion (Tax Court Rule 56(b)): A motion for review of jeopardy assessment or jeopardy levy shall be served by the taxpayer on counsel for the Commissioner.
5. Contents of Motion (Tax Court Rule 56(c)): The motion contains very specific requirements that are set forth in Tax Court Rule 56(c).
6. Response by Commissioner (Tax Court Rule 56(d)): The Commissioner must file a written response to the motion no later than 10 days after the date on which the Court receives the petitioner’s motion.
7. Hearing (Tax Court Rule 56(e)): A hearing will usually be held.

E. Appeals of Tax Court Decisions

1. Appropriate Venue: Recently, Congress changed I.R.C. § 7482(b) to provide that appellate venue for CDP cases is to the United States court of appeals for the circuit in which the taxpayer is, in the case of an individual, a legal resident or, if the petitioner is an individual other than an individual, the principal place of business or principal office or agency. See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, § 423, 129 Stat. 2242.
  - a. Historical Change: Until December 2015, the United States Court of Appeals for the District of Columbia Circuit had exclusive jurisdiction to hear appeals from Tax Court decisions based on CDP hearing final determinations where the underlying liability was not at issue. See Byers v. Commissioner, 740 F.3d 668 (D.C. Cir. 2014).

F. Most Litigated Issue:

1. Recurring Issue: The National Taxpayer Advocate has cited Appeals From Collection Due Process Hearings Under I.R.C. §§ 6320 and 6330 as a Most Litigated Issue in every Annual Report since 2001.
2. Statistics:
  - a. In General: According to the National Taxpayer Advocate’s 2017

Annual Report, there were 85 reported opinions involving appeals from CDP hearings. 1 NAT'L TAXPAYER ADVOCATE, 2017 Annual Report to Congress, 401 (2017).

- b. Success Rate: The Service prevailed in full in 78 of these cases (around 91%), taxpayers prevailed in full in 4 of these cases (around 5%), and split decisions were entered in 3 cases (around 4%). Id.
- c. Statistics Misleading as to the Number of Cases Being Brought: According to the National Taxpayer Advocate's 2017 Annual Report, the average number of published opinions concerning CDP appeals was approximately 200 from 2003 through 2007. Despite the decrease in the number of CDP opinions from around 200 in 2007 to 99 in 2016, the total number of CDP petitions filed with the Tax Court has not declined (and has actually increased).
  - (1) Trends Per the National Taxpayer Advocate: The National Taxpayer Advocate notes as follows regarding this decline in published opinions (as compared to the increase of the overall number of CDP petitions filed):

[T]his decline may seem to be attributed, in part, to a series of operational changes in fiscal years (FYs) 2011 and 2012, collectively known as the "Fresh Start" initiative, which led to fewer NFTL filings and more accepted OICs. However, it is not clear that the reduction in CDP published opinions is attributable to the reduced number of lien filings. Furthermore, the annual number of CDP cases petitioned fluctuated inconsistently over this time.

The increase in CDP cases received suggests that the reduced number of CDP opinions identified may not be the result of fewer taxpayers requesting a CDP hearing and then contesting the CDP determination by filing a Tax Court petition. Instead, it could be the result of more taxpayers deciding not to pursue litigation after filing a petition, more settlements, or more non-precedential CDP orders or bench opinions that do not result in a published opinion. Moreover, the decline in litigated cases may be due to taxpayers litigating many issues of first impression in the years immediately following the enactment of IRC §§ 6320 and 6330, which now have been resolved by the courts. [1 NAT'L TAXPAYER ADVOCATE, 2016 Annual Report to Congress, 445-446 (2016) [Footnotes omitted].]

- (2) Other Explanations: One private practitioner, Carlton M. Smith, offers a different explanation for the reduced number of CDP opinion. Specifically, Mr. has observed as

follows:

I did an order search for orders issued from 1/1/14 to 12/31/14 using the following words: “(summary judgment or remand) and (6330 or 6320).” This search turned up about 300 orders (12 pages of 25 cases per page).

Most of these orders are grants of IRS motions for summary judgment — but with multipage descriptions of (1) the facts, (2) the legal standards for summary judgment (e.g., Florida Peach Corp. v. Commissioner, 90 T.C. 678 (1988)) and CDP review (e.g., Sego v. Commissioner, 114 T.C. 604, 608 (2000)), and (3) application of the law to the stated facts to reach a ruling....

In the vast bulk of the orders, the taxpayer is told that he or she can't challenge the underlying liability (if the taxpayer tried to), and he or she loses on collection alternatives either because the taxpayer (1) is not current on paying and filing, (2) never provided a requested Form 433-A, or (3) never requested a specific collection alternative (i.e., a particular installment agreement or offer in compromise).

Still, in [some of these] rulings, the IRS loses the motion, and, sometimes a remand is ordered.... My hunch is that some of these ordered remands result in settlements so the cases never again return to the judges for a regular ruling. For those of you who are tired of reading CDP T.C. Memo. and T.C. Summary Opinions where the taxpayer loses and so conclude that Tax Court CDP review is a waste of time, I suggest you examine some of these orders where the court directs a remand. [Carlton Smith, Unpublished CDP Orders Dwarf Post-trial Bench Opinions in Uncounted Tax Court Rulings, *Procedurally Taxing* (Jan. 29, 2015), *available at* <http://www.procedurallytaxing.com/unpublished-cdp-orders-dwarf-post-trial-bench-opinions-in-uncounted-tax-court-rulings/>.]

- (3) Are CDP Cases Really On the Decline? On the one hand, the number of published opinions suggests that CDP cases are on the decline, but the number of Orders released on the Tax Court's website suggests that CDP cases are actually on the rise. So what do we make of this? The Service has increasingly been moving for summary judgment in CDP cases, and it is possible that the reduced number of CDP

opinions is a function not of the number of cases being brought, but through published opinions of the Tax Court.

G. Other Recent Developments

1. Codification of TBOR II & Creative Arguments:

- a. Background: In December 15, 2015, Congress codified the Taxpayer Bill of Rights (“TBOR II”). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, § 401, 129 Stat. 2242, 3117 (2015), codified at I.R.C. § 7803(a)(3). As amended, I.R.C. § 7803(a)(3) now provides:

\*\*\*In discharging his duties, the Commissioner shall ensure that employees of the Internal Revenue Service are familiar with and act in accord with taxpayer rights as afforded by other provisions of this title, including—

- (A) the right to be informed,
- (B) the right to quality service,
- (C) the right to pay no more than the correct amount of tax,
- (D) the right to challenge the position of the Internal Revenue Service and be heard,
- (E) the right to appeal a decision of the Internal Revenue Service in an independent forum,
- (F) the right to finality,
- (G) the right to privacy,
- (H) the right to confidentiality,
- (I) the right to retain representation, and
- (J) the right to a fair and just tax system.

- b. Creative Uses of I.R.C. § 7803(a)(3): Practitioners should keep in mind these rights when arguing collection cases administratively and before the Tax Court. To the extent that TBOR II is now part of the internal revenue laws, a violation of TBOR II is a violation of the internal revenue laws (and a *per se* abuse of discretion). Taxpayers may be able to craft arguments that Appeals abused its discretion in failing to adhere to these rights (*e.g.*, the right to pay no more than the correct of tax and the right to a fair and just tax system).

2. Fast Track Mediation Collection: On November 18, 2016, the IRS released Rev. Proc. 2016-57, which created a new fast track mediation program for collection cases, Fast Track Mediation – Collection (“FTMC”).
- a. Applicability: FTMC allows taxpayers with issues concerning OICs and TFRP cases an opportunity to mediate their case with mediator.
  - b. Governing Authority: Appeals and Collection will jointly administer the FTMC program.
  - c. OIC Cases Covered: The revenue procedure contemplates that the following OIC issues will be eligible for FTMC:
    - (1) The value of the taxpayer’s assets, including those held by a third party;
    - (2) The amount of dissipated assets that the IRS should include in the reasonable collection potential calculation;
    - (3) Whether the facts warrant a deviation from the national or local expense standards;
    - (4) Determination of a taxpayer’s proportionate interest in jointly held assets;
    - (5) Projections of future income based on calculations other than current income;
    - (6) The calculation of a taxpayer’s future ability to pay when the taxpayer lives with and shares expenses with a nonliable person;
    - (7) Doubt as to liability cases worked by Collection; and
    - (8) A catch-all provision that uses as an example whether a taxpayer’s contributions to a retirement savings account are discretionary or mandatory.
  - d. TFRP Cases Covered: The revenue procedure contemplates that the following TFRP issues will be eligible for FTMC:
    - (1) Whether the person is a responsible person of the business that failed to pay over the trust fund taxes;
    - (2) Whether the person willfully failed to collect, truthfully account for, and pay over trust fund taxes, or willfully attempted in any manner to evade or defeat the payment of such tax; and
    - (3) Whether the taxpayer properly designated a payment.
  - e. Cases Ineligible for FTMC: The revenue procedure states that the following cases are ineligible for FTMC:
    - (1) Issues requiring assessment of the hazards of litigation or use of the Appeals mediator’s delegated settlement authority;
    - (2) Cases referred to the Department of Justice;
    - (3) Cases worked at an SB/SE Campus site;
    - (4) Collection Appeals Program (CAP) cases;
    - (5) Collection Due Process (CDP) cases;

- (6) Frivolous issues, such as, but not limited to, those identified in Rev. Proc. 2016-2 § 4.04, 2016-1 I.R.B. 102, or any succeeding revenue procedure;
- (7) Collection cases in which the taxpayer has failed to respond to IRS communications or failed to submit documentation to Collection for consideration;
- (8) The following OIC cases:
  - (a) Cases in which the unadjusted financial information submitted by the taxpayer demonstrates the taxpayer has the ability to pay in full, except where an Effective Tax Administration OIC is based on economic hardship and the assessed liability is less than \$250,000.
  - (b) Cases in which the taxpayer declines to amend or increase the offer despite having no specific disagreement with the valuations, figures, or methodology used by Collection in determining the reasonable collection potential;
  - (c) Cases in which the disputed issue is explicitly addressed by IRS guidance or authority, including but not limited to regulations, published guidance, the Internal Revenue Manual, forms or instructions.
  - (d) Cases in which Delegation Order 5-1 requires a level of approval higher than that of the Collection Group Manager;
- (9) Issues for which mediation would be inconsistent with sound tax administration; and
- (10) Issues that have otherwise been identified in subsequent published guidance issued by the IRS as excluded from FTMC.

f. How to Request:

- (1) Full Development of Facts Required: Either the taxpayer or the revenue officer can request FTMC after full development of an issue and before Collection makes its final determination. Participation in the program is optional.
- (2) Form 13369: To request FTMC, a Form 13369 must be signed by both the Collection Group Manager and the taxpayer, or the taxpayer's authorized representative, if applicable (Form 2848 required).
- (3) Written Summaries Required: In addition to the form the taxpayer submits a written summary of their position with respect to the disputed issues and the IRS will submit a written summary as well.
- (4) Case Forwarded to Appeals and Appeals Vested With Discretion as to Whether to Accept the Case: Once the

parties have prepared the form and the statements, Collection sends the package to the appropriate Appeals office. The Appeals office decides whether to accept the case for FTMC. The taxpayer must consent to disclosure of their tax information to participants in the mediation and does this in signing the Form 13369. For additional information, *see* Posting of *Fast Track Mediation for Collection* to Procedurally Taxing blog, <http://procedurallytaxing.com/fast-track-mediation-for-collection/> (Nov. 30, 2016).

3. Significant Cases:

- a. Keller Tank Servs. II, Inc. v. Commissioner, 854 F.3d 1178 (10th Cir. 2017). The Taxpayer argued that the “did not otherwise have an opportunity” language of I.R.C. § 6330(c)(2)(B) applies only to another judicial opportunity, not an administrative opportunity. The Court of Appeals for the Tenth Circuit upheld the Tax Court’s decision denying a taxpayer the opportunity to raise the merits of underlying liability in a CDP case where the taxpayer had the administrative, but not judicial, opportunity to raise the issue prior to the CDP case.
- b. James v. Commissioner, 850 F.3d 160 (4th Cir. 2017). The Taxpayer similarly argued that the “did not otherwise have an opportunity” language of I.R.C. § 6330(c)(2)(B) applies only to another judicial opportunity, not an administrative opportunity. The Court of Appeals for the Fourth Circuit similarly upheld the Tax Court’s decision denying a taxpayer the opportunity to raise the merits of underlying liability in a CDP case where the taxpayer had the administrative, but not judicial, opportunity to raise the issue prior to the CDP case. The Fourth Circuit found the Treasury Regulations as a reasonable interpretation of I.R.C. § 6330(c)(2).
- c. Graev v. Commissioner, 147 T.C. No. 16 (2016). The Tax Court held that I.R.C. § 6751(b)(1), which prohibits the assessment of a penalty not calculated through automatic means, does not apply as a defense to penalties in a deficiency proceeding. The Tax Court stated, however, that its ruling does not “foreclose the possibility that a taxpayer who believes that a penalty has been assessed in violation of sec. 6751(b)(1) might raise this issue in a postassessment collection due process (CDP) proceeding. See secs. 6320(c), 6330(c)(1) (requiring the Appeals officer in a CDP hearing to obtain verification that the requirements of any applicable law or administrative procedure have been met).” 147 T.C. No. 16 n.22 (2016).
  - (1) But see Chai v. Commissioner, 851 F.3d 190, 222 (2d Cir. 2017), where the Court of Appeals for the Second Circuit held: “Because § 6751(b)(1) provides that ‘[n]o penalty...*shall* be assessed’ (emphasis added) unless the

written-approval requirement is satisfied, it would be inappropriate to impose a penalty where § 6751(b)(1) was not satisfied. Read in conjunction with § 7491(c), *the written-approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS's prima facie penalty case.*" [Emphasis supplied.] The Second Circuit ultimately held that the Tax Court in Graev was wrong that I.R.C. § 6751 was a premature defense in a deficiency proceeding (*i.e.*, that such an argument could be raised in a deficiency proceeding as a defense to a penalty).

- d. Weiss v. Commissioner, 147 T.C. 179 (2016). The Tax Court held that when the date appearing on a levy notice is earlier than the date of mailing, the 30-day period to file a Tax Court petition is calculated by reference to the date of mailing, not the date of the notice. This logic easily extends to the 90-day period to file a Tax Court petition in response to a notice of deficiency (though in practice it is less of an issue because of the longer period).
- e. Buczek v. Commissioner, 143 T.C. 301 (2014). Taxpayer raised frivolous arguments in request for CDP hearing, but did not request a collection alternative, or assert inability to pay or raise any other issue. IRS disregarded the hearing. Tax Court upheld and distinguished Thornberry v. Commissioner, 136 T.C. 356 (2011), which stated that the Court could not review portions of CDP hearing requests identified as frivolous under I.R.C. § 6702(b)(2)(A), but could review an Appeals determination that the hearing request was frivolous in its entirety and collection action could proceed. Here, unlike Thornberry, because no legitimate issues were raised, it was as if the hearing never took place (*see* I.R.C. § 6330(g)), so the Court dismissed the case for lack of jurisdiction.
- f. Budish v. Commissioner, T.C. Memo. 2014-239. IRS issued notice of intent to levy on taxpayer, an artist who sells through a wholly owned S Corporation. In the CDP hearing, the taxpayer agreed on a full-pay installment agreement, but the Appeals Officer insisted on filing a NFTL due to the amount of the liability, and because the installment agreement request did not meet the Streamlined, Guaranteed, or In-Business trust fund express criteria. Taxpayer disagreed with the decision to file the NFTL, saying it would damage his business relationships and credit and petitioned the Tax Court when an agreement could not be reached. The Court determined the Appeals Officer misinterpreted and overstated the directives set forth in the I.R.M. regarding filing a lien, that they were directive, not required, and that the I.R.M. also says that revenue officers can defer filing a NFTL if it would impede tax collection. The Court also said that the Appeals Officer failed to

discuss the balancing factors between efficient tax collection and taxpayer's legitimate concern that any collection be no more intrusive than required. The Appeals Officer therefore abused discretion. The case was remanded to Appeals for a supplemental CDP hearing with directions to perform balancing factors.

- g. Gurule v. Commissioner, T.C. Memo. 2015-61. Husband took distributions from 401(k) retirement plan, which he intended to use for a down payment on a house after he was relocated for his job, which he subsequently lost and could not buy a house. Husband and Wife moved back to prior house, which was foreclosed on. Husband took out three loans from his 401(k) plan for expenses and for the Wife's severe and their son's terminal medical conditions. IRS sent Husband and Wife notice proposing adjustments based on the 401(k) distributions. Taxpayers requested a CDP hearing for hardship, submitting an OIC, which was rejected on the grounds that the taxpayers could pay based upon their net realizable equity and future income. Taxpayers appealed to Tax Court, and the case was remanded because the record was insufficient, because (1) there was no record the IRS properly mailed a statutory notice of deficiency; (2) the Court could not determine whether the settlement officer abused her discretion (i.e., the IRS had completely ignored Vinatieri, in that a CDP hearing cannot proceed with a proposed levy action when a taxpayer establishes it would create economic hardship, and the IRS did not cite the I.R.M. section only allowing levying of retirement accounts for flagrant conduct when the taxpayer does not depend on the funds to live); (3) it was unclear whether the settlement officer properly calculated the reasonable collection potential (there may have been material errors—there was evidence that the loans may have been used for necessary living expenses); and (4) it was unclear whether the settlement officer properly considered the taxpayers' special circumstances before rejecting the OIC (Wife's and son's medical conditions).
- h. Ligman v. Commissioner, T.C. Memo. 2015-79. Taxpayer timely requested CDP hearing after receiving notice of intent to levy. Taxpayer's only source of income was his Railroad Retirement Board benefits and offered a PPIA; the Appeals Officer countered, then closed the case when Taxpayer did not immediately respond. Taxpayer appealed for abuse of discretion, saying the benefits were partially levy proof under I.R.C. §§ 6334(a)(6) and 6331(h). The IRS said it could consider the benefits for purpose of determining availability of a collection alternative. The Court agreed with the IRS, stating that Railroad Retirement benefits are similar to Social Security benefits, which are specifically included in the I.R.M.'s calculation of income, despite being partially levy proof, so the Appeals Officer did not abuse discretion in using them to calculate

ability to pay.

- i. Sanfilippo v. Commissioner, T.C. Memo. 2015-15. Decedent taxpayer left Beneficiary interest in a shopping center, of which he already owned part, and forgave a debt he owed to the Estate. For the next five years, the Estate filed extensions to pay the estate tax due to liquidity problems, and eventually the Estate, the Beneficiary and the IRS entered into a three-way security agreement, giving the IRS first priority in a Property owned by the Estate so long as the tax was unpaid. IRS sent a notice of intent to levy the property, and the Estate requested a CDP hearing and submit an OIC. The Property had interest from a potential buyer and the sale funds could satisfy the tax liability in an OIC, and the settlement officer granted CNC status until the Property was sold. When the sale was delayed, the Settlement Officer transferred the case to Appeals, but before he did, a Second Settlement Officer, not well-versed in estate cases, changed the focus of collection to Beneficiary's interest in the shopping center, including the amount which he already owned in the calculation. When the Second Settlement Officer closed the case, the Estate appealed to the Tax Court. The IRS argued the Second Settlement Officer committed "harmless error," but the Court disagreed, because the miscalculation of Beneficiary's interest in the shopping center was instrumental to sustain the levy. The Court also found that the Second Settlement Officer did not even consider the Estate's proposed OIC, or previous discussions between the Beneficiary and the first Settlement Officer. Therefore, the Second Settlement Officer abused his discretion, and the case was remanded to Appeals to consider any collection alternatives the Estate proposed.
- j. Gyorgy v. Commissioner, 779 F.3d 466 (7th Cir. 2015), aff'g T.C. Docket No. 19240-11 (Mar. 25, 2013). Taxpayer did not file returns for seven years, so IRS prepared substitute returns for the first three years and sent notices of deficiency to the address on Taxpayer's most recently filed return over the next four years, as well as a Form 2797 "R-U-There" letter to one of Taxpayer's other possible addresses. The mail was returned as undeliverable, and the IRS took no further steps to locate taxpayer. Two years later, the IRS filed a NFTL and sent a notice of Taxpayer's right to request a CDP hearing to Taxpayer's current address. Taxpayer challenged whether the IRS followed proper procedures, but the Appeals Officer sustained the NFTL. Taxpayer petitioned the Tax Court, which sustained the lien because the Taxpayer did not notify the IRS of his address change. Taxpayer appealed to the Seventh Circuit, which said (1) the Tax Court looked beyond the administrative record when it considered trial testimony, but declined to rule on whether judicial review of the CDP decision

was limited to the record because neither party raised it; (2) the proper standard of review when considering whether the IRS followed proper procedures in assessing the liability was abuse of discretion (the challenge was not to the underlying tax liability—which is *de novo*—or Appeals’ decision—abuse of discretion—but the IRS mailing procedure, which was an administrative decision unrelated to the amount of underlying liability, and Taxpayer did not challenge the liability); (3) the IRS had used reasonable diligence in finding Taxpayer’s correct address—since the Taxpayer had not filed returns for seven years and did not alert the IRS of his whereabouts, the IRS properly relied on the address on Taxpayer’s most recent return. Therefore Appeals properly sustained the NFTL.

### III. Nominee, Alter Ego, Successor Determinations and Liens, and Quiet Title Actions

#### A. Overview of Authorized Collection

1. Lien Created: As noted, I.R.C. § 6321 creates a federal tax lien on all property and rights to property of any taxpayer who neglects or refuses to pay the tax for which the taxpayer is liable. This lien continues against the taxpayer's property until the liability either has been fully paid or is legally unenforceable. I.R.C. § 6322.
2. Notice to Third Parties: To put third parties on notice and establish the priority of the government's interest in a taxpayer's property against subsequent purchasers, secured creditors, and junior lien holders, the IRS must file an NFTL in the appropriate location, such as a county registry of deeds. I.R.C. § 6223(f); Treas. Reg. § 301.6323(f).
3. Authority to File NFTLs Against Alter Egos, Nominees, and Transferees: The IRS can file NFTLs and issue levies against the property of third parties, known as nominees, alter egos, or transferees that hold property belonging to taxpayers subject to collection.
  - a. Limited Nature of Nominee and Transferee Liens: As a general rule, in transferee or nominee situations, the IRS can pursue only specific property to which the NFTL has attached. Oxford Capital Corp. v. United States, 211 F.3d 280, 284 (5th Cir. 2000).
  - b. Alter Egos Compared: As a general rule, the IRS can pursue all of an alter ego's property to collect the taxpayer's liability. Oxford Capital Corp., 211 F.3d at 284.

#### B. Nominees, Alter Egos, and Transferees

1. Nominees:
  - a. Defined: "A nominee is someone designated to act for another. As used in the federal tax lien context, a nominee is generally a third-party individual who holds legal title to property of a taxpayer while the taxpayer enjoys full use and benefit of that property. In other words, the federal tax lien extends to property 'actually' owned by the taxpayer even though a third party holds 'legal' title to the property as nominee. Generally speaking, the third party in a nominee situation will be either another individual or a trust." I.R.M., pt. 5.17.2.5.7.2 (Mar. 19, 2018).
  - b. Fraudulent Conveyances Common: A nominee situation usually involves a fraudulent conveyance or transfer of a taxpayer's property to avoid legal obligations or creditors. I.R.M., pt. 5.17.2.5.7.2 (Mar. 19, 2018).
  - c. The IRS's Proof to Establish a Nominee Lien: To establish a nominee lien, "it must be shown that while a third party may have legal title to the property, it is really the taxpayer that owns the property and who enjoys its full use and benefit." I.R.M., pt. 5.17.2.5.7.2 (Mar. 19, 2018).
  - d. Factors to Consider for a Nominee: Whether a third-party is a taxpayer's nominee is determined on the basis of the surrounding facts and circumstances in the light of the following factors:

- (1) The taxpayer previously owned the property;
- (2) The nominee paid little or no consideration for the property;
- (3) The taxpayer retains possession or control of the property;
- (4) The taxpayer continues to use and enjoy the property conveyed just as the taxpayer had before such conveyance;
- (5) The taxpayer pays all or most of the expenses of the property; and
- (6) The conveyance was for tax avoidance purposes.

**\*\*Note:** No single factor is dispositive, but a number of factors may support a finding of an alter ego.

- e. Nominees Distinguished From Alter Egos: Unlike alter ego situations, nominee situations usually involve specific pieces of a taxpayer's property that were conveyed to the nominee. Since the federal tax lien only attaches to property actually "owned" by the taxpayer, it may not reach all property that is, in fact, actually owned by the nominee. Therefore, the NFTL in a nominee situation will usually contain a notation on its face that the lien is filed to attach specifically to certain identified property. This property must be specifically identified and described in the NFTL. I.R.M., pt. 5.17.2.5.7.2 (Mar. 19, 2018).
2. Alter Egos: Alter egos connote legally distinct entities that are so intermixed that their affairs (and assets) are not readily separable. I.R.M., pt. 5.17.2.5.7.1(1) (Jan. 8, 2016).
  - a. Sham Corporations Commons: "An alter ego generally involves a sham corporation used to avoid legal obligations." I.R.M., pt. 5.17.2.5.7.1(3) (Mar. 19, 2018).
  - b. The IRS's Proof to Establish an Alter Ego Lien: To establish an alter ego lien, "it must be shown that the shareholders disregarded the corporate entity and made it an instrumentality for the transactions of their own affairs." I.R.M., pt. 5.17.2.5.7.1(3) (Mar. 19, 2018).
  - c. Factors to Consider for an Alter Ego: Whether a taxpayer is a third-party's alter ego is determined on the basis of the surrounding facts and circumstances in the light of the following factors:
    - (1) The functioning and likeness of the officers, directors, and shareholders;
    - (2) Whether the corporate form was the same between the third-party and the putative alter ego;
    - (3) Whether the third-party-corporation was grossly undercapitalized;
    - (4) Whether the third-party-corporation observed corporate formalities (e.g., issuance of stock, payment of dividends, or the existence of director or shareholder meetings) were

- observed;
- (5) Whether the third-party-corporation was insolvent at the time of the putative transfer;
  - (6) Whether funds were siphoned from the third-party-corporation to the alleged alter ego;
  - (7) Whether the third-party-corporation maintained corporate records;
  - (8) Commingling of corporate and personal finances and use of corporate funds to pay personal expenses;
  - (9) Unsecured interest-free loans between the corporation and the shareholder;
  - (10) The taxpayer is a shareholder, director, or officer of the corporation or otherwise exerts substantial control over the corporation; and
  - (11) A failure to disregard the corporation fiction presents an element of injustice or “fundamental unfairness.” See United States v. Pisani, 646 F.2d 83, 88 (3d Cir. 1981) (quoting DeWitt Truck Brokers v. W. Ray Flemming Fruit Co., 540 F.2d 681, 686-687 (4th Cir. 1976)); see also I.R.M., pt. 5.17.2.5.7.1 (Mar. 19, 2018).

\*\*Note: No single factor is dispositive, but a number of factors may support a finding of an alter ego.

- d. Element of Injustice Required: In addition, the situation “must present an element of injustice or fundamental unfairness.” DeWitt Truck Brokers, 540 F.2d at 686-687.
- e. Beware of the IRS Asserting Alter Ego Theories to Circumvent Transferee Liability Statutes of Limitation:
  - (1) In General: The IRS will sometimes assert alter ego claims in what is in essence a transferee case (*e.g.*, where the taxpayer transfers assets to another corporation and establishes that corporation as essentially a parallel entity). This may be done because the period of limitations on assessment of the taxpayer as a transferee has expired. This is also an improper attempt at an end run around the periods of limitations on transferee liability imposed by I.R.C. § 6901(c).
  - (2) Statute of Limitations on Transferee Liability Cases: The statute of limitations for transferee cases is as follows:
    - (a) With respect to the initial transferee, one year after the expiration of the period of limitation for assessment against the transferor. I.R.C. § 6901(c)(1); see also I.R.M., pt. 4.11.52.4 (Nov. 1, 2004).
    - (b) With respect to a transferee of a transferee, one year

after the expiration of the period of limitation for assessment against the preceding transferee or 3 years after the expiration of the period of limitation for assessment against the transferor, whichever expires first; except that if, before the expiration of the period of limitation for the assessment of the liability of the transferee, a court proceeding for the collection of the tax or liability in respect thereof has been begun against the initial transferor or the last preceding transferee, respectively, then the period of limitation for assessment of the liability of the transferee shall expire 1 year after the return of execution in the court proceeding. I.R.C. § 6901(c)(2); see also I.R.M., pt. 4.11.52.4 (Nov. 1, 2004).

- (c) With respect to a fiduciary, not later than one year after the liability arises or not later than the expiration of the period for collection of such tax, whichever is later. I.R.C. § 6901(c)(3); see also I.R.M., pt. 4.11.52.4 (Nov. 1, 2004).

3. Transferees:

- a. Defined: If the taxpayer transfers assets for inadequate consideration, the transferee is not considered a purchaser pursuant to I.R.C. § 6323, and the federal tax lien maintains priority over the transferee's interest in the property. I.R.C. § 6323(a), (h)(6).
- b. Lien Authorized: The IRS can file NFTLs against or levy upon property subject to a federal tax lien that has been transferred by the taxpayer, which is in the hands of the transferee or any subsequent transferee. A complete discussion of transferee liability is outside the scope of this Outline.

C. Notices and Responses to Alter Ego and Nominee:

- 1. Overview: Generally speaking, the IRS reflects its determination that a third party is an alter ego or nominee of the taxpayer by filing a federal tax lien. The mechanics of the federal tax lien filing vary depending upon the type of claim asserted.
- 2. Alter Ego Liens: In an alter ego case, a special condition NFTL is used, identifying, in the name line of the NFTL before the taxpayer's name, the third party as the alter ego. "For example, if the taxpayer is TP, and ABC Inc. is TP's alter ego, then the NFTL name line would read 'ABC, Inc., as Alter Ego of TP.'" I.R.M., pt. 5.17.2.5.7.1 (Jan. 8, 2016).
  - a. Counsel Approval Required: Area Counsel approval is required prior to filing a NFTL naming an alter ego.
- 3. Nominee Liens: The NFTL in a nominee situation is identical to the standard NFTL, except that the nominee is identified as the name of the taxpayer. "For example, if the taxpayer is TP, and My Brother-In-Law or My Trust is TP's nominee, then the name of the taxpayer on the nominee

NFTL would be 'My Brother-In-Law or My Trust, Nominee of TP.'" I.R.M., pt. 5.17.2.5.7.2 (Jan. 8, 2016).

- a. Counsel Approval Required: Area Counsel approval is required prior to filing a nominee lien.
4. FOIA Requests: Any time an alter ego or nominee determination is made, it is important to understand the basis for the IRS's determination. In order to obtain this information, taxpayers should make a FOIA request that asks the IRS to produce the following items (among others):
- a. All notices, letters, memorandum, contact history sheets, audit reports, correspondence, IRS forms, liens and levies prepared by or received by the IRS that refer or relate to the year(s) and/or period(s) referenced above, and specifically, with respect to the IRS's determination that the taxpayer is the alter ego of another;
  - b. All transcripts of account, records of assessments and abatements and any other documents reflecting all account activity and transactions that refer or relate to the year(s) and/or period(s) referenced above, and specifically, with respect to the IRS's determination that the Taxpayer is alter ego of another;
  - c. A record of persons contacted by the IRS with respect to the determination that the taxpayer is the alter ego of another;
  - d. All third-party information received by the IRS that refers or relates to the years and/or period(s) referenced above, and specifically, any and all information that the IRS received in connection with its determination that the taxpayer is the alter ego of another.
  - e. All third-party information in the IRS's possession relevant to the determination that the taxpayer is the alter ego of another.

Attached as **Exhibit B** is a sample FOIA request to submit to the IRS in connection with an alter ego determination.

5. CAP Hearing Requests: Third parties who are affected by alter ego and nominee liens are not considered taxpayers for purposes of the CDP rights under I.R.C. §§ 6320 and 6330. Thus, these third parties are currently not entitled to CDP rights in response to the filing of an alter ego or nominee lien. Thus, an administrative review with Appeals of the IRS's alter ego or nominee determination is made by submitting to the IRS Form 9423, *Collection Appeal Request*. It is advisable to include with the Form 9423 an attachment similar to that for the Form 12153 that explains the basis for the challenge that the taxpayer is the alter ego of another. Suggested items to be included as an attachment to the Form 9423 is set forth in Section II.A.3. Attached as **Appendix A** is a sample attachment for a Form 12153 (which is relevant to the CAP hearing, except that the review is not requested pursuant to I.R.C. § 6330) (*i.e.*, delete references to I.R.C. § 6330).

D. Challenges to Nominee, Alter Ego, and Transferee Determinations:

1. Overview:
  - a. Procedure to Challenge: Third parties who are affected by alter ego and nominee liens are not considered taxpayers for purposes of the CDP rights under I.R.C. §§ 6320 and 6330. Thus, these third parties are currently not entitled to CDP rights in response to the filing of an alter ego or nominee lien.
    - (1) Recommendations for Change: The National Taxpayer Advocate has recommended to Congress that I.R.C. §§ 6320 and 6330 apply to “‘affected third parties,’ known as alter egos, nominees, and transferees, who hold legal title to property subject to IRS collection actions.” See 1 Nat’l Taxpayer Advocate, 2012 Annual Report to Congress, 544-552 (Dec. 31, 2011).
  - b. Defenses Generally: As detailed below, there are at least two primary arguments to consider in response to the filing of an alter ego lien. First, that the alter ego has no right in the principal’s property because the period of limitations for asserting fraud has expired. Second, that the alter ego determination is wrong as a matter of law because there is no alter ego.
2. State Law Important: State law plays a crucial role in determining whether a federal tax lien may attach to a putative alter ego’s property or rights to property. The seminal case on this issue is Drye v. United States, 528 U.S. 49 (1999).
  - a. Drye v. United States:
    - (1) Issue Presented: In Drye, the Supreme Court decided whether a federal tax lien can attach to an inheritance that a taxpayer disclaimed under State law. Id. at 58-61.
    - (2) Lien Broadly Attaches: The Supreme Court, citing I.R.C. § 6321, noted that “the Government may impose a lien on any ‘property’ or ‘rights to property’ belonging to the taxpayer.” Id. at 55.
    - (3) The Two-Prong Test for Whether a Lien Can Attach: In determining whether a lien can attach, the Supreme Court adopted the following two-prong analysis:
      - (a) First, in deciding whether a lien may attach courts and the IRS must first look to “state law to determine what rights the taxpayer has in the property the Government seeks to reach.” Id. at 58.
      - (b) Second, if State law supports that the taxpayer has the right in property sought to be liened, courts and the IRS must then look to federal law to determine “whether the taxpayer’s state-delineated rights qualify as ‘property’ or ‘rights to property’ within the compass of the federal tax lien legislation.” Id.
  - b. Drye Reasoning Extended to Alter Ego Determinations: The two-prong analysis in Drye has been extended to alter ego

determinations by the IRS. In this regard, courts have uniformly held that State law determines the appropriateness of using alter ego theories to file a NFTL. See e.g., United States v. Scherping, 187 F.3d 796, 801-802 (8th Cir. 1999) (“Generally, federal courts will look to state law to determine whether an entity is an alter ego of a taxpayer.”); Towe Antique Ford Foundation v. I.R.S., 999 F.2d 1387, 1391 (9th Cir. 1993) (“We apply the law of the forum state in determining whether a corporation is an alter ego of the taxpayer.”); Zahra Spiritual Trust v. United States, 910 F.2d 240, 242 (5th Cir. 1990) (“In determining whether the appellants are the alter egos of the taxpayers, and whether the taxpayer has an interest in property to which the government’s tax lien attached, we look to state law.”); see also Old West Annuity and Life Ins. Co. v. the Apollo Group, 605 F.3d 856, 861-862 (11th Cir. 2010) (trial court properly applied State law to determine applicability of alter ego theories); Floyd v. I.R.S., 151 F.3d 1295, 1297-1300 (10th Cir. 1998) (applying State law to decide the applicability of alter ego theories).

- (1) Analysis of *Drye* Factor 1: Under *Drye*’s first prong, the IRS and a reviewing court must look to “state law to determine what rights a taxpayer has in the property the government seeks to reach.” *Drye*, 528 U.S. at 58. Where the alter ego is a corporate or other limited liability entity, this usually requires the IRS to pierce the corporate veil (*i.e.*, to ignore the existence of the separate corporate form).
  - (a) Veil Piercing in an Alter Ego Situation: Under many States’ laws, veil-piercing under an alter ego theory is properly invoked only where the putative alter ego abused the privilege of incorporation to perpetrate a fraud or injustice, or otherwise to circumvent the law. See, e.g., New Jersey Dep’t of Env’tl. Prot. v. Ventron Corp., 94 N.J. 473, 500-501 (N.J. 1983); Lyon v. Barrett, 89 N.J. 294, 300 (N.J. 1982). In many States, the corporate veil should not be pierced unless the putative alter ego has been so dominated by the original corporation that the successor had no separate existence and was merely an instrumentality of the putative alter ego. See, e.g., New Jersey Dept. Of Env’tl. Prot., 94 N.J. at 501.
  - (b) Alter Ego Allegations Substantives Grounded in Fraud: The IRS typically grounds its alter ego determinations in fraud. See, e.g., Culbreth v. Amosa (Pty) Ltd., 898 F.2d 13 (3d Cir. 1990) (noting that the law in New Jersey is that injustice, without fraud, is insufficient to pierce the corporate

veil under an alter ego theory); Nat'l Elevator Indus. Pension, Health, Benefit & Educ. Funds v. Lutyk, 332 F.3d 188, 192 (3d Cir. 2003) (alter ego theory “has elements of fraud theory [and] must be shown by clear and convincing evidence.”).

(c) Statute of Limitations Issues and Defenses:

(1) In General: The IRS and the Tax Division sometimes make alter ego determinations after the State statute of limitations for fraud has expired. The IRS generally cannot perfect its interest in a federal tax lien where the underlying fraud cause of action giving rise to the alter ego liability is time-barred.

(2) State Law Causes of Action for Fraud: A cause of action for fraud is usually based on common law principles or the State’s Uniform Fraudulent Transfers Act. See, e.g., N.J.S.A. 25:2-20, et seq.

(3) Statute of Limitations for Fraud Actions: The statute of limitations for common law fraud is typically six years. See, e.g., N.J.S.A. 2A:14-1. The statute of limitations for statutory fraud under Uniform Fraudulent Transfers Acts is four years. See, e.g., N.J.S.A. 25:2-31. These statutes of limitations may be equitably tolled to the extent the taxpayer (or the alter ego) made affirmative representations that were untrue.

(2) Analysis of Drye Factor 2: Under Drye’s second prong, if State law supports that the taxpayer has the right in property sought to be liened, courts and the IRS must then look to federal law to determine “whether the taxpayer’s state-delineated rights qualify as ‘property’ or ‘rights to property’ within the compass of the federal tax lien legislation.” Drye, 528 U.S. at 58.

(a) Interplay of Statutes of Limitations: As detailed above, State law sometimes does not support that the putative alter ego had a property right that may properly be liened because the cause of action for that property right, fraud under an alter ego theory, is time-barred.

(b) Effect of Failing Drye Prong 2: Where the second prong under Drye is not met because the filing of the federal tax lien was time-barred, then the lien is outside the scope of the federal tax lien.

E. Quiet Title Suits

1. Introduction:
  - a. Purpose of Quiet Title Suits: The purpose of a quiet title suit is “to determine which named party has superior claim to a certain piece of property.” United States v. Nolasco, 354 Fed. Appx. 676, 680 (3d Cir. 2009) (quoting United States v. McHan, 345 F.3d 262, 275 (4th Cir. 2003)).
  - b. Equitable Remedy and All Defenses Available: A quiet title suit is essentially an equitable remedy, and subject to equitable defenses (as well as all other defenses). Defenses routinely raised in a quiet title suit are:
    - (1) That the periods of limitations on assessment and collection under I.R.C. §§ 6501 and 6502 have expired;
    - (2) That the United States improperly computed the taxes, penalties and interest alleged to be due from the defendant-taxpayer;
    - (3) That the liabilities have been paid, in full or in part; and
    - (4) That State law precluded the lien action.

Note: Because all defenses are available, taxpayers who relied upon the erroneous advice of an IRS official may assert the doctrine of laches or the doctrine of equitable estoppel. Accord Reitmeier v. Kalinoski, 631 F. Supp. 565, 570 (D.N.J. 1986) (noting that a quiet title suit is “essentially equitable in nature and, therefore, subject to equitable defenses.”).
  - c. Typically Handled by AUSA: The United States Attorney’s Office typically handles most suits under 24 U.S.C. § 2410. The Tax Division, however, handles suits under § 2410 for interpleader or in the nature of interpleader, actions that tax protesters file, and actions that raise substantive tax issues. USAM, § 6-5.300.
2. Jurisdiction of the District Courts: I.R.C. § 7402(e) provides as follows: “The United States district courts shall have jurisdiction of any action brought by the United States to quiet title to property if the title claimed by the United States to such property was derived from enforcement of a lien under this title.”
3. Jurisdiction Under 28 U.S.C. § 2410: 28 U.S.C. § 2410 provides as follows:
  - (a) Under the conditions prescribed in this section and section 1444 of this title for the protection of the United States, the United States may be named a party in any civil action or suit in any district court, or in any State court having jurisdiction of the subject matter—
    - (1) to quiet title to,
    - (2) to foreclose a mortgage or other lien upon,

- (3) to partition,
- (4) to condemn, or
- (5) of interpleader or in the nature of interpleader with respect to, real or personal property on which the United States has or claims a mortgage or other lien.

(b) The complaint or pleading shall set forth with particularity the nature of the interest or lien of the United States. In actions or suits involving liens arising under the internal revenue laws, the complaint or pleading shall include the name and address of the taxpayer whose liability created the lien and, if a notice of the tax lien was filed, the identity of the internal revenue office which filed the notice, and the date and place such notice of lien was filed. In actions in the State courts service upon the United States shall be made by serving the process of the court with a copy of the complaint upon the United States attorney for the district in which the action is brought or upon an assistant United States attorney or clerical employee designated by the United States attorney in writing filed with the clerk of the court in which the action is brought and by sending copies of the process and complaint, by registered mail, or by certified mail, to the Attorney General of the United States at Washington, District of Columbia. In such actions the United States may appear and answer, plead or demur within sixty days after such service or such further time as the court may allow.

4. Pleadings:

a. The Complaint or the Counterclaim: The Taxpayer brings a quiet title suit in federal district court by filing a complaint with the appropriate U.S. district court or filing a counterclaim in answering the United States' Complaint (typically filed in connection with an action to reduce an assessment to judgment or a tax lien foreclosure action, in which case the taxpayer counterclaims the United States to quiet title).<sup>6</sup>

(1) Items to Be Included in the Complaint or Counterclaim: 28 U.S.C. § 2410 provides that a complaint or counterclaim to quiet title with respect to a tax lien must include the following items:

- (a) The complaint or pleading shall set forth with particularity the nature of the interest or lien of the United States (*e.g.*, “a continuing lien” on the taxpayer’s property should be a sufficient

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<sup>6</sup> An action may also be commenced in State court. As this Outline is focused on federal tax law, we do not discuss State causes of action.

allegation);

- (1) See Coplin v. United States, 952 F.2d 403 (Table), 1991 WL 270831, at \*2 (6th Cir. 1991) (holding that the trial court properly determined that it had jurisdiction to hear the taxpayers’ quiet title action under 28 U.S.C. § 2410 and observing that it “is somewhat disingenuous and illogical for the government to assert that it can place a lien on everything the taxpayers own, even when the government is unclear what ‘everything’ entails, while at the same time demanding that the taxpayers can bring a quiet title action only if their defense is more specific than the lien itself.”).
  - (b) The name and address of the taxpayer whose liability created the lien; and
  - (c) If a notice of the tax lien was filed, the identity of the internal revenue office which filed the notice and the date and place that the notice of lien was filed.<sup>7</sup>
- (2) Facial Plausibility Pleading:
- (a) The Rule: The general rule of pleadings requires a short and plain statement of the claim showing that the pleader is entitled to relief and generally need not contain detailed factual allegations. See Fed. R. Civ. P. 8(a)(2); Phillips v. Cnty. of Allegheny, 515 F.3d 224, 232-234 (3d Cir. 2008). To state a claim upon which relief can be granted requires that the complainant plead “enough facts to state a claim to relief that is plausible on its face.” Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570 (2007). A claim is facially plausible if the pleading party alleges facts that allow the Court to draw a reasonable inference that the opposing party is liable for the misconduct alleged. Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009). The Court must accept all factual allegations in the complaint as true, view them in the light most favorable to the complainant, and determine whether, under any reasonable reading of

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<sup>7</sup> In actions in the State courts service upon the United States shall be made by serving the process of the court with a copy of the complaint upon the United States attorney for the district in which the action is brought or upon an assistant United States attorney or clerical employee designated by the United States attorney in writing filed with the clerk of the court in which the action is brought and by sending copies of the process and complaint, by registered mail, or by certified mail, to the Attorney General of the United States at Washington, District of Columbia. In such actions the United States may appear and answer, plead or demur within sixty days after such service or such further time as the court may allow.

the pleadings, the complainant may be entitled to relief. Buck v. Hampton Twp. Sch. Dist., 452 F.3d 256, 260 (3d Cir. 2006); Pinker v. Roche Holdings Ltd., 292 F.3d 361, 374 n.7 (3d Cir. 2002).

- b. The Answer: The United States typically moves to dismiss the quiet title suit before answering the complaint or counterclaim. Assuming that the motion to dismiss is denied, then the United States must answer the complaint or counterclaim.

5. The Motion to Dismiss:

- a. Sovereign Immunity: The United States routinely cites sovereign immunity as grounds to dismiss a quiet title suit. This argument is unfounded.

- (1) 28 U.S.C. § 2410 Waives Sovereign Immunity: 28 U.S.C. § 2410 is the United States' waiver of sovereign immunity on which taxpayers should rely in support of its claims.

- (2) Recognition by Courts: Courts routinely recognize that 28 U.S.C. § 2410 "waives sovereign immunity" in cases seeking to quiet title to real or personal property on which the United States has or claims a mortgage or other lien. Burge v. I.R.S., 39 F.3d 1191 (Table), 1994 WL 596586 (10th Cir. 1994); see also United States v. Coson, 286 F.2d 453, 457 (9th Cir. 1961) (ruling that waiver of immunity exists for a suit to remove a cloud on title).

- b. Anti-Injunction Act and Declaratory Judgment Act Arguments: The United States routinely claims that quiet title suits are barred by the Anti-Injunction Act and the Declaratory Judgment Act.

- (1) Rejection of Argument by Courts: Courts have generally rejected that a quiet title suit runs afoul of the Anti-Injunction Act. For example, in United States v. McFarland, No. 3:14cv29-DPJ-FKB, 2014 WL 7149769 (S.D. Miss. Dec. 15, 2014), the United States claimed an interest in real property the defendant had purchased in 1997 and transferred to his son in 2003.

- (a) United States' Argument: The United States argued that the son held title as the defendant's nominee, and as such, that the government's tax liens arising after the transfer attached to the property.

- (b) Taxpayer's Counterclaim: The defendant-taxpayer counterclaimed the United States to quiet title under 28 U.S.C. § 2410.

- (c) The Motion to Dismiss: The United States moved to dismiss the counterclaim on the grounds that the Court lacked subject-matter jurisdiction and did not waive its sovereign immunity, or alternatively, on the grounds that the counterclaim violated the Anti-Injunction Act and the Declaratory Judgment Act.

- (d) Court's Ruling Re: Sovereign Immunity: The Court denied the United States' motion to dismiss. Specifically, the Court found that "the United States waived its sovereign immunity for claims under 28 U.S.C. § 2410, and the Court has subject-matter jurisdiction over the counterclaim."
- (e) Court's Ruling on Anti-Injunction and Declaratory Judgment Acts: Also, the Court held that the counterclaim did not violate the Declaratory Judgment Act because that Act "poses no barrier to a suit by a third party to clear his property of a federal tax lien since the quiet title action specifically mandated by [28 U.S.C.] § 2410 is in substance a suit for a declaratory judgment." The Court went on to similarly note that "the Anti-Injunction Act has been interpreted so as to not prohibit such third party results."

#### IV. The TFRP

##### A. Introduction

1. Amounts withheld from employee wages account for 70% of all revenues collected by the U.S Department of the Treasury (“Treasury”). As of September 2015, more than \$59 billion of tax reported as due on employment tax returns remained unpaid. Considerable revenue is also lost as a result of misclassified workers. The Treasury estimates that, based on 2011 figures, for every worker classified as an independent contractor rather than an employee, a service consumer (*i.e.*, one who uses workers to perform services)<sup>8</sup> “saves” \$3,710 in employment taxes and \$43,007 in income paid annually.<sup>9</sup> It is in the light of these staggering statistics that the IRS and the Tax Division recently identified civil and criminal employment tax enforcement as among the agencies’ top priorities.

##### B. Employee Misclassification

###### 1. Employee Classification:

- a. Overview: There are numerous relationships that can exist between a service consumer and a worker, including:

- (1) Employer-employee;
- (2) Independent contractor;
- (3) Statutory employee; and
- (4) Non-statutory employee.

Note: The relationships are defined by common law and statute.

###### b. Employer-Employee:

- (1) Defined: An employer-employee relationship generally exists when the persons (or businesses) for whom the services are being performed:

have a right to *control and direct the individual who performs the services*, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if the employer has the *right* to do so.

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<sup>8</sup> The term “service consumer” is used in this Outline to mean an individual, business enterprise, organization, State, or other entity for which a worker has performed services. The term “employer” is used only when an employer-employee relationship has already been assumed or established for purposes of a particular discussion.

<sup>9</sup> TREASURY INSPECTOR GEN. FOR TAX ADMIN., AUDIT REP. NO. 2013-30-058, EMPLOYERS DO NOT ALWAYS FOLLOW INTERNAL REVENUE SERVICE WORKER DETERMINATION RULINGS (2013), *available at* <http://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf>. These statistics do not account for the additional “savings” employers realized from not providing benefits or paying for workers’ compensation premiums, unemployment insurance, minimum wage and overtime pay, among others.

Rev. Rul. 87-41, 1987-1 C.B. 296 (emphasis added); Treas. Reg. § 31.3121(d)-1(c)(2).

- (2) Title Inconsequential: So long as this relationship exists, a worker is generally designated as an employee, regardless of whether the parties agreed otherwise; any title or designation claiming that the worker is anything other than an employee is inconsequential.

c. Independent Contractor:

- (1) Defined: An independent contractor relationship may exist where a worker follows an “independent trade, business or profession in which they offer their services to the public.” Rev. Rul. 87-41, 1987-1 C.B. 296.

- (2) Examples: Service-providers, such as doctors, veterinarians, and auctioneers, are more easily classified as independent contractors because, as the IRS explains, “the person for whom the services are performed[] ha[s] the right to control or direct only the result of the work and not the means or method of accomplishing the result.” IRS Pub. 15-A (2018), available at <http://www.irs.gov/pub/irs-pdf/p15a.pdf>; see also Treas. Reg. § 31.3121(d)-1(c)(2).

- (3) Balancing Test Applied: The IRS applies a detailed balancing test to resolve the somewhat nebulous issue of whether an employer-employee relationship exists. In Rev. Rul. 87-41, 1987-1 C.B. 296, the IRS established a list of 20 factors, weighted in terms of importance, depending upon the worker’s occupation and the factual context, to determine whether sufficient control was present to create an employer-employee relationship.

d. Statutory Employee:

- (1) Statutorily Defined: In addition to the common law tests discussed above, the Code also classifies the following workers as employees:

- (a) Officers of corporations, as well as superintendents, managers, and other supervisory personnel are generally considered employees unless the officer performs few to no services for the corporation and is not paid (or entitled) to be paid.

- (b) Statutory Employees: Specific categories of statutory employees that the Code recognizes include:

- (1) Drivers engaged in distributing meat, vegetable, fruit, or bakery products; beverages (other than milk); or laundry or dry-cleaning services, see I.R.C. § 3121(d)(3)(A);

- (2) Fulltime life insurance salesmen, see I.R.C. § 3121(d)(3)(B);
  - (3) People who perform work from home according to the service consumer's specifications, using materials or goods furnished by the service consumer that are required to be returned, see I.R.C. § 3121(d)(3)(C); and
  - (4) Fulltime traveling or city salespersons engaged in solicitation and transmission to the service consumer of orders of wholesalers, retailers, contractors, or operators of hotels, restaurants, or other establishments for merchandise for resale or supplies for use in their business operations, see I.R.C. § 3121(d)(3)(D).
  - (c) Comparable State Laws: Many States also have comparable statutes defining an employee. See, e.g., N.Y. LABOR LAW § 511.
- e. Non-Statutory Employee:
- (1) Defined by Statute: The Code also designates as nonemployees three categories of workers:
    - (a) Licensed real estate agents for whom a substantial part of their income is paid on commission under a contract specifying that they are not an employee for tax purposes;
    - (b) "Direct sellers" (*i.e.*, those who sell consumer products in a place other than a permanent retail establishment, are engaged in selling consumer products to any buyer on a buy-sell basis, deposit-commission basis, or any similar basis for resale, or are engaged in newspaper or shopping news delivery); and
    - (c) Companion sitters (*i.e.*, babysitters or careworkers for the elderly or disabled) who are not employees of a companion-sitting placement service. I.R.C. §§ 3506, 3508; IRS Pub. 15-A (2014), at 6.
2. Employer-Employee Taxes:
- a. Individual Components: Federal employment taxes consist of five separate employment taxes:
    - (1) Federal Insurance Contributions Act ("FICA"), with operative provisions at I.R.C. §§ 3101 through 3128;
    - (2) Railroad Retirement Tax Act ("RRTA"), with operative provisions at I.R.C. §§ 3201 through 3233;
    - (3) Federal Unemployment Tax Act ("FUTA"), with operative provisions at I.R.C. §§ 3301 through 3311;

- (4) Railroad Unemployment Repayment Tax (“RURT”), with operative provisions at I.R.C. §§ 3321 and 3322;
  - (5) Collection of Income Tax at Source on Wages (“ITW”), with operative provisions at I.R.C. §§ 3401 through 3406; and
  - (6) Self-Employment Contributions Act (“SECA”), with operative provisions at I.R.C. §§ 1401 through 1403.
- b. Liability for Employment Taxes: A determination of employment tax liabilities requires finding that there is an employer, an employee, and a payment of wages or compensation. I.R.M., pt. 4.23.8.1 (June 7, 2011).
  - c. Importance of Worker Classification to Employment Taxes: A worker’s status or classification (*i.e.*, employee, independent contractor, or other non-employee) determines what taxes are paid and who is responsible for reporting and paying these taxes. I.R.M., pt. 4.23.8.2 (Dec. 11, 2013).
    - (1) Types of Taxes That Apply to Employer-Employee: Generally, if an employer-employee relationship exists, the employer is liable for FICA, FUTA, and ITW under I.R.C. §§ 3101, 3102, 3111, 3301, 3402, and 3403, respectively.
    - (2) Exceptions Abound: There are exceptions to these general rules that are outside the scope of this outline. For more information on determining employment tax liability, see I.R.M., pt. 4.23.8 (Dec. 11, 2013).
  - d. Income tax/withholding
  - e. Social Security and Medicare (“FICA”) Tax
    - (1) Employer and Employee are jointly responsible (7.65%/7.65%)
    - (2) For more information on calculating employment tax on unreported tip income, see I.R.M., pt. 4.23.7 (Jan. 13, 2014).
  - f. Federal Unemployment (“FUTA”) Tax
    - (1) Employer pays 6.0%, but up to 5.4% credit possible if taxes timely paid and the state is not determined to be a credit reduction state.
    - (2) For more information about filing FUTA tax returns, see Topic 759 – Form 940 – *Employer’s Annual Federal Unemployment (FUTA) Tax Return – Filing and Deposit Requirements*, <http://www.irs.gov/taxtopics/tc759.html> (last visited Aug. 9, 2018).
- 3. SECA Tax for Independent Contractors: Independent Contractors must pay Self-Employment (“SECA”) Tax (15.3%), which covers both the worker’s and the employer’s contributions to the worker’s Social Security and Medicare.

C. Overview of the TFRP

1. Introduction:

a. In General:

- (1) Authorization of the Penalty: I.R.C. § 6672(a) imposes personal liability on any person required to collect, truthfully account for, and pay over taxes held in trust who willfully fails to do so. This liability is known as the trust fund recovery penalty (again, “TFRP”).
  - (a) Collection Device or Penalty? An issue that often arises is whether the I.R.C. § 6672 TFRP is a collection device with respect to which interest does not accrue independent of the underlying employment tax liability or whether the TFRP is a separately assessable penalty with respect to which interest accrues independent of the underlying employment tax. Courts are split on this issue.
  - (b) Collection Device: One set of courts, including the Tax Court, recognizes the I.R.C. § 6672 TFRP “as a collection device by assessment of unpaid employment tax against an individual as a ‘responsible person’.” Robinson v. Commissioner, 117 T.C. 308, 318 (2001); see also Aardema v. Fitch, 684 N.E.2d 884, 896 (Ill. App. Ct. 1997).
  - (c) Penalty: Another set of courts, including the U.S. Courts of Appeals for the Second, Seventh, and Ninth Circuits, hold that the I.R.C. § 6672 imposes a penalty and is not a mere collection device. See, e.g., Mortenson v. Nat’l Union Fire Ins. Co., 249 F.3d 667 (7th Cir. 2001); Duncan v. Commissioner, 68 F.3d 315, 317-319 (9th Cir. 1995), aff’g in part, rev’g in part, and remanding in part, T.C. Memo. 1993-370; Kalb v. United States, 505 F.2d 506, 510 (2d Cir. 1974).
  - (d) Why the Distinction Matters: Whether the TFRP is a penalty or a collection device affects not only the accrual of interest, but also the procedure that must be complied with to assess the penalty; namely, I.R.C. § 6751(b)(1) (discussed below).
- (2) Amount of the Penalty: The amount of the liability is equal to the amount of the tax evaded, not collected, or not accounted for and paid over. I.R.C. § 6672(a).
- (3) Full Unpaid Trust Fund Amount Will Be Collected Only Once: The full unpaid trust fund amount will be collected only once in a particular case, whether it is collected from the employer/collecting agent, from one or more of its responsible persons, or from a combination of the employer/collecting agent and one or more of its responsible persons.

- (a) Dixon v. Commissioner: In Dixon v. Commissioner, 141 T.C. 173, 193 (2013), the Tax Court summarized the “well-established IRS policy against double collection of trust fund taxes”. The Court went on to note that an employer’s payment of employment tax must be credited toward a responsible person’s potential liability for the I.R.C. § 6672 penalty to avoid double collection of the same tax. Id. at 194-194.
  - (b) IRS’s Policy Statements: The IRS’s policy statements also state that the TFRP, including interest and penalties, should be collected only once (either from the business or from one or more of its responsible persons). See I.R.M., pt. 1.2.14.1.3(2) (June 9, 2003) (Policy Statement 5-14); see also I.R.M., pt. 5.17.7.1.9(2) (Aug. 1, 2010) (“If, after the assertion of the TFRP, the corporation pays the delinquent tax, the TFRP assessment will be abated.”).
- (4) Tax Forms to Which the TFRP Can Relate: Assessments of the TFRP are possible based on liabilities for the following tax forms:
- (a) Form 941, *Employer’s QUARTERLY Federal Tax Return*;
  - (b) Form 720, *Quarterly Federal Excise Tax Return*;
  - (c) Form CT-1, *Employer’s Annual Railroad Retirement and Unemployment Return*;
  - (d) Form 943, *Employer’s Annual Federal Tax Return for Agricultural Employees*;
  - (e) Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*;
  - (f) Form 945, *Annual Return of Withheld Federal Income Tax*;
  - (g) Form 944, *Employer’s ANNUAL Federal Tax Return*;
  - (h) Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*; and
  - (i) Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*. See I.R.M., pt. 5.7.3.1.1(3) (Aug. 6, 2015).

\*\* This outline focuses on the applicability of the TFRP in the employment tax context.

- (5) Bad Acts to Which TFRP Can Apply: The TFRP may be imposed, with respect to the taxes described above for:

- (a) Willful failure to collect tax;
    - (b) Willful failure to account for and pay over tax; and
    - (c) Willful attempt in any manner to evade or defeat tax or the payment thereof. See I.R.M., pt. 5.7.3.1.1(5) (Aug. 6, 2015).
  - (6) Applicability to Excise Taxes: The TFRP is normally applied to employment tax returns for withheld income tax, withheld Social Security tax, and withheld Railroad Retirement Tax, but the TFRP also applies to those excise taxes which are commonly referred to as “collected excise taxes”. Collected excise taxes are those which are imposed on persons other than the person who is required by law to collect the tax and pay it over to the Government (a collecting agent). See I.R.M., pt. 5.7.3.1.1(6) (Aug. 6, 2015).
- b. As Applied to Employment Taxes:
- (1) Employer’s Withholding Obligation: The Code requires employers to withhold Social Security and Federal excise taxes from their employees’ wages.
  - (2) Amounts Withheld in Trust for the United States: The employer is required to hold these monies in trust for the United States and pay such funds over to the United States. I.R.C. § 7501(a).
  - (3) Interest Accruals on the TFRP: Interest on the TFRP begins to accrue on the date notice and demand for payment is given to the responsible person. I.R.C. § 6601(e)(2)(A).
    - (a) Interest Accruals on Employment Taxes by Contrast: Interest on unpaid employment taxes generally begins to accrue on the first date upon which such taxes are due and not paid (*i.e.*, on the due date of the return). I.R.C. § 6601. As a result of this timing difference, there is a potential for mismatch with respect to the accrual of interest on an underlying employment tax liability and related TFRP.
    - (b) Note: For this reason, it is important to check the IRS’s calculations of interest with respect to the employment tax and the TFRP.
  - (4)
- c. What Are Trust Fund Taxes? Trust fund taxes are the amounts that an employer withholds from an employee’s wages for the employee’s federal income taxes, social security, Medicare, and unemployment taxes (*i.e.*, they are the employee-portion of various employment taxes).
- d. Filing Obligations: The employer is required to file quarterly tax

returns (Form 941, *Employer's Quarterly Federal Tax Return*, to report taxes withheld and to make federal tax deposits (FTD) with commercial banks designated as depositories by regulations.

(1) Employee's Share: The employer withholds the trust fund taxes in trust for the Government until they are paid over to the Government to be applied to the employee's tax accounts.

(a) Withholding taxes are actually part of the wages of the employee, held by the employer in trust for the government; it is a function of administrative convenience; the employer withholds money from a worker's paycheck and briefly holds that money before forwarding it to the IRS. See Bell v. United States, 355 F. 3d 387 (6th Cir. 2004).

(2) Employer's Share: The employer is also required to report and pay its own portion of the Social Security and Medicare taxes as well as the federal unemployment tax.

e. Practical Issues That Arise: The TFRP becomes an issue for business owners who, due to business cash-flow problems, fail to remit employment taxes and instead use those monies to try to keep their business afloat.

(1) When the business goes under, the IRS will not be able to collect the employment taxes from the business.

(2) The TFRP is a civil penalty imposed upon persons for the unpaid trust fund taxes. See I.R.C. § 6672.

(3) While the TFRP is a "penalty" and not a "tax" for purposes of the Code, it is has also been described as a device to enforce collection of the unpaid trust fund taxes from persons other than the business.

(4) Thus, the IRS will seek to impose the TFRP on the business owners who failed to pay the employment taxes.

(a) The Trust Fund includes only the employee's portion of income tax, Social Security and Medicare.

(b) The following is not included in the TFRP: Penalties and interest for failure to pay employment tax.

(c) Once the TRFP is assessed, interest will start to accrue and the employer will be responsible for the TFRP and interest.

(5) No TFRP Assessment is required for disregarded limited liability companies, sole proprietors, or general partners of a partnership.

2. The Statute: I.R.C. § 6672, entitled "Failure to collect and pay over tax, or attempt to evade or defeat tax", provides as follows:

(a) General rule

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 or part II of subchapter A of chapter 68 for any offense to which this section is applicable.

(b) Preliminary notice requirement

(1) In general

No penalty shall be imposed under subsection (a) unless the Secretary notifies the taxpayer in writing by mail to an address as determined under section 6212 (b) or in person that the taxpayer shall be subject to an assessment of such penalty.

(2) Timing of notice

The mailing of the notice described in paragraph (1) (or, in the case of such a notice delivered in person, such delivery) shall precede any notice and demand of any penalty under subsection (a) by at least 60 days.

(3) Statute of limitations

If a notice described in paragraph (1) with respect to any penalty is mailed or delivered in person before the expiration of the period provided by section 6501 for the assessment of such penalty (determined without regard to this paragraph), the period provided by such section for the assessment of such penalty shall not expire before the later of—

- (A) the date 90 days after the date on which such notice was mailed or delivered in person, or
- (B) if there is a timely protest of the proposed assessment, the date 30 days after the Secretary makes a final administrative determination with respect to such protest.

\* \* \* \* \*

(d) Right of contribution where more than 1 person liable for penalty

If more than 1 person is liable for the penalty under subsection (a) with respect to any tax, each person who paid such penalty shall be entitled to recover from other persons who are liable for such penalty an amount equal to the excess of the amount paid by such person over such person's proportionate share of the penalty. Any claim for such a recovery may be made only in a proceeding which is separate from, and is not joined or consolidated with—

- (1) an action for collection of such penalty brought by the United States, or
- (2) a proceeding in which the United States files a counterclaim or third-party complaint for the collection of such penalty.

(e) Exception for voluntary board members of tax-exempt organizations

No penalty shall be imposed by subsection (a) on any unpaid, volunteer member of any board of trustees or directors of an organization exempt from tax under subtitle A if such member—

- (1) is solely serving in an honorary capacity,
- (2) does not participate in the day-to-day or financial operations of the organization, and
- (3) does not have actual knowledge of the failure on which such penalty is imposed.

The preceding sentence shall not apply if it results in no person being liable for the penalty imposed by subsection (a).

3. IRS Policy Statements:

- a. In General: The IRS's policy on assertion of the TFRP is in Policy Statement 5-14 (Formerly P-5-60), Trust Fund Recovery Penalty Assessments. It contains numerous subparts, which are set forth below.
- b. Appropriateness of TFRP Assessments:

The trust fund recovery penalty, applicable to withheld income and employment (social security and railroad retirement) taxes or collected excise taxes, will be used to facilitate the collection of tax

and enhance voluntary compliance. If a business has failed to collect or pay over income and employment taxes, or has failed to pay over collected excise taxes, the trust fund recovery penalty may be asserted against those determined to have been responsible and willful in failing to pay over the tax. Responsibility and willfulness must both be established. The withheld income and employment taxes or collected excise taxes will be collected only once, whether from the business, or from one or more of its responsible persons.

See I.R.M., pt. 1.2.14.1.3(2) (June 9, 2003).

c. Goal is to Collect the Correct Amount of Tax, Not to Necessarily Impose a Penalty: The Policy Statement provides:

Collection of the withheld income and employment taxes or collected excise taxes is achieved when the Service's right to retain the amount collected is established.

See I.R.M., pt. 1.2.14.1.3(3) (June 9, 2003).

d. TFRP Assessments Generally Wait for the Resolution of In-Business Installment Agreements and Bankruptcy Payments Plans:

Absent statute considerations, assertion recommendations normally will be withheld in cases of approved and adhered to business installment agreements and bankruptcy payment plans. To the extent necessary, information will be gathered to support a possible assessment in the event the agreement is defaulted.

See I.R.M., pt. 1.2.14.1.3(8) (June 9, 2003).

D. General Rules Related to Assessment

1. Appropriateness of TFRP Assessments:

a. Penalty Authorized: Any person required to collect, truthfully account for, and pay over any "trust fund tax" who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof. I.R.C. § 6672.

b. Requirements: Based on the statutory language, two conditions *must* be satisfied in order for a person to be assessed:

(1) The person was "responsible;" and

(2) The person was "willful."

c. Amount of the Penalty: The amount of the penalty is equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. I.R.C. § 6672.

2. Statute of Limitations: The IRS has three years beginning on the date that the employment or excise tax return that gave rise to the proposed TFRP assessment to issue Letter 1153 (the statutory notice required pursuant to I.R.C. § 6672(b)) to the person who the IRS proposes to assess with the TFRP. The statute of limitations does not expire before the later of:
  - a. the date 90 days after the date on which Letter 1153 was mailed or delivered in person, or
  - b. 30 days after the final determination in response to a protest timely-filed in response to Letter 1153.
3. Trust Fund Taxes: As noted, the taxes for which the penalty applies are those reportable on the following forms:
  - a. Form 941, *Employer's QUARTERLY Federal Tax Return*;
  - b. Form 720, *Quarterly Federal Excise Tax Return*;
  - c. Form CT-1, *Employer's Annual Railroad Retirement and Unemployment Return*;
  - d. Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*;
  - e. Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*;
  - f. Form 945, *Annual Return of Withheld Federal Income Tax*;
  - g. Form 944, *Employer's ANNUAL Federal Tax Return*;
  - h. Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*; and
  - i. Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*. See I.R.M., pt. 5.7.3.1.1(3) (Aug. 6, 2015).
4. Requirement 1: Responsible Person:
  - a. In General: The first requirement for imposition of the TFRP is that the person must be a "responsible person". Responsibility is a matter of status, duty, and authority. Those performing ministerial acts without exercising independent judgment will not be deemed responsible. A "responsible person" is one who has the duty to perform or the power to direct the act of collecting, accounting for, or paying over trust fund taxes.
  - b. Responsible Person Defined: A "responsible person" is one who has the duty to perform or the power to direct the act of collecting, accounting for, or paying over trust fund taxes.
    - (1) Must Be Duty to Account For, Collect, and Remit Trust Fund Taxes: Regardless of a person's corporate title, a person will not be held liable for the TFRP unless he or she has the duty to account for, collect, and pay over the trust fund taxes to the government. I.R.M., pt. 5.17.7.1.1 (July 18, 2012).
    - (2) Title Inconsequential: Even an officer of the business will not be a responsible person if he or she is an officer in title only and has no substantive duties with the business. O'Connor v. United States, 956 F.2d 48 (4th Cir. 1992).

On the other hand, a person who has no corporate title but has control of financial affairs or controls payment of funds by the business, may be held responsible for the TFRP. I.R.M., pt. 5.17.7.1.1 (July 18, 2012).

- (3) Factors: A responsible person has:
- (a) Duty to perform;
  - (b) Power to direct the act of collecting trust fund taxes;
  - (c) Accountability for and authority to pay trust fund taxes; and
  - (d) Authority to determine which creditors will or will not be paid.

- (4) When Does Responsibility Begin: A person who becomes a “responsible person” when the business does not have the funds to pay an employment tax liability that arose under previous management and who uses funds acquired after he became a “responsible person” to pay the operating expenses of the business rather than to pay the prior withholding tax delinquency is not personally liable for the delinquency under I.R.C. § 6672. Slodov v. United States, 436 U.S. 238 (1978).

- (a) Using Funds for Improper Purposes: If funds are available to pay delinquent trust fund taxes at the time a responsible person assumes control of the business and the responsible person fails to use those funds to pay the delinquent taxes, that person will be liable for the delinquent taxes to the extent of the funds available to pay the trust fund taxes. Slodov v. United States, 436 U.S. 238, 255 (1978).

- c. Typical Responsible Persons: The IRS may look to one or more of the following directors, officers, employees or owners for potential TFRP assessment:

- (1) Officer or employee of a corporation;
- (2) Partner or employee of a partnership;
- (3) Member or employee of an LLC;
- (4) Corporate director or shareholder;
- (5) Another corporation;
- (6) Surety or lender;
- (7) Payroll Service Provider (“PSP”);
- (8) Responsible parties within a PSP;
- (9) Professional Employer Organization (“PEO”);
- (10) Responsible parties within a PEO; and
- (11) Responsible parties within the common law employer (*i.e.*, a client of PSP or a PEO).

- d. Liability Not Mutually Exclusive: Any of the individuals listed above may be held liable if that person fails to collect, truthfully account for or pay over the taxes. Slodov v. United States, 436

U.S. 238 (1978). One or more persons may be responsible persons within the meaning of I.R.C. § 6672 for the same quarter. Thomas v. United States, 41 F.3d 1109 (7th Cir. 1994).

- e. Facts and Circumstances Test: A determination of “responsibility” depends upon the facts and circumstances of each case. Common factors considered by the court include the following:
- (1) Identification of the person as an officer, director, or principal shareholder of the corporation, a partner in a partnership, or a member of an LLC;
  - (2) Duties of the officer as set forth in the by-laws;
  - (3) Authority to sign checks;
    - (a) Signature authority may be mere convenience and does not necessarily mean that a person was responsible.
  - (4) Identification of the person as the one in control of the financial affairs of the business;
  - (5) Identification of the person as the one who had authority to determine which creditors would be paid and those who exercised that authority;
  - (6) Identification of the person as the one who controlled payroll disbursements;
  - (7) Identification of the person as the one who had control of the voting stock of the corporation; and
  - (8) Identification of the person as the one who signed the employment tax returns.

\*\* The crucial test is whether the person has the “effective power to pay the taxes owed.” Purcell v. United States, 1 F.3d 932, 937 (9th Cir. 1993). A person is deemed to have such power if he or she possesses the authority to exercise significant control over the company’s financial affairs whether or not such control is in fact exercised. Id. at 937. Significant control generally relates to the person’s status, duty, and authority in the business that failed to carry out one of the three statutory duties. Davis v. United States, 961 F.2d 867 (9th Cir. 1992).

- f. Factors Considered: Responsibility is a matter of status, duty, and authority. Those performing ministerial acts without exercising independent judgment will not be deemed responsible. I.R.M., pt. 8.25.1.4.1 (Dec. 7, 2012). The holding of corporate office, control over financial affairs, the authority to disburse corporate funds, stock ownership, and the ability to hire and fire employees are important factors to consider in determining responsibility. Thibodeau v. United States, 828 F.2d 1499 (11th Cir. 1987).

- g. Superior Order Defense Rejected: A person may be liable for failure to pay over withheld funds to the United States, even if

ordered by the corporation's chief executive officer not to pay the taxes. Roth v. United States, 779 F.2d 1567 (11th Cir. 1986). An employee who is otherwise a responsible person may not be relieved of liability merely because he was instructed to not pay the taxes. Brounstein v. United States, 979 F.2d 952 (3d Cir. 1992).

- h. Non-officers and Non-employees May Be Held Liable: A director who is not an officer or employee of the corporation may be responsible for the TFRP if he or she was responsible for the corporation's failure to pay taxes that were due and owing. Commonwealth Nat'l Bank of Dallas v. United States, 665 F.2d 743 (5th Cir. 1982).
- i. Title Not Dispositive: An officer of the business will not be a responsible person if he or she is an officer in title only and has no substantive duties with the business. O'Connor v. United States, 956 F.2d 48 (4th Cir. 1992).
- j. Penalty Will Generally Not Be Applied Against Unpaid Volunteers or Members of the Board of Trustees: The penalty will not be imposed against any unpaid, volunteer member of any board of trustees or directors of an organization exempt when the member:
  - (1) is solely serving in an honorary capacity,
  - (2) does not participate in the day-to-day or financial operations of the organization, and
  - (3) does not have actual knowledge of the failure on which such penalty is imposed. This exclusion does not apply when it results in no person being liable for the TFRP.
- k. Multiple Responsible Persons Can Exist: More than one person may be held responsible, not just the most responsible person. Howard v. United States, 711 F.2d 729 (5th Cir. 1983).
- l. TFRP Not Required in Sole Proprietorships or Disregarded Entities: The TFRP is not needed to assert liability against the owner of a sole proprietorship or a disregarded entity because the individual owner is personally liable for employment taxes under I.R.C. §§ 3101, 3402, and 3403.
- m. General Partners Fully Liable: Similarly, general partners will be fully liable for entire employment tax, and not just the trust fund portion. See United States v. Galletti, 541 U.S. 114 (2004). This is because general partners are individually liable under State law for the debts of a partnership; therefore, assessments are made in the name of the partnership and the names of the general partners. Accordingly, there is usually no reason to make a separate TFRP assessment against the various partners. United States v. Galletti, 541 U.S. 114 (2004).
- n. Partners and Members Generally: In accordance with I.R.C. § 6671(b), a member of a partnership, LLC, or limited liability partnership may be liable for the TFRP. I.R.M., pt. 5.17.7.1.1.3

- (Aug. 1, 2010).
- o. Employers Potentially Liable: An employee may be liable for the TFRP if he or she made the decision not to pay the taxes due. Gephart v. United States, 818 F.2d 469 (6th Cir. 1987). As noted, employees are generally under the dominion and control of an employer; however, instructions from a supervisor not to pay taxes do not relieve an employee who is an otherwise “responsible person” from I.R.C. § 6672 liability. Brounstein v. United States, 979 F.2d 952 (3d Cir. 1992).
5. Requirement 2: Willfulness:
- a. Willfulness: The second requirement for imposition of the TFRP is that the responsible person must have acted “willfully”. A “responsible person” must be willful in the failure to comply in order to be assessed with the TFRP.
  - b. Defined: Willfulness indicates intentional, deliberate, voluntary, reckless, or knowing (not accidental) conduct. No evil intent or bad motive is required. Domanus v. United States, 961 F.2d 1323 (7th Cir. 1992). “Willfulness” is the attitude of a responsible person who with free will or choice either intentionally disregards the law or is plainly indifferent to its requirements. Some factors to consider when determining willfulness are:
    - (1) Whether the responsible person had knowledge of a pattern of noncompliance at the time the delinquencies were accruing;
    - (2) Whether the responsible person had received prior IRS notices indicating that employment tax returns have not been filed, or are inaccurate, or that employment taxes have not been paid;
    - (3) The actions the responsible party has taken to ensure its Federal employment tax obligations have been met after becoming aware of the tax delinquencies; and
    - (4) Whether fraud or deception was used to conceal the nonpayment of tax from detection by the responsible person.
  - c. Aware of Taxes and Chose Not to Pay: Willfulness exists when the person was aware of the outstanding taxes and either deliberately chose not to pay the taxes or recklessly disregarded an obvious risk that the taxes would not be paid. Phillips v. United States, 73 F.3d 939, 942 (9th Cir. 1996).
  - d. Willful Blindness: Willful blindness to the failure to pay which can be demonstrated by a failure to investigate or correct mismanagement satisfies the willfulness factor. Finley v. United States, 123 F.3d 1342 (10th Cir. 1997).
  - e. Payment of Net Wages: The payment of net wages (wages minus trust fund taxes) constitutes willfulness. Hochstein v. United States, 900 F.2d 543, 548 (2d Cir. 1990). If funds are not available

- to cover both wages and withholding taxes, a responsible person has a duty to prorate the available funds between the United States and the employees so that the taxes are fully paid on the amount of wages paid. For purposes of determining willfulness, an employee owed wages is merely another creditor of the business, and preferences to employees over the government constitute willfulness. Id.
- f. Mistaken Belief: A mistaken belief that payments to other creditors were required to be made in preference to trust fund taxes does not make the failure to pay non-willful. Thomsen v. United States, 887 F.2d 12, 17-18 (1st Cir. 1989).
  - g. Duty Not Absolute: The statute does not impose upon the responsible person an absolute duty to pay over amounts that should have been collected and withheld by prior responsible persons. Slodov v. United States, 436 U.S. 238 (1978).
    - (1) A person who becomes a “responsible person” when the business does not have the funds to pay an employment tax liability that arose under previous management and who uses funds acquired after he became a “responsible person” to pay the operating expenses of the business rather than to pay the prior withholding tax delinquency is not personally liable for the delinquency under I.R.C. § 6672.
    - (2) If funds are available to pay delinquent trust fund taxes at the time a responsible person assumes control of the business and the responsible person fails to use those funds to pay the delinquent taxes, that person will be liable for the delinquent taxes to the extent of the funds available to pay the trust fund taxes.
  - h. Failure to Act Following Notice That Taxes Not Paid: A responsible person’s failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid satisfies the I.R.C. § 6672 “willfulness” requirement. Finley v. United States, 123 F.3d 1342 (10th Cir. 1997).
  - i. Criminal Cases Compared: The TFRP is a civil penalty; so the degree of willfulness in failing to collect or pay over any tax leading to liability for this penalty is not as great as that necessary for criminal proceedings.
6. Extent of Liability, Voluntary Payments, and Involuntary Payments:
- a. In General: I.R.C. § 6672 is limited to the trust fund portion of the tax; that is, to the tax that the “responsible person” is required to collect or withhold from the wages of employees.
  - b. Designation of Voluntary Payments of Paramount Importance: It is important when submitting voluntary payments that the payments be designated to the trust fund portion first. To determine the application of payments and other credits for purposes of determining the TFRP, follow the guidelines in I.R.M.,

pt. 5.7.7, *Payment Application and Refund Claims*.

- (1) Rule to Designate Voluntary Payments: In order to meet the requirements for a proper designation, two prerequisites must be met:
    - (a) The payment must be voluntary.
    - (b) The request or designation for the application of the payment must be specific, in writing, and made at the time of the payment.
  - (2) Designations in Connection With Installment Agreements: While under an approved installment agreement, a business may not designate that its monthly installment payment be applied to the trust fund portion of the tax liability.
  - (3) Designations in Connection With Offers in Compromise: Payments made on a corporate OIC may be designated for trust fund if the designation is made in writing at the time of the payment.
- c. Involuntary Payments Compared:
- (1) Applied in Best Interest of the Government: Involuntary payments are applied in the best interest of the Government. I.R.M., pt. 8.25.2.4.4.4 (Oct. 14, 2014).
  - (2) Involuntary Payments Defined: Involuntary payments are those received by the Government as the result of an action other than that of the taxpayer. I.R.M., pt. 8.25.2.4.4.4 (Oct. 14, 2014). Typically, this would be a levy.
  - (3) Refund Offsets and Payments Through an Installment Agreement: Refund offsets are considered involuntary, as are payments made through an approved installment agreement.
- d. Basis of TFRP After Designation of Payments: After the application of payments has been made, the TFRP is based on the remaining outstanding amount of withheld income tax and employee's FICA tax. I.R.M., pt. 5.17.7.1.6 (Aug. 1, 2010).
- e. Limits of the TFRP: The TFRP does not apply to direct taxes such as the employer's portion of FICA or FUTA. Neither does it apply to non-collected excise taxes.
- f. Allocation of Non-Designated Payments: Any payment made on the business account is deemed to represent payment of the non trust fund portion of the tax liability (e.g., employer's share of FICA) unless designated otherwise by the taxpayer. The taxpayer, of course, has no right of designation of payments resulting from enforced collection measures. To the extent partial payments exceed the non trust fund portion of the tax liability, they are deemed to be applied against the trust fund portion of the tax liability (e.g., withheld income tax, employee's share of FICA, collected excise taxes). Once the non trust fund and trust fund taxes are paid, the remaining payments will be considered to be

applied to assessed fees and collection costs, assessed penalty and interest, and accrued penalty and interest to the date of payment. I.R.M., pt. 1.2.14.1.3 (June 9, 2003).

7. Interest Accruals:

- a. Computation of Interest: I.R.C. § 6601(e) (2) provides that “Interest shall be imposed under subsection (a) in respect of any assessable penalty, additional amount, or addition to the tax (other than an addition to tax imposed under section 6651 (a)(1) or 6653 or under part II of subchapter A of chapter 68) only if such assessable penalty, additional amount, or addition to the tax is not paid within 21 calendar days from the date of notice and demand therefor (10 business days if the amount for which such notice and demand is made equals or exceeds \$100,000), and in such case interest shall be imposed only for the period from the date of the notice and demand to the date of payment.” Stated simply, interest accrues on the TFRP, but does not start until the penalty is assessed against the responsible person and notice and demand for payment is sent to the last known address.

8. Defenses to the TFRP:

- a. Overview: The following may be defenses to the assertion of the TFRP:
- (1) The person was not responsible (fact-specific, and be sure to focus on the factors discussed above);
  - (2) The person did not act willfully;
  - (3) The person acted with reasonable cause, depending upon the State in which the taxpayer lives. [See discussion below on the split among the federal circuit courts];
  - (4) The IRS misapplied designated payments;
  - (5) The period of limitations on assessment expired;
  - (6) The period of limitations on collection expired;
  - (7) The IRS failed to follow proper procedure with respect to the assessment of the TFRP, including noncompliance with I.R.C. § 6751(b);
  - (8) The minimal likelihood of collection;
  - (9) Sue other responsible persons for contribution; and
  - (10) Sue business to pay.
- b. Reasonable Cause Defense:
- (1) In General: The federal circuit courts are split on the issue of allowing a reasonable cause defense to negate willfulness.
  - (2) Reasonable Cause Not a Defense: The Courts of Appeals for the First and Eighth Circuits have determined that reasonable cause is not a defense. Olsen v. United States, 952 F.2d 236 (8th Cir. 1991); Harrington v. United States, 504 F.2d 1306 (1st Cir. 1974).
  - (3) Reasonable Cause Maybe a Defense: The Court of Appeals

for the Ninth Circuit has not stated specifically that the reasonable cause defense does not apply; however, it has determined that “conduct motivated by a reasonable cause may, nonetheless, be willful.” Phillips v. United States, 73 F.3d 939, 942 (9th Cir. 1996).

- (4) Reasonable Cause a Defense: The Courts of Appeals for the Second, Fifth, Tenth, and Eleventh Circuits have determined that the reasonable cause defense could apply to willfulness determinations under I.R.C. § 6672, but under extremely limited circumstances. Smith v. United States, 555 F.3d 1158, 1170 (10th Cir. 2009) (reasonable cause defense must be narrowly construed with respect to I.R.C. § 6672); Thosteson v. United States, 331 F.3d 1294, 1301 (11th Cir. 2003) (court does not decide whether reasonable cause applies, but notes that this defense is exceedingly limited); United States v. Winter, 196 F.3d 339, 354 (2d Cir. 1999) (reasonable cause defense negated willfulness only if the responsible person reasonably believed that taxes were being paid); Logal v. United States, 195 F.3d 229, 233 (5th Cir. 1999) (reasonable cause defense is exceedingly limited.).

E. Assessments of and Protests to the TFRP

1. Determinations of the TFRP by Revenue Officers: Revenue officers are responsible for determining collection potential as well as investigating whom they believe was responsible and willful for the nonpayment of trust fund taxes.
2. Assessment of the TFRP:
  - a. IRS’s Assessment Policies: The IRS considers the following factors when determining whether or not to impose the TFRP:
    - (1) “The trust fund recovery penalty, applicable to withheld income and employment (social security and railroad retirement) taxes or collected excise taxes, will be used to facilitate the collection of tax and enhance voluntary compliance. If a business has failed to collect or pay over income and employment taxes, or has failed to pay over collected excise taxes, the trust fund recovery penalty may be asserted against those determined to have been responsible and willful in failing to pay over the tax. Responsibility and willfulness must both be established. The withheld income and employment taxes or collected excise taxes will be collected only once, whether from the business, or from one or more of its responsible persons.” Policy Statement 5-14 (Formerly P-5-60).
    - (2) “Absent statute considerations, assertion recommendations normally will be withheld in cases of approved and adhered to business installment agreements and bankruptcy

payment plans. To the extent necessary, information will be gathered to support a possible assessment in the event the agreement is defaulted.” I.R.M. 1.2.14.1.3.8 (June, 9, 2003).

- (3) The goal of the TFRP is to recover the trust fund taxes that have not been paid. Accordingly, if the business enters into an in-business installment agreement, the IRS policy is generally to withhold assessment provided that the statute of limitations is not at risk. Therefore, the potential responsible person(s) will be required to submit a IRS Form 2750, *Waiver Extending Statutory Period for Assessment of Trust Fund Recovery Penalty*. to extend the statute of limitations for assessment. If the business defaults, the IRS will proceed with assessment against the responsible person(s).

3. Trust Fund Investigation:

a. The Form 4180:

- (1) Relevance: The revenue officer will use Form 4180, *Report of Interview With Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes*, to ask the potential “responsible person(s) questions to determine if they should be assessed.
- (2) Importance of the Form 4180: The revenue officer conducting the interview will use the Form 4180 to perform his or her analysis.
- (3) Questions Asked: The form asks the following questions:
  - (a) Did you determine the financial policy for the business?
  - (b) Did you direct or authorize payment of bills?
  - (c) Did you open or close bank accounts for the business?
  - (d) Did you guarantee or co-sign loans?
  - (e) Did you sign or countersign checks?
  - (f) Did you authorize or sign payroll checks?
  - (g) Did you authorize or make federal tax deposits?
  - (h) Did you prepare, review, sign, or transmit payroll tax returns?
- (4) Use Attachments: Each question on the Form 4180 requires a “yes” or “no” response. The short response format sometimes results in inaccurate, misleading, and inconsistent statements. The taxpayer needs to make the IRS aware of exculpatory facts. Stated simply, in many instances the answer is not as simple as yes or no.

b. The Form 4180 Interview:

- (1) Relevance: The revenue officer should ask to question the individuals that may be “responsible”, including with those

who have signatures on bank checks and owners, investors, and officers of the business. Depending upon the facts, you may want to decline this interview and let the Form 4180 speak for itself. For example, in cases with criminal concerns, it is never a good idea to submit to the interview. Moreover, as a practical matter, some revenue officers will altogether waive the Form 4180 interview, even though the I.R.M. technically requires the interview.

- (2) Naming Other Potentially Responsible Persons: The Form 4180 interview also request the interviewee to turn in others--colleagues, investors, family members--who may have been involved in the occupation. The relevant question asked is: "Who else performed this duty?" "Performing the duty" is not always the same as the control and authority over financial matters. Other individuals can be wrongly implicated if the interviewee lacks a proper understanding of the question.
- (3) When to Decline the Interview: IRS guidelines require the revenue officer to take an in-person interview, but many revenue officers will waive the interview and accept the Form 4180 by mail. This may be advisable in a number of situations, especially where the client may be criminally liable.

4. Best Practices:

- a. In General: Some best practices before completing the Form 4180 or submitting to the Form 4180 Interview are:
  - (1) Review the bank statements and canceled checks;
    - (a) As bank checks are a primary source in directing the IRS to those with responsibility, it is important to recognize how many checks the taxpayer signed. Also, knowing when the checks were signed can be important. If the checks were only signed during one quarter, but the business had a payroll tax problem for three quarters, there may be limits to the taxpayer's liability to just that one quarter. Knowing how many checks the taxpayer drafted can also be important. The authority to write a few checks a month for deliveries to the office is not the same as control over company finances.
  - (2) Interview with the client;
    - (a) As noted, the overly simplified format of the Form 4180 can cause important facts to be omitted. Thus, in most cases, it is essential to send the IRS a supplement that clarifies the issues the form does not take into account. The statements should be direct and to the point and no more than two

typewritten pages, if possible. The statement should concentrate on the distinguishing facts, such as the process of how an officer manager had to submit invoices to a chief financial officer for review before payment.

- (3) Interview third parties; and
    - (a) Third parties with exculpatory knowledge should also be interviewed. Third-party statements provide additional credibility to your witness/taxpayer and another point of view.
  - (4) Complete the Form 4180 in advance of the interview.
    - (a) Complete the Form 4180 in advance of the interview and send it to the Revenue Officer. Although IRS guidelines require the revenue officer to take an in-person consultation, many revenue officers will waive the interview and accept the Form 4180 by mail.
- b. In-Business Installment Agreements: For in-business installment agreement, negotiate non-assertion of the TFRP against the potential responsible person(s) by taking the following steps:
- (1) Offer extension of time for assessment of the TFRP by agreeing to execute Form 2750, *Waiver Extending Statutory Period for Assessment of Trust Fund Recovery Penalty*;
  - (2) Demonstrate that the in-business installment agreement will serve to repay the unpaid taxes;
  - (3) While review of the proposed installment agreement is pending, make voluntary payments towards the liability. All voluntary payments should be designated to the unpaid trust fund liability amount. Once the installment agreement is granted, the taxpayer will not be able to designate how payments are applied. The IRS will apply those payments and all undesignated payments in the “best interest of the government.”
    - (a) The payment designation must be specific, in writing and made at the time that the payment is submitted. Example: “Payment designated to the ‘trust fund’ portion of the Form 941 taxes owed for the tax period ending on March 31, 2015.”
- c. Out-of-Business Companies: For out-of-business companies, negotiate placement of the business into currently-not-collectible status. The IRS will expect the business to liquidate its assets and use proceeds from liquidation to pay towards its outstanding liability.
- (1) Liquidation Proceeds: Payments from the proceeds obtained from the liquidation of the business assets should

be submitted as voluntary payments designated to the trust fund taxes that are owed.

d. Insolvent Responsible Persons: For insolvent, potential responsible person(s), consider negotiation of non-assertion of the TFRP based on the IRS Non-Assertion Policy for insolvent taxpayers.

(1) Non-Assessment for Non-Collectibility: The IRS will normally not assess the TFRP when:

- (a) There is no present or future collection potential;
- (b) Neither the responsible person nor their assets/income sources can be located;
- (c) There is no collection potential;
- (d) The aggregate trust fund balance is below the amount in I.R.M., pt. 5.7.4.1.1(3) (Nov. 12, 2015) (currently \$25,000); and
- (e) There is no potential the taxpayer will accrue additional liabilities. See I.R.M., pt. 5.7.5.1 (Nov. 12, 2014).

5. TFRP Assessment and Protests:

a. Issuance of the Letter 1153: Before a TFRP is assessed, taxpayers must be mailed or hand-delivered a Letter 1153, *Proposed Notice of Trust Fund Recovery Penalty*, (i.e., the notice required by I.R.C. § 6672(b)(1)). See *Mason v. Commissioner*, 132 T.C. 301, 317 (2009).

(1) Significance of Letter 1153: Letter 1153 advises taxpayers of the proposed penalty and of their right to appeal the determination within 60 days. Issuance of the Letter 1153 prior to the ASED is required on all TFRP assessments.

(2) Managerial Approval: I.R.C. § 6751(b) requires that most penalty assessments, including the TFRP, be approved in writing by the IRS employee's immediate supervisor. The examiner is not required to provide a copy of the written approval to the taxpayer, but taxpayers are entitled to request these documents under FOIA. To provide for proper notice of the assessment of trust fund penalties, I.R.C. § 6672 refers to the instructions in I.R.C. § 6212(b) that provide for a properly mailed notice of deficiency. I.R.C. § 6672(b); *Mason v. Commissioner*, 132 T.C. at 317.

(a) Accordingly, in order for the IRS to properly assess a TFRP, the Letter 1153 must be either mailed to the responsible person in the same manner as a notice of deficiency or personally delivered to the responsible person.

b. Procedures When Responsible Person Agrees with Assessment: If a responsible person agrees with the assessment, he or she will be asked to sign Form 2751, *Proposed Assessment of Trust Fund*

*Recovery Penalty*, and return the signed form to the revenue officer.

c. Procedures When the Responsible Person Disagrees with Assessment: If a responsible person disagrees with the assessment, then the following steps should be taken:

(1) Within 60 days of the issuance of the Letter 1153, submit a written protest to the revenue officer. In response to the protest, the revenue officer can rescind the Letter 1153 by issuing Letter 1153W, *Proposed Trust Fund Recovery Penalty Rescission Notification*, but is likely to forward the case to Appeals.

(a) Items to Include With Protest: The protest should:

- (1) List the taxpayer's name, address and social security number;
- (2) Enclose a copy of the Letter 1153 or list the date and number of the letter received;
- (3) List the tax period(s) being protested;
- (4) Enclose a list of the disputed issues and the reasons for the disagreement;
- (5) Identify the dates and amount of any payments in dispute;
- (6) Include specific dates, names, amounts and locations which support his or her position;
- (7) Include a clear explanation of the taxpayer's duties and responsibilities; specifically, address the duty and authority to collect, account for and pay the trust fund taxes.
- (8) If signed by the taxpayer, he or she should sign the written protest under penalties of perjury by making the following statement (the jurat): "Under the penalties of perjury, I declare that I have examined the facts stated in this protest, including any accompanying documents, and to the best of my knowledge and belief, they are true, correct and complete."

(i) If the taxpayer's representative signs the protest, he or she must substitute a declaration stating: (1) he or she submitted the protest and accompanying documents; and (2) whether or not he or she knows personally that the facts stated in the protest and accompanying documents are true and correct.

(b) Deficient Protests: A timely mailed protest is still

timely for purposes of I.R.C. 6672(b)(3)(B) even if the protest is inadequate.

- (c) Failure to Resolve With Appeals: If the case cannot be resolved in appeals, the next step would be litigation in the appropriate U.S. district court.

6. Collectability Determinations:

- a. Required for Assessment: A collectability determination must be made in order to determine if the TFRP should be assessed.

- b. When TFRP Will Not Be Assessed: The TFRP will normally not be assessed when:

- (1) There is no present or future collection potential;
- (2) Neither the responsible person nor their assets/income sources can be located; or
- (3) When investigation has determined that:
  - (a) There is no collection potential
  - (b) The aggregate trust fund balance is *de minimis*; and
  - (c) There is no potential the taxpayer will accrue additional liabilities.

- c. The Process to Facilitate Collectability Determinations: In connection with making a collectability determination, the IRS will:

- (1) Information to Facilitate Determination: The revenue officer will secure Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, in order to determine collectability.

- (a) Short Forms: Form 433-F, *Collection Information Statement*, may be used instead of Form 433-A if the individual is a wage earner and the potential TFRP liability is less than \$100,000.

- (b) Previously Submitted Collection Information Statements: A collection information statement (*i.e.*, a form within the Form 433 series) is not required if one was obtained within the past 12 months, but current research of the taxpayer's information is still required.

- (2) Factors Considered: The following factors will be considered when determining collectability of the TFRP:

- (a) Current financial condition;
- (b) Involvement in a bankruptcy proceeding;
- (c) Income history and future income potential; and
- (d) Asset potential (*i.e.*, the likelihood of increases in equity in assets and taxpayer's potential to acquire assets in the future).

- (3) Action Taken: Pursuant to I.R.M., pt. 5.7.5.3.1 (Nov. 12, 2014), below are the guidelines revenue officers use to determine whether or not to assert the TFRP based on

collectibility:

If a responsible person's financial analysis shows. . .	Then. . .
Any present or future ability to pay	Assess the penalty and take the appropriate collection action based on an analysis of the taxpayer's financial condition.
No present, but future ability to pay	Assess the TFRP based on future income potential and possible refund offset. Prepare a pre-assessed Form 53, <i>Report of Currently Not Collectible Taxes</i> , and file a lien if appropriate.
The responsible person cannot be located or contacted but internal research identifies assets or income sources	Assess the TFRP since there is a good possibility of some collection from the assets/income sources that were located.
No present or future income potential exists over the collection statute period	Do not assess the TFRP since the financial analysis shows there is little prospect that the taxpayer will receive any increase in income or acquire assets that will enable the IRS to collect any of the penalty.

F. Strategies to Challenge Assessment of the TFRP

1. In-Business Company, Responsible Person Assessment: Assume that XYZ Corp. is a going concern but has delinquent trust fund taxes. Proceed as follows:
  - a. Determine the financial viability of XZY Corp.
  - b. Can XYZ Corp. afford to stay current with its deposit requirements?
  - c. Can XYZ Corp. afford to pay off the liability with an in-business installment agreement?
  - d. If XYZ Corp. can afford to stay current with its deposit requirements and pay off its liability through an installment agreement, consider negotiating an in business installment agreement.
  - e. Negotiate non-assertion of the TFRP against the potential responsible persons.
    - (1) To defer assessment of the TFRP:
      - (a) Negotiate the in-business installment agreement;
      - (b) Extend the statute of limitations for assessment of the TFRP by submitting a Form 2750.
  - f. To the extent possible, before the installment agreement is accepted, consider submission of voluntary payments from the business to the IRS.

- g. Voluntary payments should be designated to a specific tax, tax period and trust fund.
  - 2. Out-of-Business Company, Responsible Person Assessment: Assume that XYZ Corp. is no longer a going concern, but has net realizable equity in assets to be liquidated. Proceed as follows:
    - a. For employer's that cease business operations, it is important to negotiate placement of the employer's case in "currently not collectible" status pending the sale of any business assets.
    - b. The IRS will expect that the employer submit proceeds from the sale of business assets to the IRS.
  - 3. Responsible Person Assessment: Assume that the corporation is no longer a going concern and that the IRS proposes to assess the TFRP. Proceed as follows:
    - a. Determine the financial status of the potential "responsible" person.
    - b. If the IRS will not be able to collect from the individual, the IRS policy is to forgo assessment of the TFRP.
    - c. Evaluate the facts and circumstances to determine defenses on the merits:
      - (1) Is the person responsible?
      - (2) Was the person willful?
    - d. Determine how much the company can afford to pay and submit designated, voluntary payments to the IRS pending resolution of the business case.
    - e. IRS must issue Letter 1153 to responsible person before it can assess the TFRP.
    - f. The person has 60 days from the date of the letter to timely file a protest with the IRS.
    - g. The protest is filed with the Revenue Officer assigned to the case.
- G. Resolution of Multiple TFRP Assessments
- 1. Joint and Several Liability:
    - a. Liability for Taxes: Individuals assessed with the TFRP are jointly and severally liable for the trust fund taxes owed.
    - b. Right of Contribution: When the company and/or any individual makes payments towards the liability, all individuals assessed should receive credit for that payment.
      - (1) The IRS Compliance Services Collection Operations ("CSCO") group is responsible for cross referencing posted payments. Typically, these payments are coded as "290", which means that payments by the entity should be credited against the individual taxpayer's TFRP liability.
      - (2) Voluntary payment should be designated to "trust fund" taxes and include instructions for cross-references to the business and/or the individual.
    - c. Join Other Responsible Persons in District Court Litigation: If the IRS brings suit to compel collection of the TFRP, then the named

defendant should join the other responsible persons in the suit.

H. Repeating, Pyramiding, Criminal Referrals & Injunctions

1. Repeaters:

- a. Repeater Defined: The IRS defines a repeater as a taxpayer that has had more than one module with a Taxpayer Delinquency Account (a/k/a “TDA”) or Taxpayer Delinquency Investigation (a/k/a “TDI”) delinquency that first came into existence in the immediate past two years from the current cycle.
- b. Early-Intervention: Early intervention and monitoring may bring repeaters into compliance. In order to stop pyramiding immediately, the IRS encourages its Revenue Officers to seek enforced collection immediately in these cases.
  - (1) I.R.M. Instructions: The I.R.M. directs the revenue officer to make initial contact within 45 days and prevent the pyramiding of trust fund taxes. See I.R.M., pt. 5.7.8.4 (May 7, 2012). During the initial contact, revenue officers are to (1) conduct the 4180 Interview at the time of the initial contact, (2) get the taxpayer current with employment tax obligations, and (3) secure financial statements. Id. Once this information is received, then the revenue officers are to work a case with a view towards preventing a repeater from becoming a pyramider. Id.

2. Pyramiders:

- a. Pyramider Defined: The IRS defines a pyramider as a taxpayer that is in-business, is not current with tax deposit requirements, and has at least two quarters with balances owed. I.R.M., pt. 5.7.8.4 (Mar. 9, 2017).
- b. Early-Intervention: Early intervention and monitoring may bring pyramiders into compliance. In order to stop pyramiding immediately, the IRS encourages its Revenue Officers to seek enforced collection immediately in these cases.

3. Disqualified Employment Tax Levies:

- a. When Sought: If the taxpayer previously requested a CDP hearing for employment taxes and pyramided additional liabilities, the IRS may pursue a disqualified employment tax levy. I.R.M., pt. 5.7.8.5 (12) (Mar. 9, 2017).
- b. Background: The Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, Title VIII, § 8243, 121 Stat. 112, modified the CDP procedures for certain employment tax liabilities by amending I.R.C. § 6330(f) and (h) to permit issuance of a disqualified employment tax levy for collection of certain employment taxes without first giving the taxpayer pre-levy CDP notice.
  - (1) Disqualified Employment Tax Levy Defined: I.R.C. § 6330(h) describes a disqualified employment tax levy, as any levy for the collection of employment taxes for a

- taxable period that is within the two-year period after an employment tax period for which the taxpayer or predecessor timely requested a hearing under I.R.C. § 6330.
- (2) Elements for a Disqualified Employment Tax Levy: The IRS is authorized to issue a disqualified employment tax levy when the following elements are met:
- (a) A levy was served to collect employment taxes;
  - (b) The taxpayer or its predecessor previously requested a CDP levy hearing relating to employment taxes; and
  - (c) The prior CDP hearing included unpaid employment taxes that arose within the two-year period prior to the beginning of the period for which the levy is served. I.R.M., pt. 5.11.5.2 (Aug. 1, 2014).
- c. Effective Date and Applicable Forms: This amendment is effective for such levies served on or after September 22, 2007, and relates to Forms 941, 943, 944, 945, 940, and CT-1.
4. Letter 903 and Notice 931: If levy sources are exhausted and the repeater or pyramiding taxpayer has no assets which can be seized to resolve or offset the liability, consider issuing Letter 903 (DO) and Notice 931. I.R.M., pt. 5.7.8.5(12) (Mar. 9, 2017).
- a. Significance of the Issuance of Letter 903: IRS Letter 903, *You Haven't Deposited Federal Employment Taxes*, is used by revenue officers to alert taxpayers to the provisions of I.R.C. § 7402(a), which provides the U.S. district courts with the jurisdiction to pursue civil injunctions under the Internal Revenue Code and Title 18 of the United States Code.
- (1) Egregious Cases: The IRS instructs its employees that the Letter 903 procedures should be used in egregious cases of noncompliance and the collection procedures have already been unproductive or would be futile to stop or reduce trust fund pyramiding. See I.R.M., pt. 5.7.2.1 (Sept. 28, 2012).
  - (2) Historical Uses of the Letter 903: Historically, the Letter 903 was provided to pyramiding taxpayers prior to the revenue officer requiring the taxpayer to file monthly 941 returns or obtain a special bank account to ensure timely compliance in accordance with I.R.C. § 7215. I.R.M., pt. 5.7.2.1 (Sept. 28, 2012). The IRS no longer requires monthly filing and special deposits before escalating employment tax cases. Id.
  - (3) Reading Between the Lines: Issuance of Letter 903 is required before a taxpayer can be recommended for civil injunction or criminal prosecution. I.R.M., pt. 5.7.2.2(2) (Mar. 19, 2015). Thus, practitioners should be mindful that the issuance of Letter 903 signals the escalation of the case

to the Tax Division and, perhaps, the conversion of the case from civil to criminal.

5. Civil Injunctions: In situations of continued taxpayer noncompliance, and if no viable levy sources exist, then revenue officers may pursue civil injunctions per I.R.M., pt. 5.17.4.17. I.R.M., pt. 5.7.8.5(12) (Mar. 9, 2017).
  - a. Injunction Defined: An injunction is a court order that requires a party either to refrain from certain actions or to perform certain actions. Injunctions can be obtained to restrain the future conduct of any person when necessary or appropriate to enforce the internal revenue laws. United States v. Ernst & Whinney, 735 F.2d 1296, 1300-1301 (11th Cir. 1984), cert. den., 470 U.S. 1050 (1985); United States v. Hart, 701 F.2d 749 (8th Cir. 1983); United States v. Ekblad, 732 F.2d 562 (7th Cir. 1984).
    - (1) Appropriate for Employment Taxes: Suits for injunctions may be appropriate against employers and their responsible officers who have a history of pyramiding federal trust fund taxes and who continue to do so. I.R.M., pt. 5.17.4.17 (Aug 1, 2010).
    - (2) Types of Injunctive Relief Sought: In past trust fund pyramiding cases, the government has sought a preliminary injunction against in-business taxpayers preventing them from:
      - (a) Failing to timely pay their future corporate income tax, FUTA tax, and withholding and FICA tax liabilities;
      - (b) Transferring any money or property to any other entity to have that entity pay the salaries or wages of the defendants' employees; and
      - (c) Assigning any property or making any payments after the preliminary injunction is issued until the trust fund liabilities, accruing after the preliminary injunction, are first paid to the Service. I.R.M., pt. 5.17.4.17.2 (Aug. 1, 2010).
    - (3) Other Relief Sought: The government has also obtained injunctions imposing the following obligations or allowing further relief:
      - (a) The individual defendants and other persons authorized to disperse company funds have been required monthly to sign and deliver to the Service statements that they have read the court's preliminary injunction order and will obey it;
      - (b) The court issue a preliminary injunction authorizing the Service to enter the defendant-taxpayers' premises and seize and sell corporate property if the defendant-taxpayers violated the injunction. Such

violations may result in further court proceedings against the violator for civil or criminal contempt, including the possibility of imprisonment. If a district court judge is initially unwilling to imprison the principals of a failing business for violating a preliminary injunction, then the court may be willing to order the failing company (through its principals) to file a bankruptcy petition for immediate liquidation and appointment of a trustee; and

- (c) Seek an injunction against corporate principals who have a pattern of creating new companies after the Service (or other creditors) seek to collect overdue accounts. See United States v. Wolf, 352 F.Supp.2d 1195 (W.D. Okla. 2004) (enjoining professional employer organization where it underpaid client's trust fund liability, diverted funds to related corporations, and left only a shell entity). Under these circumstances, the government has sought an injunction requiring the principals to, among other things, notify the Service if they acquire, manage, or work for another company in the next five years (or other appropriate time period). Id.; see also United States v. Campbell, 897 F.2d 1317, 1323-1324 (5th Cir. 1990), for an injunction case sustaining affirmative duties of this nature under I.R.C. § 7408.

See I.R.M., pt. 5.17.4.17.3 (Jan. 8, 2016).

- b. Standard for Injunctive Relief Under I.R.C. § 7402(a): In order to obtain an injunction, a plaintiff must be able to show “irreparable harm” and that it has no adequate remedy at law.
  - (1) Proof of Irreparable Harm in Employment Tax Cases: The Service has presented proof on irreparable harm satisfying these standards in trust fund cases referred for injunction.
  - (2) When Injunctions Are Sought: The Service's practice has been to limit injunction suits against trust fund pyramiding to cases where the amount of tax due is significant, and the Service has first exhausted all administrative means to collect the taxes. Accord I.R.M., pt. 5.17.4.17.1(1) (Jan. 8, 2016).
  - (3) Steps Before Seeking an Injunction: Before seeking an injunction the Service employee should:
    - (a) Exhaust all administrative remedies,
    - (b) Consult with Counsel where the taxpayer has

- previously abandoned other business ventures, leaving unpaid and uncollectible tax liabilities, and
- (c) Refer to I.R.M., pt. 5.7.2, Trust Fund Compliance, including ensuring compliance with the issuance of Letter 903. I.R.M., pt. 5.17.4.17.1(1) (Jan. 8, 2016).
- c. District Courts' Jurisdiction: The U.S. district courts have jurisdiction to issue injunctions pursuant to I.R.C. § 7402(a).
- (1) Factors Considered: In a civil injunction request related to the TFRP, courts typically focus on two factors:
    - (a) The defendant-taxpayer's persistent failure to comply with employment tax laws after repeated administrative efforts to effect voluntary compliance; and
    - (b) The reasonable likelihood that the defendant-taxpayer will continue to pyramid trust fund liabilities. United States v. Buttorff, 761 F.2d 1056, 1062 (5th Cir. 1985); United States v. Kaun, 827 F.2d 1144, 1149-50 (7th Cir. 1987). I.R.M., pt. 5.17.4.17.1(2) (Jan. 8, 2016).
  - (2) Facts DOJ Tax and the Service May Investigate: The I.R.M. instructs that requests for injunctions against a trust fund violator should show:
    - (a) The violation is not an isolated occurrence, but part of a pattern of past violations including, where applicable, evidence of prior assessments and penalties;
    - (b) The defendant-taxpayer is a responsible person with respect to the pyramided taxes;
    - (c) The defendant-taxpayer's activities place him or her in a position where continued violations can be anticipated; and
    - (d) The anticipated violations jeopardize the effective enforcement of the employment tax laws. I.R.M., pt. 5.17,4.17.1 (Jan. 8, 2016).
  - (3) Injunction Monitoring:
    - (a) Period of Injunction: Injunctions are generally issued for a period of time (*e.g.*, five years), during which the taxpayer is monitored for violations of the injunction. See I.R.M., pt. 5.17.4.17.3 (Jan. 8, 2016).
6. Criminal Referrals and Prosecution:
- a. Top Priority: Civil and criminal employment tax enforcement is among the Department of Justice's highest priorities.
    - (1) Aggravating Factors in Prosecutions: Recent prosecutions routinely include the following aggravating factors:
      - (a) Use of trust fund taxes to pay personal expenses;

- (b) Use of trust fund taxes to pay other creditors;
- (c) Payment of workers in cash;
- (d) Filing false employment tax returns; and
- (e) Pyramiding.

I. TFRP Litigation

1. Overview:

a. No Substantive Right to Challenge TFRP Assessment in Tax Court: Individuals assessed with the TFRP cannot challenge the assessment in Tax Court in deficiency or collection cases.

(1) Collection Actions May Be Challenged: Individuals assessed with the TFRP can challenge the IRS's collection actions in Tax Court if they file a timely CDP request.

b. District Court Sole Venue to Challenge: Individuals assessed with the TFRP can challenge the assessment in District Court in refund litigation.

2. Divisible Taxes: "The employment tax for which an employer is liable under subtitle C is a 'divisible tax' because each portion of the tax relates to a specific employee and calendar quarter. An employer is permitted to pay a divisible portion of its employment tax liability, file a refund claim for that amount, and commence refund litigation under 28 U.S.C. sec. 1346(a)(1) when the claim is denied. The United States then typically counterclaims for the balance of the tax in dispute." Dixon v. Commissioner, 141 T.C. 173 (2013).

3. Plain Vanilla TFRP Challenges:

a. Step 1: Payment of the Tax:

(1) Payment: The individual must pay tax, request a claim for refund from the IRS, and then bring suit in District Court.

(a) Importance of Divisible Taxes: Because employment taxes are divisible taxes, the taxpayer need only pay one quarter of employment taxes for one employer in order to be able to file suit in District Court. Then, the Tax Division will counterclaim for the balance due.

(b) Strategy: Generally, it is advisable to pay the lowest paid employee for each quarter, sue for a refund, and let the Government counterclaim you for all other employees and quarters.

b. Step 2: Administrative Claim for Refund: The individual must file Form 843, *Claim for Refund and Request for Abatement*, for each quarter in question prior to filing a complaint in District Court.

(1) Time for Filing: The Form 843 must be filed within two years of the payment. See I.R.C. § 6511(a).

c. Step 3: Bring Suit in District Court: Suit may be brought to claim a refund of the employment tax paid. Typically, the United States then counterclaims for the balance allegedly owed for the other

quarters and employees.

(1) The Pleadings:

(2) The Counterclaim:

(3) Trial:

4. FOIA & TBOR II Requests:

a. Right to Information: A person assessed with the TFRP is entitled to receive, and should request from the IRS:

(1) The name of any other person assessed with the TFRP:

(2) Information about the IRS's collection actions against those individuals;

(3) The current status of those individual's accounts (*i.e.*, installment agreements, CNC, offers in compromise); and

(4) The amount collected from each individual.

V. Recent Developments in Bankruptcy

A. The Importance of Filing Tax Returns: *United States v. Schmidt*

1. Summary: In *United States v. Schmidt*, No. 2:14-cv-0237, 2016 WL 7230503 (E.D. Wa. Dec. 14, 2016), the United States filed suit to reduce federal tax assessments to judgment and to foreclose a federal tax lien. The taxpayers filed a bankruptcy petition in Bankruptcy Court for the Eastern District of Washington, and the Bankruptcy Court ultimately entered a discharge for the taxpayers. After the bankruptcy discharge, the Government amended its complaint, adding a request to exclude from discharge the taxpayers' 1998 federal income tax liabilities, with the exception of penalties and interest on penalties, under 11 U.S.C. § 523(a)(1)(C), asserting the taxpayers "made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." With respect to the 1998 income tax return, the taxpayers took the position that certain income was not taxable to them, that they timely filed a tax return to that effect, and explained the position to the IRS. The IRS declined to treat this return as a valid return, and the taxpayer ultimately submitted a second tax return reporting such income as taxable. In the suit to reduce the assessments to judgment, the government took the position that the 1998 liabilities were non-dischargeable because the original 1998 return was fraudulent. The court cited the rule in *Hawkins v. Franchise Tax Bd. of California*, 769 F.3d 662, 669 (9th Cir. 2014) and *Cheek v. United States*, 498 U.S. 192, 201 (1991), that a taxpayer "'willfully attempt[s] ... to evade or defeat' a federal tax if the defendant knows of the duty to pay additional federal income tax, attempts to violate that duty, and specifically intends to avoid the tax." The court ruled there was no fraud involved in the case because the taxpayers believed in good faith they did not have a filing obligation.
2. Takeaway: Counsel clients to file often and on time, even if a filing obligation is uncertain.

B. The Broad Reach of the Fraudulent Transfer Rules: *United States v. Citibank N.A. (In re Kipnis)*

1. Summary: In *United States v. Citibank N.A. (In re Kipnis)*, 555 B.R. 877 (S.D. Fla. 2016), the debtors filed a bankruptcy petition in Bankruptcy Court for the Southern District of Florida. When the petition was filed, the Service's period of limitations on assessment had not expired, but the statute of limitations under applicable Florida fraudulent transfer law had expired. The bankruptcy trustee sought to step into the shoes of the Service and use the Service's ten year period of limitations on collection to avoid transfers that occurred in 2005. The bankruptcy court allowed the trustee to step into the shoes of the Service and allowed the bankruptcy trustee's statute of limitations to extend to ten years. Because the action is *in rem*, the trustee's recovery was limited to the property transferred.
2. Takeaway: When taxes are involved in bankruptcy, the fraudulent transfer rules can reach well beyond the rules of the Bankruptcy Code.

**Appendix A: Sample Attachment to Form 12153:**

**REQUEST FOR A TRANSCRIBED FACE-TO-FACE HEARING  
PURSUANT TO  
IRC § 6330**

Taxpayer	ABC Construction Corp.
EIN	
Type of Tax	940
Tax Period	12/31/17
Date of IRS Notice	June 25, 2018 (Exhibit B)

Ladies & Gentlemen:

We represent the taxpayer identified above (sometimes hereinafter referred to as "Taxpayer"). A copy of our IRS Form 2848, Power of Attorney and Declaration of Representative is annexed hereto as *Exhibit A*.

**REQUEST FOR A COLLECTION DUE PROCESS HEARING**

IRC § 6330 (b)(1) provides:

If the person requests a hearing in writing under subsection (a)(3)(B) and states the grounds for the requested hearing, such hearing shall be held by the Internal Revenue Service Office of Appeals.

*See also* IRC § 7803 (a)(3)(D)(guaranteeing taxpayers the right to challenge the position of the Internal Revenue Service and be heard) and IRC § 7803 (a)(3)(E)(the right to appeal a decision of the Internal Revenue Service in an independent forum)

Enclosed for filing are an original and one copy of:

IRS Form 12153, "*Request for a Collection Due Process Hearing*" ("CDP").

This *Request for a CDP Hearing* relates to the Internal Revenue Service ("IRS") Into to Seize and Notice of Your Rights to a Hearing (the "Notice"). The Taxpayer is not in possession of the Notice. Attached hereto as **Exhibit B** is the IRS transcript of account showing the issuance of the Notice.

**REQUEST FOR FACE-TO-FACE TRANSCRIBED HEARING**

Pursuant to IRC §§ 6330 and 7521, the Taxpayer hereby requests:

- (1) a Face-to-face Hearing, and
- (2) a Transcribed Hearing,

at the IRS Office of Appeals in **Newark, New Jersey**.

**REQUEST THAT THE APPEALS OFFICER OBTAIN VERIFICATION FROM THE IRS THAT THE REQUIREMENTS OF ANY APPLICABLE LAW OR ADMINISTRATIVE PROCEDURE HAVE BEEN MET.**

Exhibit B explains: The IRS may seize (levy) your property or your rights to property . . .  
Property includes:

- Wages and other income
- Bank accounts
- Business assets
- Personal assets (including your car and home)•
- Social Security benefits.

IRC § 6330(c)(1) provides: "The appeals officer shall at the hearing obtain verification from the Secretary that the requirements of any applicable law or administrative procedure have been met."

IRC § 7803 (a)(3)(A) guarantees "taxpayers the right to be informed."

The Taxpayer requests that the Appeals Officer obtain and *provide the Taxpayer at or before the hearing* the documents verifying that the requirements of any applicable law or administrative procedure have been met. These documents, include but are not limited to:

<b>Verification Requests</b>	<b>Internal Revenue Code Section</b>
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<b>Verification Requests</b>	<b>Internal Revenue Code Section</b>
The Record of Assessment	<p>IRC § 6203 provides that:</p> <p>Upon request of the taxpayer, the Secretary shall furnish the taxpayer a copy of the record of the assessment.</p>
If the assessment is for more than the tax shown on the return, the notice of deficiency	IRC § 6212
The Notice and Demand referred to in IRC §§ 6303(a) and 6601(e)	<p>Collectively, IRC § s 6303(a), 6321, and 6331(a) provides that:</p> <p>Notice and demand must be provided to a taxpayer before the IRS can collect through the tax lien or levy.</p>
<p>Statute of Limitations on Assessment</p> <p>If the assessment at issue was made more than three years after the filing of the returns at issue, please verify that the statute of limitations prescribed by IRC § 6501 does not invalidate the assessment.</p>	IRC § 6501

<b>Verification Requests</b>	<b>Internal Revenue Code Section</b>
<p>Statute of Limitation on Collection of the Assessment.</p> <p style="text-align: center;">If the assessment at issue was made more than ten years ago, please verify that the statute of limitations prescribed by IRC § 6502 does not invalidate the assessment.</p>	IRC § 6502
First Time Abatement	IRM 20.1.1.3.6.1 (08-05-2014)  First Time Abate (FTA)
The documents demonstrating compliance with IRC §§ 7524, 6751(a) and (b)	IRC § 6751(b) provides that:  No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.
Verification Required by IRC §§ 7524, 6404(f) 6404(g)	IRC § 6404((f) and (g) provides for the suspension of interest and certain penalties.
If the IRS intends to proceed against third parties, the approval required by Area Counsel.	IRM 5.12.7 <i>et seq.</i>

Pursuant to IRC § 7805(a)(3) and IRC § 6404, the Taxpayer request that the Appeals Office direct the IRS to abate the unpaid portion of the assessment of any tax, penalty or other liability in respect thereof, which:

- (1) is excessive in amount, or
- (2) was assessed after the expiration of the period of limitation properly applicable thereto, or
- (3) erroneously or illegally assessed.

Exhibit B includes among the items subject to seizure (a) Wages and other income, (b) Bank accounts, (c) Business assets, (d) Personal assets (including your car and home) and (e) Social Security benefits. IRC § 6334 exempts certain of these assets; the IRM requires supervisory approvals to seize others. As for the items set forth in the chart below, the taxpayer respectfully request that the appeals officer obtain verification from the Secretary that the requirements of any applicable law or administrative procedure have been met. The taxpayer further requests that any determination issued by the Appeals Office specifically address whether the IRS has complied with the procedures applicable to the seizure of each of items set forth below.

<b>Verification Request</b>	<b>Statutory Basis or Administrative Basis for Exemption</b>
Wearing apparel	IRC § 6334
Furniture, arms and personal effects	IRC § 6334 IRM 5.10.2.5
Taxpayer's Business Assets, including but not limited to Books and tools of a trade, business, or profession	IRC § 6334 IRM 5.10.2
Unemployment benefits	IRC § 6334
Annuity, pension payments and retirement benefits	IRC § 6334
Child Support and/or Alimony	IRC § 6334
Taxpayer's Residence	IRC § 6334 IRM 5.10.2.3
Alleged Nominees that Are Not Referred to in this Letter	IRC § 6334 IRM 5.12

**REQUEST FOR A DE NOVO REVIEW OF TAX, INTEREST AND  
INTEREST ASSESSED AND THE PENALTIES**

IRC § 7805(a)(3) provides the

“In discharging his duties, the Commissioner shall ensure that employees of the Internal Revenue Service are familiar with and act in accord with taxpayer rights as afforded by other provisions of this title, including — (c)the right to pay no more than the correct amount of tax. . .”

IRS Policy Statement 4-7 and the regulations governing the Appeals Function, 26 CFR 601.106, recognize Appeals role in protection the taxpayer’s right to due process of law in controversies with the IRS:

An exaction by the United States government, which is not based upon, statutory or otherwise, is a taking of property without due process of law, in violation of the Fifth Amendment to the United States Constitution. Accordingly, a Service representative in his/ her conclusions of fact or application of law, shall hew to the law and the recognized standards of legal construction.

**It shall be his/ her duty to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers.** (emphasis added)

IRC §§ 6330(c) and 7805 gives this long standing Appeals policy the force of law. Taxpayer hereby requests a *de novo* review of the tax, interest and the tax, penalties and interest, if any, on the penalties assessed. *Goza v. Commissioner*, 114 T.C. 176, 181-182 (2000); IRC § 6601(e).

Against this background:

1. Taxpayer requests FTA relief and all other penalty relief described in and available pursuant to IRM 20.1.1.3 (11-25-2011)(Criteria for Relief From Penalties)
2. Taxpayer further requests that the Appeals Office provide a *de novo* review of whether the Taxpayer is entitled to reduction of the interest, penalty, additional amount, or additions to the tax assessed pursuant to IRC § 7508A.
3. Taxpayer further requests that the Appeals Office provide a *de novo* review of whether the Taxpayer is entitled to an abatement or reduction of the interest, penalty, additional amount, or additions to the tax assessed pursuant to IRC § 6404.

If the Appeals Office contends that the Taxpayer had a prior opportunity to dispute the tax liability hear at issue:

1. the Taxpayer requests copies of any documents demonstrating that the taxpayer had an opportunity to dispute such tax liability; and
2. the Taxpayer requests that the Appeals Office process this request as an offer in compromise based on doubt as to liability pursuant to IRC § 7122 or
3. the Taxpayer requests that the Appeals Office process this request as a request for audit reconsideration pursuant to IRS Publication 3598.

**CHALLENGE TO THE APPROPRIATENESS OF THE PROPOSED  
COLLECTION ACTION AND SUMMARY OF TAXPAYER'S  
DISAGREEMENT WITH THE IRS'S DECISION TO FILE LEVY**

IRC § 6330(a)(3) provides that the "notice required under paragraph (1) shall include in simple and nontechnical terms— . . . (C) *the proposed action by the Secretary and the rights of the person with respect to such action*, including a brief statement which sets forth—

- (i) the provisions of this title relating to levy and sale of property;
- (ii) the procedures applicable to the levy and sale of property under this title

(IRC § 6330(c)(2)(A) provides: The person may raise at the hearing any relevant issue relating to the unpaid tax or the proposed levy, including— . . . (ii) challenges to the appropriateness of collection actions . . .

Exhibit B explains: The IRS may seize (levy) your property or your rights to property . . .  
Property includes:

- Wages and other income
- Bank accounts
- Business assets
- Personal assets (including your car and home)•
- Social Security benefits.

Exhibit D does not explain in "simple and nontechnical terms": (a) the proposed action by the Secretary and (b) the rights of the person with respect to such action.

the Taxpayer challenges to the appropriateness of the collection action. Specifically, the collection action proposed by the IRS will create an unfair economic hardship due to the financial condition of the taxpayer, including but not limiting the Taxpayer's ability to:

1. Provide food for his family
2. Pay his mortgage or rent
3. Keep the utilities on
4. Obtain transportation to and from work
5. Keep his or her job
6. Obtain necessary medical treatments and medications needed
7. Obtain a reasonable amount of clothing
8. Take advantage of educational opportunities that would facilitate the payment of taxes.

A levy will default the taxpayer's working capital financing.

**IRC § 6334 BASED CHALLENGE TO THE APPROPRIATENESS OF  
THE PROPOSED COLLECTION ACTION AND SUMMARY OF  
TAXPAYER'S DISAGREEMENT WITH THE IRS'S DECISION TO FILE  
A LEVY**

If the Appeals Office concludes that the collection action should proceed, pursuant to IRC § 6334, the Appeals Office determination should explicitly preclude levy on the following:

Requested Exemption	Statutory Basis or Administrative Basis for Exemption
Wearing apparel	IRC § 6334
Furniture, arms and personal effects	IRC § 6334 IRM 5.10.2.5
Taxpayer's Business Assets, including but not limited to Books and tools of a trade, business, or profession	IRC § 6334 IRM 5.10.2
Unemployment benefits	IRC § 6334
Annuity, pension payments and retirement benefits	IRC § 6334
Child Support and/or Alimony	IRC § 6334

Taxpayer's Residence	IRC § 6334 IRM 5.10.2.3
Alleged Nominees that Are Not Referred to in this Letter	IRC § 6334 IRM 5.12

The determination should prohibit these actions based on the statutes and procedures referred to above and because the requirements of IRC § 6330(c) have not been satisfied.

### **PROPOSED COLLECTION ALTERNATIVES**

IRC § 6330 (c)(2)(A)(iii): "a person may raise at the hearing . . . offers of collection alternatives, which may include . . . an installment agreement, or an offer-in-compromise."

The Taxpayer respectfully requests that the Appeals Office evaluate the following collection alternatives:

We are in the process of evaluating collection alternatives. We will provide a 433B, if necessary, at or before the hearing.

Upon the written request of the Appeals Office, the Taxpayer will provide any information required by the appeals office to analyze the Taxpayers income and expenses and more concrete proposed collection alternatives.

### **THE TAXPAYER'S PROPOSED COLLECTION ACTION BALANCES THE NEED FOR THE EFFICIENT COLLECTION OF TAXES WITH THE LEGITIMATE CONCERN OF THE TAXPAYER THAT ANY COLLECTION ACTION BE NO MORE INTRUSIVE THAN NECESSARY.**

IRC § 6330(c)(3)(C) requires the Appeals office to balance the need for efficient collection of the tax with legitimate concerns of the taxpayer that actions be no more intrusive than necessary.

Toward this end, the Appeals Office should consider the following factors: (a) the taxpayer's actions or inaction; (b) The taxpayer's compliance history; (c) The taxpayer's financial circumstance, and (d) the tax consequences of a proposed seizure and sale.

The Taxpayer is in the process of reconciling tax credits due against this liability. To the extent a liability remains, we will request an installment agreement.

As mentioned above, a levy will default the taxpayer's working capital financing.

The foregoing compels the conclusion that the taxpayer's proposed collection alternative strikes the proper balance between the IRS need for the efficient collection of the tax and the legitimate concerns of the taxpayer that actions be no more intrusive than necessary.

**IRC § 6330(b)(3) AND REVENUE PROCEDURE 2000-43 REQUEST**

Pursuant to IRC § 6330(b)(3), the Taxpayer Requests that the hearing be conducted by an officer or employee who has had no prior involvement with respect to the unpaid tax here in dispute.

Pursuant to Revenue Procedure 2000-43, we request that the IRS implement the procedures necessary to prohibit any ex parte communications between appeals officers and all other IRS employees assigned to the Taxpayer's matter.

**REQUEST FOR RECEIPT**

Kindly acknowledge receipt of this request by countersigning the enclosed copy of this letter and returning it in the self-addressed, stamped envelope provided.

Very truly yours,

By: \_\_\_\_\_

Super Attorney

Enclosures:

1. IRS Form 12153
2. Exhibit A: IRS Form 2848
3. Exhibit B: IRS Notice dated June 25, 2018

RECEIPT ACKNOWLEDGED:

***INTERNAL REVENUE SERVICE***

BY: \_\_\_\_\_  
TITLE: \_\_\_\_\_  
DATE \_\_\_\_\_



**Appendix B:** FOIA Letter for Alter Ego Determination

**TRANSCRIPT REQUEST  
PRIVACY ACT, FOIA & IRC § 6103 REQUEST**

**Sent Via Facsimile to (877) 891-6035**

Internal Revenue Service  
IRS FOIA Request  
Stop 93A  
Post Office Box 621506  
Atlanta, GA 30362-3006

**ATTENTION: FOIA REQUESTS**

**Re:** ABC Construction Corp.  
**Tax Period(s) Ending:** 12/31/2003 through 12/31/2014  
**EIN:** XX-XXXXXXX  
**Our File:** 1234

Dear Ladies and Gentlemen,

We represent ABC Construction Corp. (“Taxpayer”). Enclosed is a copy of our filed Form 2848, *Power of Attorney and Declaration of Representative*, for the Taxpayer. Pursuant to the provisions of sections 6103 and 7602(c) of the Internal Revenue Code (“I.R.C.”) and the Freedom of Information Act (the “Act” or “FOIA”), 5 U.S.C. § 552, as amended, we request access to and copies of the following records maintained by the Internal Revenue Service (“IRS”):

1. All notices, letters, memorandum, contact history sheets, audit reports, correspondence, IRS forms, liens and levies prepared by or received by the IRS that refer or relate to the year(s) and/or period(s) referenced above, and specifically, with respect to the IRS’s determination that the Taxpayer is the alter ego of XYZ Construction, Inc. (EIN: XX-XXXXXXX) (“XYZ Corporation”).
2. All transcripts of account, records of assessments and abatements and any other documents reflecting all account activity and transactions that refer or relate to the year(s) and/or period(s) referenced above, and specifically, with respect to the IRS’s determination that the Taxpayer is alter ego of XYZ Corporation.
3. A record of persons contacted by the IRS with respect to the determination that the Taxpayer is the alter ego of XYZ Corporation.

4. All third-party information received by the IRS that refers or relates to the years and/or period(s) referenced above, and specifically, any and all information that the IRS received in connection with its determination that the Taxpayer is the alter ego of XYZ Corporation.

5. All third-party information in the IRS's possession relevant to the determination that the Taxpayer is the alter ego of XYZ Corporation.

In accordance with IRS Statement of Procedural Rules, Reg. § 601.702(c)(4)(ii), we agree to pay reasonable charges incurred in locating and copying the requested documents, to an upper limit not to exceed \$200.

***If you decide that any portion of a requested record is exempt from disclosure under the Act, I request that you send me the remaining nonexempt portion of that record.*** In addition, to the extent that access is denied to inspect any part of the requested administrative files and documents, please send me an index and a detailed description of the deleted material and a statement of the statutory basis for withholding each such document.

As stated above, we have attached a copy of the IRS Form 2848 that authorizes us to make this request for the Taxpayer. ***In accordance with the provisions of the Act, we expect to receive a reply within 20 working days.***

Kindly acknowledge receipt of this letter by countersigning the enclosed copy of this letter and returning the in the enclosed self-addressed, stamped envelope.

Very truly yours,

Jane A. Attorney

JAA/jaa

Enclosures as stated

cc: ABC Construction Corp., Mr. John Q. Taxpayer, President (via email)

RECEIPT ACKNOWLEDGED:  
INTERNAL REVENUE SERVICE  
BY: \_\_\_\_\_  
TITLE: \_\_\_\_\_  
DATE: \_\_\_\_\_

# IRS Exam Part I

LIU Civil and Criminal Tax Controversy Forum  
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## I. Record Keeping

### A. Overview

1. Why should taxpayers conducting a trade or business keep records?
  - a. Monitor the progress of their business. A taxpayer conducting a business needs good records to monitor the progress of the business. Records can show whether the business is improving, which items are selling, or what changes may need to be made. Good records can increase the likelihood of business success.
  - b. Identify source and amount of receipts. A taxpayer will receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate business from non-business receipts and taxable from nontaxable income.
  - c. Keep track of deductible expenses. A taxpayer is required to deduct the correct amount of expenses, and only the allowable expenses on their tax return. Good records are necessary to record the source and amount of expenses incurred in the business.
  - d. Prepare tax returns. Taxpayers need good records to prepare tax returns. These records must support the income, expenses, and credits reported.
  - e. Support items reported on tax returns. Taxpayers must keep business records available at all times for inspection by the IRS. If the IRS examines the tax returns, the taxpayer will be asked to explain the items reported. A complete set of records will speed up the examination.
2. What should be included in the taxpayer's books and records?
  - a. A system of books and records may be as simple as a calendar showing business income earned each day and business expenses paid each day or they may be a detailed accounting system.
  - b. The system of records should include enough information to correctly determine gross receipts, business expenses incurred and the purchase price of assets acquired for use in the business.
  - c. These records should also include inventory purchases, payroll, and other transactions occurring in the course of operating the business.
  - d. The taxpayer's books and records should include supporting documents.
  - e. Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. These documents are important to support the entries in the books and the tax return.
  - f. These records will also help the taxpayer determine the value of inventory at the end of the year.
3. What are examples of supporting documents?
  - a. Gross Receipts: Gross receipts are the income received by the business. The taxpayer should keep supporting documents that show the amounts and sources of gross receipts. Documents that show gross receipts include the following.

- i. Cash register receipts
    - ii. Bank statement and deposit slips
    - iii. Receipt books
    - iv. Invoices
    - v. Credit card charge slips
    - vi. Forms 1099-MISC
    - vii. Any format (calendar, income ledger, etc.) that the taxpayer consistently uses to record receipts of the business.
  - b. Purchases: Purchases are the items bought to resell to customers. Supporting documents should show the amount paid and that the amount was for purchases. Documents for purchases include the following.
    - i. Cancelled checks
    - ii. Cash register tape receipts
    - iii. Credit card sales slips
  - c. Expenses: Expenses are the costs incurred (other than purchases) to carry on the business. The supporting documents should show the amount paid and that the amount was for a business expense. Documents for expenses include the following.
    - i. Canceled checks
    - ii. Cash register receipts
    - iii. Account statements
    - iv. Credit card sales slips
    - v. Invoices
    - vi. Petty cash slips for small cash payment
  - d. Assets. Assets are the property, such as machinery and furniture owned and used in the business. Taxpayers must keep records to verify certain information about business assets. They need records to figure the annual depreciation and the gain or loss when assets are sold. The records should show the following information:
    - i. When and how an asset was acquired
    - ii. Purchase price including purchase invoice, real estate closing statements, cancelled checks, etc.
    - iii. Cost of any improvements including invoices and cancelled checks
    - iv. Section 179 deduction taken
    - v. Deductions taken for depreciation
    - vi. Deductions taken for casualty losses, such as losses resulting from fires or storms
    - vii. How the asset was used
    - viii. When and how the asset was disposed of, including sales invoice or closing statement
    - ix. Selling price
    - x. Expenses of sale
4. What should you do if the taxpayer does not have records?
- a. To comply with their EITC due diligence requirements, a paid preparer should make adequate inquiries to be satisfied that the taxpayer is carrying on a

business and that the income and expenses reported on the tax return are substantially correct and complete.

- b. In the event of a loss of client records or due to poor recordkeeping, a paid preparer may need to help his client reconstruct the records. The reconstruction will demonstrate that the paid preparer exercised due diligence and it will also teach the client about recordkeeping.
- c. The goal of record reconstruction is to use available documentation to develop a sound and reasonable estimate of the taxpayer's business income and expenses to support the Schedule C prepared. Although the taxpayer may not have formal books and records with supporting documentation, they may have partial records that can be used as a basis for reconstruction.
- d. The knowledgeable tax preparer can guide their client on how to use these partial records to develop support for the Schedule C. This reconstruction can also provide support for the return in the case of an audit. Numerous court cases exist that support the use of reasonable estimates and reconstruction of income and expenses to determine a taxpayer's correct tax liability. However, if the tax preparer is not satisfied with the accuracy of the reconstructed records, he has the right to refuse to prepare the return.

5. Tools to use in reconstruction

Example source	How to use to reconstruct records
Appointment books or calendars	<p>An appointment book could be used to develop:</p> <ul style="list-style-type: none"> <li>• Where a taxpayer traveled to provide services, and how many trips</li> <li>• A count of how many people were provided services</li> <li>• A count of how many of each type of service was rendered; for example, how many haircut appointments, how many manicure appointments</li> </ul> <p>Using summary counts of the number of each kind of service rendered, the taxpayer could apply an average or standard cost to come up with an estimate of total receipts. The number of trips made and the locations traveled to could be combined with online map tools data to support total business miles driven.</p>
Online map tools	Online map tools can be used to reconstruct mileage calculations.
IRS standard allowances	The IRS provides standard expense allowances including per diem expenses for truck drivers and standard mileage rates.
Checkbook, cancelled checks, bank statements or credit card statements	These documents can be used to gain information about expenses incurred and what types of services were performed for clients. Using summary counts of the number of each kind of service rendered, the taxpayer could apply an average or standard cost to come up with an estimate of total costs and receipts.

Example source	How to use to reconstruct records
List of regular clients	Using a list of regular clients, a taxpayer could reconstruct a reasonable calendar of services. Regular expenses could be extrapolated from that information. The taxpayer could apply an average or standard cost to come up with an estimate of total receipts.
Partial receipts or sales tax records	Partial receipts can lend information regarding what expenses were incurred for services. The taxpayer could apply an average or standard cost to come up with an estimate of total receipts.
Cell phone records and call history or computer logs	Cell phone records and call history can be used to develop a list of clients served during specific timeframes.
Prior year returns	Prior year returns can provide the basis for records if activities are similar from year to year.

6. What choices do you have if you are not satisfied with the records?
  - a. As a preparer you must make a decision whether you are comfortable that the information presented by your client is substantially correct.
  - b. If you are not satisfied with the taxpayer's records, you may:
    - i. Request the taxpayer attempt to reconstruct his records on his own.
    - ii. Assist him with reconstructing his records.
    - iii. Suggest filing without an EITC claim.
    - iv. Refuse to prepare the Schedule C return altogether.
  - c. You have a professional responsibility to prepare returns that are accurate.
  - d. The taxpayer is ultimately responsible for the figures computed through record reconstruction, and you should inform the taxpayer of possible repercussions of filing a false EITC claim whether with or without your assistance.
  - e. However, as a tax preparer you must exercise due diligence and apply reasonableness as you may be subject to penalties and additional consequences.

## B. Schedule C

1. Who is self-employed?
  - a. You are self-employed if you carry on a trade or business with a profit motive as a sole proprietor or as an independent contractor.
  - b. An individual, who performs services on a part-time basis or does occasional "odd jobs" and receives compensation for that work, may be self-employed. An individual doesn't need to have a business name or a formal business structure in order to be self-employed, and is required to report the income and related expenses from selling goods or performing services for others for money.

- c. Since many businesses in this industry are cash oriented, have weak internal controls, lack an audit trail, and have inadequate books and records, the examiner's audit should focus on probing for unreported income.
2. How is self-employment reported on a tax return?
    - a. Income received from all sources in a self-employed taxpayer's business must be reported, unless it is excluded by law.
    - b. All ordinary and necessary expenses incurred in a self-employed taxpayer's business must also be reported. See IRC § 1402(a).
    - c. Form 1040, Schedule C, Profit or Loss From Business, is used to report the activity on the individual's tax return.
  3. What Schedule C situations should raise a red flag for you as a tax preparer?
    - a. Schedule C income in round numbers
    - b. Schedule C cash businesses as the only income on a return claiming EITC
    - c. Schedule C with little or no expenses when expenses would be expected
    - d. Schedule C taxpayers with little or no records for income and expenses
    - e. Any Schedule C income that brings the taxpayer to the maximum EITC
    - f. Schedule C without a Form 1099
  4. What techniques can be used to obtain information from your client?
    - a. Conducting a thorough and in depth interview with your client about the business activity.
    - b. When the basic question/answer format does not seem to be creating a clear and consistent picture, asking your client to describe daily and weekly activities can provide a great deal of information.
    - c. Casual conversations about business practices may prove insightful.
    - d. Return preparers should take the time to educate their clients on the need for
    - e. Record keeping and the consequences of failure to keep records. Thought should be given to reaching out to existing clients at the beginning of the tax year to educate them and to help them to establish a good recordkeeping system so that come the next filing season they will have a much easier time of filing an accurate return.
    - f. Form 11652, Questionnaire and Supporting Documentation Form 1040 Schedule C (Profit or Loss from Business), used during IRS examinations of Schedule C, provides a starting point for addressing client's recordkeeping.
    - g. Reviewing supporting material.
    - h. If supporting material is not provided, return preparers should inform their clients that the IRS may audit them. In that event, the client would need to provide receipts to support the figures. Taxpayer claims of having supporting documentation is not sufficient to meet tax preparer due diligence. Preparers should inquire how income and expenses were computed and document the responses. In circumstances where you feel the information is not accurate or the supporting material is sufficient, you may ask to see the supporting material.

## C. Examination Techniques Overview

### 1. Examination Techniques for a Cash Business

- a. Since many businesses in this industry are cash oriented, have weak internal controls, lack an audit trail, and have inadequate books and records, the examiner's audit should focus on probing for unreported income.
- b. It is the responsibility of the business owner to maintain the documents needed to verify their reported income. When the source documents are available, there will be more than one way to test income and other transactions, because different documents will have the same information (a bill of lading and a sales invoice, for example) to check for consistency. When the source documents are not available the examiner must look for ways to discover if all income is reported.
- c. The most likely method for a cash intensive business that does not report their full income is to skim cash prior to its entry in the accounting system. This can be done by failing to deposit all of the funds, by failing to use a cash register to record sales or by failing to report an income stream. The result is that the books will reconcile to the return and the bank deposits, but income will be missing. Skimming can be discovered through excess expenditures or when markup percentages are corrected.
- d. Someone with access to incoming checks can remove a check before it is recorded. Later the check can be added to a cash register in exchange for cash in the same amount. If a check for \$500 is taken from the mail, it can later be substituted into the cash register for \$500 in cash. This way the total receipts will match the amount deposited. However, when the examiner checks the amount of cash received and the cash deposited, a discrepancy will be evident. The examiner should follow up with the person who worked the register and ask about the check included in that drawer. If necessary, follow up with the payer and find out how it was delivered to the business.

### 2. Purchases Can Reveal Sales

- a. A quick first step is to look for a purchase that will reveal sales. For example, when a smog certificate is required on each vehicle sold, the number of smog certificates purchased will equal the number of vehicles sold. Once the examiner knows the correct number of items sold, either the taxpayer can produce the missing data or sales can be determined by multiplying the number by the average of the reported sales.
- b. When workers wear uniforms the uniform service invoices can be inspected. They usually list the number of pants and shirts laundered and include the worker's name embroidered on the shirt. Compare the names on the uniform invoices to the names on the W-2's to determine if there are more people wearing uniforms than working. (Also, anyone who has ever worn a uniform for work knows the employer doesn't pay for that- so be sure to check payroll deductions for the amount paid by the employee.)
- c. When a vehicle is towed to a repair shop, the shop initially pays the tow truck, and then passes the cost on to the customer. Use the tow receipts as a sample to

ensure each vehicle's repairs are reported on a sales invoice. If necessary the examiner can locate the customers and contact them to provide their work invoices that were never reported in the shop's sales.

d. Another avenue to pursue when the taxpayer does not produce contracts, but it is unlikely the particular industry would do business without them, is to summons the deposit slips, deposit sources and cancelled checks to reveal customers and suppliers. The suppliers, identified through the taxpayer's cancelled checks, can be contacted to obtain their invoices. In the building industry, the invoices will reveal the delivery addresses and can identify specific homes that were built.

### 3. Other Scenarios that the IRS Looks For:

a. Selling the business – When a business is being offered for sale the new owner and possibly a lender will be looking at financial records. It is in the taxpayer's interest to give these sources the correct business information, first because the healthier the business the better price it will garner, but also because the potential buyer may be in the same business and will recognize problematic records. They may think if the records are shoddy, what else is wrong. If the examiner learns of purchase negotiations, it would be helpful to speak with the potential buyer. If there have been potential buyers in the past, it would be helpful to interview them.

b. Getting a loan – When a business is looking for funding or to expand, they will need to supply the lender with healthy financial statements. Similarly, if the sole proprietor, majority shareholder or partner is seeking personal loans, banks will want to see the business financials. These financial statements are usually accurate. When an application is made for a loan, the taxpayer is required to list income and expenses, and attests the information is true by signing and dating the application. Loans funded and loans applied for can be summonsed.

c. Divorce – A disadvantaged spouse can attest to the amount of money flowing into the household by verifying what was spent. The spouse may also have knowledge of hidden assets or unidentified sources of income, such as sideline sales or another cash business.

d. Employees – especially mistreated employees can discuss business practices they have observed over time. They can say who handled cash and what procedures were overridden. Employees may also be able to prove they were paid in cash to avoid payroll taxes.

### 4. Hidden Family and Employee Transactions

a. When employees or workers in the business are extended family members or fellow immigrants, there can be diverted profits in the form of unreported benefits. A convenience store owner, who pays very little to employees, may also allow the worker to remove inventory for personal use.

i. The examiner should be alert to store owners offering workers:

1. free or low rent in their residential rental properties
2. payment of personal expenses
3. removal of inventory for personal use

b. When a cash intensive business makes payments in cash and there is no information reporting made or it is not required to be made.

### 5. Check Cashing Services

- a. A check cashing service may refer to a large or small company that will cash personal or payroll checks for a fee. The check cashing service earns its income by charging a percentage of the amount of the check.
- b. Some convenience stores will offer this service, typically charging a 3-5% fee. For example, cashing a \$1,000 payroll check at a local convenience store may cost between \$30-\$50.
- c. As with a bank, the check casher will require identification, and may not accept certain types of checks, based on their experience. A business that has been in operation for several years will not usually have losses from check cashing. Whenever losses or bad debts are claimed, the examiner must determine that sufficient efforts were made by the business. Contact should be made with the customer to ensure the funds were not repaid to the business in cash and the collection was not recorded.

#### D. Indirect Methods

- 1. Formal Indirect Methods of Determining Income – IRM 4.10.1.6 (05-27-2011)
  - a. The five basic formal indirect methods of reconstructing income discussed are:
    - i. Source and application of funds
    - ii. Bank deposits and cash expenditures method
    - iii. Markup method
    - iv. Unit and volume method
    - v. Net worth method.
  - b. Limitation of Use of Examination Techniques: Personal Living Expenses – IRM 4.10.4.6.1.2 (08-09-2011).
    - i. "Examination techniques" include examining and testing the taxpayer's books and records, analytical tests, observing, and interviewing the taxpayer. None of these techniques are unique to the use of a formal indirect method and do not trigger the limitation of IRC 7602(e).
    - ii. Examiners should adjust PLE based on information received during the interview and update the T-Account during the audit process. In developing the PLE for the T-Account, examiners should only use the PLE information that was made available through the minimum income probes.
    - iii. Obtaining PLE information beyond the minimum income probes will likely trigger the limitation of IRC 7602(e). If there are indications of unreported income and you need to go beyond the minimum income probes, use a Financial Status Audit Technique and document your files with the reasons to support your use of the indirect method.
    - iv. Form 4822, *Statement of Annual Estimated Personal and Family Expenses*, may be used as a guide by the examiner for determining the taxpayer's personal living expenses. The form lists the typical expenses incurred by most individuals. It is inappropriate to ask the taxpayer to complete the form independently.

- v. Care should be taken to avoid duplicating amounts when modifying estimates for actual costs.
- c. Use of Bureau of Labor Statistics Data or Other Statistical Information to Reconstruct Taxable Income – IRM 4.10.4.6.1.3 (05-27-2011).
  - i. In certain cases, as described below, income may be reconstructed using Bureau of Labor Statistics (BLS) data or comparable statistics from a reliable source. The analysis is completed using the tables for annual expenses, not income, because determining the expenses represents a better reflection of the actual costs to maintain a household.
  - ii. The BLS data can be accessed at [www.bls.gov](http://www.bls.gov), select "Inflation and Consumer Spending." Tables' specific to year, region within the United States, and individual expenses are available.
  - iii. Statistical data cannot be used as a substitute for reconciling the taxpayer's books and records. If the taxpayer provides information, or information becomes available, which shows that income in a specific amount was earned, statistical data cannot be used to increase income to the national average
  - iv. In court proceedings involving individuals, IRC 7491(b) may shift the burden of proof. IRC 7491(b) provides that the Service will have the burden of proof for any item of income where income is reconstructed using only BLS data or other comparable statistical information on unrelated taxpayers.
- d. When to Use Statistical Data – IRM 4.10.4.6.1.3.1 (08-09-2011).
  - i. Statistical data can be used in conjunction with other available information (tax return information, IRP documents, etc.) at any time.
  - ii. Statistical data should be used as the **sole** source of information needed to calculate taxable income only when **no other information is available**. The following are examples of conditions where statistical data may be used as the sole source:
    1. The taxpayer is in a business or income producing activity other than as an employee and no information is available. Evidence of employment and wages earned, such as a filed Form W-2, constitutes evidence precluding the use of statistical data unless the taxpayer can be placed in an unrelated income producing activity that could have generated unreported income. See Senter v. Commissioner, T.C.M. 1995-311.
    2. If the taxpayer is a nonfiler. If the taxpayer filed a tax return and reported income, then the examiner must use other recognized methods (specific item, indirect methods) to confirm or reconstruct additional income. Statistical data is not a substitute for obtaining and considering relevant evidence in reaching a determination. See *IRM 4.10.4.3.5*
    3. The taxpayer must be uncooperative with the examiner during the audit. Examples of noncooperation include a taxpayer who

is not willing to meet with the examiner or provide any information or records regarding income producing activities, whether or not the examiner has been able to actually identify that activity. Examiners must use judgment to determine whether the taxpayer is cooperative. Examiners must use all available administrative tools, including the summons enforcement, to gather necessary information before statistical data is used.

e. Case Law for Using Statistical Data – IRM 4.10.4.6.1.3.2 (08-09-2011).

- i. In Miller v. Commissioner, T.C.M. 1993-121, the taxpayer filed tax returns for 1982-1985, but they contained virtually no information other than his name, address, occupation, filing status, and the number of exemptions claimed. The various line items on the returns either stated "none" or were footed to statements containing specific objections based upon amendments to the United States constitution. The taxpayer signed the returns, but added a disclaimer. The taxpayer was totally uncooperative during the audit and did not provide books or records. Bank records were used to reconstruct the taxpayer's business receipts and expenses. Because the bank records reflected virtually no personal expenditures, BLS cost-of-living data was used to determine income attributable to some other untraced source from which personal expenses were paid in addition to the reconstructed gross business receipts. The Court sustained the use of BLS data under these circumstances, except where the BLS figures appeared to be duplications of expenses paid from the bank accounts.
- ii. In Portillo v. Commissioner, 932 F.2d 1128 (5th Cir. 1991), the examiner relied upon a filed Form 1099 to determine that a taxpayer had additional unreported income. The taxpayer agreed he had additional income, but not the amount reported on the Form 1099. Ultimately, the filer of the Form 1099 was only able to document the portion of additional income with which the taxpayer agreed. The statutory notice of deficiency reflected the entire amount shown on the Form 1099. The Court found that the notice of deficiency was arbitrary because it merely matched the taxpayer's return with the Form 1099, assuming the taxpayer's return was false and the Form 1099 was correct. In such circumstances, the Service is obligated to investigate.
- iii. In Senter v. Commissioner, T.C.M. 1995-311, the taxpayer failed to provide requested information or appear for scheduled meetings. The taxpayer's correspondence with the examiner raised "protestor" type arguments. The taxpayer did not comply with, and objected to, administrative summonses, but the examiner did not seek enforcement. The notice of deficiency reflected unreported income determined using prior year reported earnings adjusted by the Consumer Price Index (CPI). The Court held this determination of unreported income to be arbitrary and erroneous. Some predicate (preexisting) evidence

establishing income was necessary to support a determination of unreported income.

- f. When to Use a Formal Indirect Method – IRM 4.10.4.6.2.1 (05-27-2011).
  - i. The use of a formal indirect method to make the actual determination of tax liability should be considered when the factual development of the case leads the examiner to the conclusion that the taxpayer's tax return and supporting books and records do not accurately reflect the total taxable income received and the examiner has established a reasonable likelihood of unreported income.
  - ii. The following list, which is not intended to be all inclusive, identifies circumstances that, individually or in combination, would support the use of a formal indirect method.
    1. A financial status analysis that cannot be balanced; i.e., the taxpayer's known business and personal expenses exceed the reported income per the return and nontaxable sources of funds have not been identified to explain the difference.
    2. Irregularities in the taxpayer's books and weak internal controls.
    3. Gross profit percentages change significantly from one year to another, or are unusually high or low for that market segment or industry.
    4. The taxpayer's bank accounts have unexplained items of deposit.
    5. The taxpayer does not make regular deposits of income, but uses cash instead.
    6. A review of the taxpayer's prior and subsequent year returns show a significant increase in net worth not supported by reported income.
    7. There are no books and records. Examiners should determine whether books and/or records ever existed, and whether books and records exist for the prior or subsequent years. If books and records have been destroyed, determine who destroyed them, why, and when.
    8. No method of accounting has been regularly used by the taxpayer or the method used does not clearly reflect income. See IRC 446(b).
- f. Selecting a Formal Indirect Method – IRM 4.10.4.6.2.2 (06-01-2004).
  - i. The selection of a formal indirect method is critical to effectively and efficiently determine the tax liability. For example, although the Bank Deposits and Cash Expenditures Method and the Source and Application of Funds Method are frequently used, they are not the most effective methods if cash is not deposited and/or the cash outlays cannot be determined unless voluntarily disclosed by the taxpayer. Realistically, it may be difficult to identify significant personal acquisitions or expenditure that the taxpayer has deliberately

camouflaged. These weaknesses can be overcome by using a formal indirect method based on the taxpayer's business activities to make the actual determination of tax liability; i.e., the Markup Method or Unit and Volume Method.

- ii. The following factors should be considered when selecting a formal indirect method:
  - 1. The industry or market segment in which the taxpayer operates,
  - 2. Inventories are a principle income producing activity,
  - 3. Suppliers can be identified and/or merchandise is purchased from a limited number of suppliers,
  - 4. Merchandise and/or service pricing is reasonably consistent,
  - 5. The volume of production and variety of products,
  - 6. Availability and completeness of the taxpayer's books and records,
  - 7. The taxpayer's banking practices,
  - 8. The taxpayer's use of cash to pay expenses,
  - 9. Expenditures exceed income,
  - 10. Stability of assets and liabilities, and
  - 11. Stability of net worth over multiple years under audit.
- g. Source and Application of Funds Method – IRM 4.10.4.6.3 (09-11-2007).
  - i. The Source and Application of Funds Method is an analysis of a taxpayer's cash flows and comparison of all known expenditures with all known receipts for the period. Net increases and decreases in assets and liabilities are taken into account along with nondeductible expenditures and nontaxable receipts. The excess of expenditures over the sum of reported and nontaxable income is the adjustment to income.
  - ii. The Source and Application of Funds Method and the financial status analysis are both based on an evaluation of the taxpayer's cash flows. The only difference is the use of statistics to estimate unknown personal living expenses. Therefore, when the financial status analysis indicates a reasonable likelihood of unreported income and establishes a reasonable likelihood of unreported income, the Source and Application of Funds Method is an efficient method for determining the actual amount of the understatement of income.
  - iii. Case Law
    - 1. The use of the Source and Application of Funds Method of proof in establishing unreported income received the Supreme Court's approval in United States v. Johnson, 319 U.S. 503 (1943). In addition to proving the taxpayer owned gambling establishments whose winnings were unreported, it was proven that in three of the years involved, the taxpayer's personal expenditures exceeded his current income plus his declared accumulated funds.
  - iv. When to Use

1. This method is based on the theory that any excess expense items (applications) over income items (sources) represent an understatement of taxable income.
2. The Source and Application of Funds Method is recommended in the following situations:
  - a. The review of a taxpayer's return indicates that the taxpayer's deductions and other expenditures appear out of proportion to the income reported.
  - b. The taxpayer's cash does not all flow from a bank account which can be analyzed to determine its source and subsequent disposition.
  - c. The taxpayer makes it a common business practice to use cash receipts to pay business expenses.

#### E. Indirect Method Examples

1. Source and Application of Funds Method
  - a. Sources of funds are the various ways the taxpayer acquires money during the year. Decreases in assets and increases in liabilities generate funds. Funds also come from taxable and nontaxable sources of income. Unreported sources of income even though known, are not listed in this computation since the purpose is to determine the amount of any unreported income. Specific items of income are denoted separately. Examples of sources of funds include:
    - i. Decrease in cash-on-hand, in bank account balances (including personal and business checking and savings accounts), and decreases in accounts receivable,
    - ii. Increases in accounts payable,
    - iii. Increases in loan principals and credit card balances,
      1. Taxable and nontaxable income, and
      2. Deductions which do not require funds such as depreciation, carryovers and carrybacks, and adjusted basis of assets sold.
    - iv. Application of funds are ways the taxpayer used (or expended) money during the year. Examples of applications of funds include:
      1. Increases in cash-on-hand, increase in bank account balances (including personal and business checking and savings accounts), business equipment purchased, real estate purchased, and personal assets acquired,
      2. Purchases, business expenses,
      3. Decreases in loan principals and credit card balances, and
      4. Personal living expenses.

**Exhibit 4.10.4-10**  
**Source and Application of Funds Method: Example of Computation for Cash and Accrual Based Taxpayer**

Source and Application of Funds Method Example

Sources of Funds		Applications of Funds	
Wages		Withholdings (W-2)	
Interest Income		Investment Interest	
Dividends			
Tax Refunds			
Alimony Received			
Sch. C Receipts	\$50,000	Sch C Expenses (net of depreciation)	
		Sch C Purchases	
		Sch C Labor	\$32,000
		Sch C Material and Supplies	
		Sch C other period costs	
Sch. D - Gross Sales		Sch. D Asset and Investment Purchases	
Sale of Business Property			
IRA/Pension Distributions		Contributions to IRA, annuities and pensions,	
		Penalties for early withdraw	
Rental Income		Rental Expenses (net of depreciation)	
Sch F Receipts		Sch F Expenses (net of depreciation)	
Unemployment Comp.			
Social Security Benefits			
Unreported Income (IRP)			
Cash Distributions:		Contribution of Capital	
-- S-Corps		-- S-Corps	
-- Partnerships		-- Partnerships	
-- Fiduciaries			
Sale: Personal Residence		Sale of Residence Costs (Form 2119)	
Sale: Personal Property		Insurance Policies	
Advanced EITC			
Child Support Received			
Cash-on-Hand (beginning)		Cash-on-Hand (ending)	
Cash in Bank (beginning)	\$300	Cash in Bank (ending)	\$600
Credit Cards (End. Bal.)		Credit Cards (Beg. Bal.)	
Loans		Loan repayments	
Nontaxable Income -gifts, inheritances, etc.		Personal Capital Acquisitions	
Other sources of funds		Personal Living Expenses	\$40,000
		Other "cash out" items	
Accrual Basis Taxpayer		Accrual Basis Taxpayer	
-- Decrease in Accts/Rec.		-- Increase in Accts/Rec.	
-- Increase in Accts/Pay		-- Decrease in Accts/Pay	

Sources of Funds		Applications of Funds	
Total Sources of Funds:	\$50,300	Total Expenditures:	\$72,600

Computing understatement of taxable income

Total Applications of Funds \$72,600

Total Sources of Funds \$50,300

Excess Applications over Sources (understatement of taxable income). \$22,300

a. Accrual Basis Taxpayers

1. Since the results of this method are on a cash basis, adjustments must be made for an accrual basis taxpayer. Accounts receivable at the beginning of the period examined are shown on the debit side, as they are presumed to be collected during the period. Ending accounts receivables are a credit adjustment, required to effect a non-cash increase in income.
2. Accounts payable are shown as adjustments in the reverse order of accounts receivables. Beginning accounts payable are a credit adjustment having the result of increasing income and transferring a current period cash expenditure to the prior period in which it was incurred and deductible under the accrual method. Conversely, ending accounts payable balances are a debit adjustment having the effect of reducing income to result in a non-cash reduction of income.

2. Bank Deposits and Cash Expenditures Method – IRM 4.10.4.6.4 (05-27-2011).

- a. An important feature of any examination is the inspection or analysis of the taxpayer's bank records. This is particularly so in the examination of inadequate, nonexistent or possibly falsified books and records. The depth of the bank account analysis (see *IRM 4.10.4.3.3.7*) will depend upon the facts and circumstances of the individual case. When the bank account analysis indicates a reasonable likelihood of unreported income, the examination of income may be expanded to include the use of the formal Bank Deposits and Cash Expenditures Method to determine the actual understatement of taxable income.
- b. In summary, income is proven through a detailed, in-depth analysis of all bank deposits, cancelled checks, currency transactions, and electronic debits, transfers, and credits to the bank accounts AND identification of the taxpayer's cash expenditures. The Bank Deposits and Cash Expenditures Method is distinguished from the Bank Account Analysis by:
  1. The depth and analysis of all the individual bank account transactions, and
  2. The accounting for cash expenditures, and
  3. Determination of actual personal living expenses.

4. The Bank Deposits and Cash Expenditures Method computes income by showing what happened to a taxpayer's funds. It is based on the theory that if a taxpayer receives money, only two things can happen: it can either be deposited or it can be spent.
  5. This method is based on the assumptions that:
    - a. Proof of deposits into bank accounts, after certain adjustments have been made for nontaxable receipts, constitutes evidence of taxable receipts.
    - b. Outlays, as disclosed on the return, were actually made. These outlays could only have been paid for by credit card, check, or cash. If outlays were paid by cash, then the source of that cash must be from a taxable source unless otherwise accounted for. It is the burden of the taxpayer to demonstrate a nontaxable source for this cash.
    - c. The Bank Deposits and Cash Expenditures Method can be used in the examination of both business and nonbusiness returns.
    - d. The Bank Deposits and Cash Expenditures Method may supply leads to additional unreported income, not only from the amounts and frequency of deposits, but also by identifying the sources of such deposits. Determining how deposited funds are dispersed or accumulated (to whom and for what purpose) might also provide leads to other sources of income.
    - e. If the Bank Deposits and Cash Expenditures Method indicates an understatement of taxable income, it may be due to either underreporting of gross receipts or overstating expenses, or a combination of both.
3. Case Law (Bank Deposits and Cash Expenditures Method) – IRM 4.10.4.6.4.1 (09-11-2007).
- a. The classic bank deposits case is Gleckman v. United States, 80 F.2d 394 (8th Cir. 1935). The court held that standing alone bank deposits and large items of receipts do not prove additional tax due. On the other hand, if it is shown that these amounts can be associated with a business or income-producing activity, then the income is taxable. Since the Gleckman case, the Bank Deposits Method has received consistent judicial approval.
  - b. The Gleckman case, and the cases that followed, taught that in order to use the Bank Deposits and Cash Expenditures Method in determining income, it must be shown that:
    - i. The taxpayer was engaged in a business or income-producing activity,
    - ii. The taxpayer made periodic deposits of funds into a bank account or accounts,

- iii. An adequate investigation of deposits was made by the examiner in order to negate or eliminate the likelihood that the deposits arose from nontaxable sources of income, and
    - iv. Unidentified bank deposits have the inherent appearance of income; i.e., the size of the deposits, odd or even amounts, source of checks deposited, dates of deposits, etc.
- 4. When to Use the Bank Deposits and Cash Expenditures Method – IRM 4.10.4.6.4.2 (09-11-2007).
  - a. The Bank Deposits and Cash Expenditures Method should not be the automatic choice when selecting a formal indirect method. For example, cash intensive businesses, where significant amounts of gross receipts are not deposited and numerous cash outlays occur, do not lend themselves to this method.
  - b. If the Bank Deposits and Cash Expenditures Method is the method of choice, the entire analysis must be completed; shortened versions that do not account for business and personal cash expenditures are insufficient.
  - c. The Bank Deposits and Cash Expenditures Method is recommended when:
    - 1. The taxpayer's books and records are unreliable, unavailable, withheld, or incomplete.
    - 2. The taxpayer makes periodic deposits of funds into bank account(s) which appear to be generated from an income-producing activity.
    - 3. The taxpayer pays most business expenses by check.
    - 4. The taxpayer previously used bank account deposits to determine and report taxable income.
  - d. The advantages of the Bank Deposits and Cash Expenditures Method include:
    - 1. Provides a complete picture of the taxpayer's activities; it clearly reflects the size and scope of the taxpayer's financial activities.
    - 2. Avoids necessity of documenting business expenses, with the exception of technical adjustments such as depreciation.
    - 3. When the taxpayer overstates business expenses, the overstatement is automatically accounted for in the mechanics of the computation. It is not necessary to audit expenses claimed on the tax return.
- 5. Factor to Consider – IRM 4.10.4.6.4.5 (09-11-2007).
  - a. Are there any unusual or extraneous deposits which appear unlikely to have resulted from reported sources of income?
    - 1. Size of Deposit — Due to the need for expediency, the examiner may limit the examination to large deposits or deposits over a certain amount. However, the identification of smaller regular deposits may be indicative of dividend income, interest, rent, or other income, leading to a source of investment income.

2. Kind of Deposit — An item of deposit may be unusual due to the kind of deposit, check or cash, in its relationship to the taxpayer's business or source of income. An explanation may be required if a large cash deposit is made by a taxpayer whose deposits normally consist of checks. Also, a bank statement noting only one or two large even dollar deposits, in lieu of the normal odd dollar and cents deposits, would be unusual and require an explanation.
  3. Pattern and Frequency of Deposits — Many taxpayers, due to the nature of their business or the convenience of the depository used, will follow a set pattern in making deposits. Deviation from this pattern may bear questioning.
  4. Frequency of Deposits — Bank statements or deposit slips which indicate repeat deposits of the same amount on a monthly basis, quarterly or semi-annual basis may indicate rental, dividend, interest or other income accruing to the taxpayer.
  5. Location of Bank On Which the Check Was Drawn — The examination of deposit slips may indicate items of deposit which appear questionable due to the location of the bank on which the deposited check was drawn. It is common practice when preparing a deposit slip to list either the name of the bank, city of the bank or identification number of the bank upon which the deposited check was drawn. If an identification number is used, the name and location of the bank can be determined by reference to the banker's guide. In all cases, if the location of the bank on which the check for deposit was drawn bears little relation to the taxpayer's business location or source of income, it may indicate the need for further investigation.
- b. Are there any loan proceeds, collection of loans, or extraneous items reflected in deposits? In the analysis of bank deposits, the examiner should identify all items of this nature. This is a necessary step before comparing receipts to deposits.
1. If loan proceeds are identified, request the loan application documents to verify the source and amount of the nontaxable funds. Review the loan application information for consistency with other information; i.e., cash flows, assets, anticipated gross receipts, etc. Discrepancies should be resolved with the taxpayer's assistance.
  2. If repayments of loans are identified, request the debt instruments to establish that a loan was made, the terms of the debt, and the repayment schedule. Ask the taxpayer to document the flow of funds to the borrower (e.g., a cancelled check) and to explain where the money came from (e.g., Accumulated Funds). Ask how much money has been collected to date and whether the taxpayer reported interest earned. Contact the party receiving the loan and ask for a notarized statement outlining the terms of the loan, when it was received, and the amount of money repaid.

- c. Are there transfers between bank accounts or redeposit's?
  1. Before an examiner can reach any conclusion about the relationship between deposits and reported receipts, transfers and redeposits must be eliminated.
  2. For example, if a taxpayer draws a check to cash for the purpose of cashing payroll checks and then redeposits these payroll checks, the examiner would be incorrect if total deposits were compared to receipts reported without adjusting for this amount. The taxpayer has done nothing more than redeposit the same funds in the form of someone else's checks.
- d. Are there personal or nonbusiness bank accounts?
  1. Unreported income may be found in personal accounts. If the analysis is limited to an inspection of the business bank accounts only, omitted taxable income in personal accounts may not be discovered.
  2. The examiner should ascertain whether the deposits, as reflected in these accounts, can be accounted for by withdrawals or transfers from business accounts or from other known sources of funds.
  3. The examiner should not overlook the possibility of more than one personal or business bank account.
- e. Are the deposits in personal and business accounts, as adjusted, during short periods of time, accounted for by the records?
  1. It is not unusual to find that total deposits will reconcile on a yearly basis with the total receipts for the year reported on the tax return.
  2. A closer examination of deposits on a weekly or monthly basis may indicate that these deposits do not reconcile with the receipts reported during the same periods.
  3. Reported receipts may not be deposited in the closing months of the year to balance out the excess of deposits and the understatement of receipts in the earlier months.
6. Gross Receipts Formula – IRM 4.10.4.6.4.6 (08-09-2011).
7. The Bank Deposits and Cash Expenditures Method is used to determine gross receipts from all sources; i.e., it is not limited to consideration of business receipts and it is not necessary to audit or verify expenses deducted on the return.

1. Total bank deposits

**Less:**

2. Nontaxable receipts deposited

3. Net deposits resulting from taxable receipts

**Add:**

4. Business expenses paid by cash

5. Capital items paid by cash (personal and business)

6. Personal expenses paid by cash

7. Cash accumulated during the year from receipts

**Subtract:**

8. Nontaxable cash used for lines 4-7.

For accrual basis taxpayers:

For accounts receivable, subtract the beginning balance from the ending balance. A net increase represents additional taxable gross receipts and is added here. A net decrease represents payments included in prior year gross receipts and is subtracted here.

10. For accounts payable, subtract the beginning balance from the ending balance. A net increase represents purchases on account during the year and is subtracted here. A net decrease represents payments on accounts and is added here.

11. Gross Receipts as corrected

8. Adjustments for an Accrual Basis Taxpayer I.R.M 4.10.4.6.4.6.2 (05-27-2011)

- a. If the taxpayer is on the accrual basis, the differences between the beginning and ending balances of accounts receivable and accounts payable should be added to or subtracted from the corrected gross receipts to convert the computation to the accrual basis accounting method. In some cases, it will not be practical to determine the amount of accounts receivable and accounts payable due to the inadequacy of the records. In such cases, these adjustments may be ignored unless the amount appears to be material. Changes in the balances of accounts receivable and accounts payable should be handled as listed in the paragraphs below.
- b. An increase in accounts receivable is added to gross receipts. An increase in receivables results from sales on accounts during the year being in excess of collections on account during the year. Therefore, the taxpayer has income from sales that is not reflected in deposits or cash expended because the cash has not yet been received. This increase is added to gross receipts, as determined, so that the taxpayer's current income is properly reflected.
- c. A decrease in accounts receivable is subtracted from gross receipts. A decrease in receivables results from collections on account during the year. Therefore, the taxpayer has received cash during the year which is attributable to sales made in a previous year. This decrease is subtracted from gross receipts so that the taxpayer's current income is properly reflected.
- d. An increase in accounts payable is subtracted from gross receipts. An increase in accounts payable results from purchases on account during the year. This affects the bank deposit computation in the following manner:
  1. The total outlays per return includes all purchases and expenses deducted on the return regardless of whether or not they were all paid (except depreciation, amortization, etc.). Thus, the amount of

accounts payable at the end of the year is included in total outlays per return.

2. The taxpayer presumably paid for all purchases and expenses incurred during the year, except for the accounts payable balance at the end of the year, and also paid off the accounts payable amount owing at the beginning of the year. Business expenses paid by check include all such payments, i.e., payments on accounts payable and payments of current expenses.
  3. The amount of business expenses paid by cash, which is added to deposits and other cash expenditures in arriving at gross receipts, is determined by subtracting business checks from total outlays per return.
  4. If the balance of accounts payable at the end of the year is greater than the balance at the beginning of the year, the total outlays per return will be greater than the actual amount paid by check and cash. Therefore, if an increase in accounts payable is NOT subtracted from gross receipts, the amount of business expenses paid by cash will be overstated in the amount of the increase in accounts payable, and the gross receipts as determined will be overstated in the same amount.
  - e. A decrease in accounts payable is added to gross receipts. A decrease in accounts payable results from payments on account during the year being in excess of purchases on account during the year. This has the direct opposite effect on the bank deposit computation as an increase in accounts payable discussed in paragraph 4 above. In other words, the total outlays per return will be less than the actual amount paid by check and cash. This will result in an understatement of business expenses paid by cash in the amount of the decrease in accounts payable, and an understatement of the gross receipts as determined in the same amount.
9. Markup Method – IRM 4.10.4.6.5 (08-09-2011).
- a. The Markup Method produces a reconstruction of income based on the use of percentages or ratios considered typical for the business under examination in order to make the actual determination of tax liability. It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markup to arrive at the taxpayer's gross receipts. By reference to similar businesses, percentage computations determine sales, cost of sales, gross profit, or even net profit. By using some known base and the typical applicable percentage, individual items of income or expenses may be determined. These percentages can be obtained from analysis of Bureau of Labor Statistics data or industry publications. If known, use of the taxpayer's actual markup is required.
  - b. The Markup Method is a formal indirect method that can overcome the weaknesses of the Bank Deposits and Cash Expenditures Method, Source and Application of Funds Method, and Net Worth Method, which do not effectively reconstruct income when cash is not deposited

and the total cash outlays cannot be determined unless volunteered by the taxpayer. If personal enrichment occurs that cannot be identified, the effectiveness of these methods is diminished. For example, the possibility exists that significant personal acquisitions or expenditures are paid with cash and are not evident. The Markup Method is similar to how state sales tax agencies conduct audits. The cost of goods sold is verified and the resulting gross receipts are determined based on actual markup.

- c. This method is most effective when applied to businesses whose inventory is regulated or purchases can be readily broken down in groups with the same percentage of markup.
- d. An effective initial interview with the taxpayer is the key to determining the pertinent facts specific to the business being examined.

10. Case Law (Markup Method) – IRM 4.10.4.6.5.1 (08-09-2011).

- a. In United States v. Fior D'Italia, Inc., 536 U.S. 238 (2002), the majority held that IRC 446(b) does not limit authority to use aggregate estimation of income taxes (unreported tip income).
- b. In Barragan v. Commissioner, T.C.M. 1993-92, the Service properly determined gross receipts from a gas station based on the supplier's delivery records and the retail prices per an independent market survey. Similarly, in Stafford v. Commissioner, T.C.M. 1992-637, the Service properly determined gross receipts from gas stations based on Bureau of Labor Statistics data.
- c. In Nichols v. Commissioner, T.C.M. 1983-242, the Service was upheld in applying an established tip rate to the taxpayer's gross receipts to determine unreported tip income.
- d. In Webb v. Commissioner, 394 F.2d 366, 371-372 (5th Cir. 1966), aff'g T.C.M. 1966-81, the government determined Webb's income from liquor sales using the Markup Method.
- e. It was held in the Estate of Bernstein v. Commissioner, T.C.M. 1956-260, that the inability to use other "formal" indirect methods is not prerequisite for using a percentage method.
- f. In the case of Yorkville Live Poultry Co. v. Commissioner, 18 BTA 47 (1929), the Board of Tax Appeals approved a net income computation based upon four percent of the net sales where no books were available.

11. When to Use the Markup Method – IRM 4.10.4.6.5.2 (05-27-2011).

- a. The Markup Method is recommended in the following situations:
  - 1. When inventories are a principal income producing factor and the taxpayer has nonexistent or unreliable records.
  - 2. Where a taxpayer's cost of goods sold or merchandise purchased is from a limited number of sources, these sources can be ascertained with reasonable certainty, and there is a reasonable degree of consistency as to sales prices.
  - 3. This method is effective for industries such as liquor stores, taverns, gasoline retailers, restaurants, and jewelry stores.

- b. Examiners should address the following issues when applying the Markup Method:
1. Use the taxpayer's own records and oral testimony to establish the markup percentages based on known costs and sales prices. This should be the best source of information. Plausible explanations for why the taxpayer's markup percentages differ from national averages should be accepted.
  2. If it appears that the cost of goods sold and/or purchases are also understated, issue a summons to the taxpayer's suppliers for sales records.
  3. Judgment should be exercised by examiners when using industry standards or surveys to make sure the comparisons are valid and are for similar situations. Consider the availability of valid sources of information containing the necessary percentages and ratios. Adjust percentages and ratios to reflect those during the time of the return under audit. IRC 7491(b) places the burden of proof on the Service with respect to any item of income that was reconstructed solely through the use of statistical information on unrelated taxpayers.

12. Gross Profit Margin to Sales – IRM 4.10.4.6.5.3 (08-09-2011).

- a. The gross profit to sales ratio indicates the average markup on products. The calculation divides the gross profit margin (sales less cost of goods sold) by total sales:

Sales - Cost of Sales

Sales

- b. Example: A taxpayer sells two products, A and B, and reports \$140,000 in gross sales. The costs for product A are \$50,000 and the costs for product B are \$80,000. The costs are verified with the third party supplier and adjusted for opening and closing inventory.

Sales per return:	\$140,000
Cost of Goods Sold (Product A):	\$50,000
Cost of Goods Sold (Product B):	\$80,000

The examiner determines the gross profit margins for products A and B by interviewing the taxpayer, analyzing the taxpayer's records, and reviewing industry standards.

Product A:	10%
Product B:	20%

Step 1: Determine the COGS Percentage

	<u>Product A</u>	<u>Product B</u>
Gross Receipts:	100%	100%
Less: Gross Profit %	<u>10%</u>	<u>20%</u>
COGS %	90%	80%

Step 2: Determine the correct Gross Receipts: (COGS/COGS % = Gross Receipts)

	<u>Product A</u>	<u>Product B</u>
\$50,000/.90	\$55,555	
\$80,000/.80		\$100,000

Step 3: Determine the Adjustment to Gross Receipts

Sales of Product A:	\$ 55,555
Sales of Product B:	+ \$100,000
Sales as Recomputed:	\$155,000
Sales per Tax Return:	- \$140,000
Adjustment to Gross Receipts:	\$15,555

13. Costs of Sales to Gross Receipts Ratio – IRM 4.10.4.6.5.4 (08-09-2011).

- a. Using the cost of sales to gross receipts ratio is a variation of the gross profit margin to sales ratio. It also is a comparison of costs to sales.

**Example:**

Example: A taxpayer sells two products, A and B, and reports \$70,000 in gross receipts. The costs for product A are \$20,000 and the costs for product B are \$30,000. The costs are verified with the third party supplier and adjusted for opening and closing inventory.

Sales per return:	\$ 70,000
Cost of Sales (Product A)	\$ 20,000
Cost of Sales (Product B)	\$ 30,000

The examiner determines that cost of sales is 75% of sales for product A and 50% of B by interviewing the taxpayer, analyzing the taxpayer's records, and reviewing industry standards.

Step 1: Determine the COGS Percentage

	<u>Product A</u>	<u>Product B</u>
Cost of Sales %	75%	50%

Step 2: Determine the correct Gross Receipts: (COS/COS % = Gross Receipts)

	<u>Product A</u>	<u>Product B</u>
\$20,000/.75	\$26,666	
\$30,000/.50		\$60,000

Step 3: Determine the Adjustment to Gross Receipts

Sales of Product A:	\$ 26,666
Sales of Product B:	+ \$ 60,000
Sales as Recomputed:	\$ 86,666
Sales per Tax Return:	- \$ 70,000
Income Adjustment:	\$16,666

14. Unit and Volume Method – IRM 4.10.4.6.6 (08-09-2011).
- a. In many instances gross receipts may be determined or verified by applying the sales price to the volume of business done by the taxpayer. The number of units or volume of business done by the taxpayer might be determined from the taxpayer's books as the records under examination may be adequate as to cost of goods sold or expenses. In other cases, the determination of units or volume handled may come from third party sources.
  - b. This method for determining the actual tax liability has been effectively applied in carry out pizza businesses, coin operated laundromats, and mortuaries.
15. Case Law (Unit and Volume Method) – IRM 4.10.4.6.6.1 (08-09-2011).
- a. In Salami v. Commissioner, T.C.M. 1997-347, the court held that a cab driver's gross income could be determined using claimed gas expenses, price per gallon, miles per gallon, occupancy rates, etc. Same for the cab driver in Irby v. Commissioner, T.C.M. 1981-399.
  - b. In Maltese v. Commissioner, T.C.M. 1988-322, the Service was upheld in determining gross income by determining the number of pizza crusts per 100 pounds of flour times the average price per pizza.
  - c. In Stanoch v. Commissioner, T.C.M. 1959-132, the Service established gross receipts for a tavern by allowing a specific measurement of liquor per drink and a percentage for spillage.
16. When to Use the Unit and Volume Method
- a. The Unit and Volume Method is recommended for making the actual determination of tax liability when:
    1. The examiner can determine the number of units handled by the taxpayer and also know the price charged per unit.
    2. The business has only a few types of products which are sold or there is little variation in the types of services performed, and the charges made by the taxpayer (sales price) for merchandise or services are relatively the same throughout the tax period.
17. Other Considerations – IRM 4.10.4.6.6.3 (06-01-2004).
- a. Examiners should be aware of the following when considering the Unit and Volume Method:
    1. Is there a common denominator for the business that drives gross receipts?
    2. Can the number of units handled or consumed by the taxpayer be ascertained?
    3. Is the price per unit or profit per unit obtainable?
    4. Is there a third party from whom the taxpayer's consumption, units of production, or sales are available?
18. Example of Computation – IRM 4.10.4.6.6.4 (06-01-2004).
- a. This example is for a coin operated laundry, where the known unit is the amount of water needed for each unit of sale (load of laundry). Per the utility bills, the taxpayer consumed 3,000,000 gallons of water.

Gallons of water consumed:	3,000,000
Non washing machine consumption (spillage):	<u>- 50,000</u>
Net water available for paid loads (gallons):	2,950,000

Gallons of water per load of wash, determined from manufacturer or credible oral testimony, is 27 gallons.

The reconstructed number of loads of wash is  $2,950,000/27 = 109,259$ .

The price per washing machine load is \$2.50. The gross receipts from washing machines is  $109,259 \text{ loads} \times \$2.50 / \text{load} = \$273,148$ .

The price per dryer load is \$1.50. Based on observations on different days of the week, the examiner determines that customers' use of dryers is 75% of their wash loads. The price per dryer load is \$1.50. Therefore, the gross receipts for dryer use is  $.75(109,259) \times \$1.50 = \$122,916$ .

Summarize the gross receipts for all the services and compare to the gross receipts reported on the tax return.

Gross Receipts from washers:	\$ 273,148
Gross Receipts from dryers:	+ \$122,916
Other Receipts (vending, arcade):	<u>\$ 25,000</u>
Sales as Recomputed:	\$ 421,064
Sales per Tax Return:	<u>- \$ 376,745</u>
Income Adjustment:	\$44,319

19. Net Worth Method – IRM 4.10.4.6.7 (06-01-2004).

- a. The Net Worth Method for determining the actual tax liability is based upon the theory that increases in a taxpayer's net worth during a taxable year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income. This method requires a complete reconstruction of the taxpayer's financial history, since the government must account for all assets, liabilities, nondeductible expenditures, and nontaxable sources of funds during the relevant period.
- b. The theory of the Net Worth Method is based upon the fact that for any given year, a taxpayer's income is applied or expended on items which are either deductible or nondeductible, including increases to the taxpayer's net worth through the purchase of assets and/or reduction of liabilities.
- c. The taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year. The difference between these two amounts will be the increase or decrease in net worth. The taxable portion of the income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible items, and subtracting that portion of the income which is partially or wholly nontaxable.

- d. The purpose of the Net Worth Method is to determine, through a change in net worth, whether the taxpayer is purchasing assets, reducing liabilities, or making expenditures with funds not reported as taxable income.
20. Case Law (Net Worth Method) – IRM 4.10.4.6.7.1 (06-01-2004).
- a. The Net Worth Method is a very old method of determining income. See United States v. Frost, 25 F.Cas. 1221 (N.D. Ill. 1869). The first criminal case involving the Net Worth Method was United States v. Beard, 222 F.2d 84 (4th Cir. 1955), which involved delinquent returns.
  - b. The use of the Net Worth Method of proof has been approved by the Supreme Court in: Holland v. United States, 348 U.S. 121 (1954). Holland set forth the following requirements that the government must meet when using the Net Worth Method:
    - 1. Establish an opening net worth, also known as the base year, with reasonable certainty.
    - 2. Negate reasonable explanations by the taxpayer inconsistent with guilt; i.e., reasons for the increased net worth other than the receipt of taxable funds. Failure to address the taxpayer's explanations might result in serious injustice.
    - 3. Establish that the net worth increases are attributable to currently taxable income.
    - 4. Where there are no books and records, willfulness may be inferred from that fact coupled with proof of an understatement of taxable income. But where the books and records appear correct on their face, an inference of willfulness from net worth increases alone might not be justified.
    - 5. The government must prove every element beyond a reasonable doubt, though not to a mathematical certainty.
21. When to Use the Net Worth Method – IRM 4.10.4.6.7.2 (08-09-2011).
- a. The Net Worth Method is generally recommended in the following situations:
    - 1. Two or more years are under examination.
    - 2. Numerous changes to assets and liabilities are made during the period.
    - 3. No books and records are maintained.
    - 4. The books and records are inadequate or not available.
    - 5. The books and records are withheld by the taxpayer.
  - b. The Net Worth Method should be used only if:
    - 1. The group manager concurs that the Net Worth Method is the more appropriate method and should be used, or
    - 2. Criminal Investigation has requested that the Net Worth Method be used.
  - c. The fact that the taxpayer's books and records accurately reflect the figures on a return does not prevent the use of the Net Worth Method of proof. The government can still look beyond the "self-serving declarations" in a taxpayer's books and records and use any evidence

available to determine whether the books accurately reflect the taxpayer's financial history.

- d. While the Net Worth Method was originally used against taxpayers whose principal source of income was from an illegal activity, it is now regularly recommended in fraud cases, especially where significant changes in net worth have occurred and other methods of proof are insufficient.
- e. In addition to being used as a primary means of proving taxable income so that an actual determination of tax liability can be made, the Net Worth Method is relied upon to corroborate other methods of proof and test the accuracy of reported taxable income.

22. Formula for the Net Worth Method – IRM 4.10.4.6.7.3 (09-11-2007).

- a. The formula for computing income using the Net Worth Method is as follows:

Total Assets	\$XXX
Total Liabilities Less:	<u>(XXX)</u>
Net Worth, end of year	\$XXX
Net Worth, beginning of year Less:	<u>(XXX)</u>
Increase or decrease in net worth	\$XXX
Nondeductible expenditures Add:	<u>XXX</u>
Sub-Total	XXX
Nontaxable income Less:	<u>(XXX)</u>
Adjusted gross income (this figure would be net or taxable income in the case of partnerships and corporations)	\$XXX

## II. Substantiation

### A. Burden of Proof

1. The Taxpayer (“TP”) bears the burden of proving entitlement to claimed deductions. U.S. Tax Ct. R. 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933); *Hradesky v. Commissioner*, 65 T.C. 87, 89-90 (1975), *affd.* 540 F.2d 821 (5th Cir. 1976)
2. Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records... as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to... keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title.” IRC § 6001.
  - a. Generally, TP must keep permanent books of account or records, including inventories, sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information. Treas. Reg. 1.6001-1.
  - b. Books of account only have probative force if fairly and honestly kept; they have no evidential value, absent satisfactory explanation, when suspicious marks of erasure and alteration in any material respect appear on them. *Del Marcelle v. Collector of Internal Revenue*, 80 F. Supp. 616 (E. D. Wis. 1948).

### B. Cohan Rule and Section 274 Strict Substantiation Rules

1. When TP establishes that TP paid or incurred deductible expenses but does not establish the amount of the deduction to which TP is entitled, TP may be entitled to estimate the amount allowable. *Cohan v. Commissioner*, 39 F.2d 540 (2d. Cir. 1930); *Vanicek v. Commissioner*, 85 T.C. 731 (1985).
  - a. TP must present sufficient evidence for Court to make estimate because without such a basis, any allowance would amount to largesse. *Williams v. United States*, 245 F.2d 559, 560-561 (5th Cir. 1957); *Vanicek v. Commissioner*, 85 T.C. 731 (1985).
  - b. Deductions for certain expenses are subject to strict substantiation
  - c. requirements, and an allowance therefore may not be estimated by the Court. *Garza v. C.I.R.*, 107 T.C.M. (CCH) 1586 (T.C. 2014).
2. Section 274(d) Substantiation required.--No deduction or credit shall be allowed—
  - a. under section 162 or 212 for any traveling expense (including meals and lodging while away from home),
  - b. for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation,

- or with respect to a facility used in connection with such an activity,
- c. for any expense for gifts, or
  - d. with respect to any listed property (as defined in section 280F(d)(4)),

Unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified non-personal use vehicle (as defined in subsection (i)).

## C. Audit Techniques -Cash Intensive Businesses Audit Techniques Guide – Chapter 6 Evaluation Evidence of an Audit

### 1. Techniques to Corroborate or Refute Income Related Items

Evaluate the Initial Facts Concerning the Non-Taxable Sources and The Current State of the Audit:

- Ask the taxpayer for the specific dates and amounts of the currency received from friends or family – a vague and self serving letter from a friend or relative is not sufficient, the examiner will need to know exactly how much currency was received on each specific date.
- Was it US currency or foreign currency?
- Can the loan be verified by any other source?
- Can the lender show it was withdrawn from their bank on that date?
- Were FinCEN forms filed if currency was brought into the country?
- What day did the taxpayer get the money?
- How much did the taxpayer get on that day?
- What did the taxpayer do with the money that day? –the examiner can look for a cash influx in the bank or business that day. (A taxpayer didn't need to borrow money to keep it in a sock drawer for 3 months.)
- Ask for name, address, telephone number of each person providing cash loans. Inform the taxpayer that you will be contacting these individuals for proof, including requesting copies of their tax returns or other documents.
- How the foreign currency was converted to US currency?
- Where did the lender convert the currency?
- Now, ask for a copy of the exchange receipt issued by the bank or whomever exchanged the foreign currency for US currency

- If the lender converted the currency and brought it into the US, also ask for a copy of their passport showing entry to the US on that day
- If the taxpayer converted the currency, ask them to produce the exchange receipt.

## 2. Other IRS Considerations

- The examiner must get specific information from the taxpayer. The taxpayer must have records of this, because if currency was received, the taxpayer will definitely know how much it was. If it is a loan, they will need to know what was borrowed so they can pay it back. They will need to know when it was borrowed to calculate interest. Even groups who use income pooling keep track of who has borrowed, what amounts are borrowed and when repayment is expected.
- If the taxpayer cannot provide specific information the examiner should question the credibility of the statements. Real loans always have real records. This questioning should be intensive and will bring out inconsistencies if the cash loans do not exist.
- Specific dates and amounts are important, because large cash expenditure in January can't be explained by a trip to a foreign country to obtain cash in March.
- The examiner should consider issuing an IDR for this information.
- If the taxpayer cannot provide specific amounts and dates of the currency received, they cannot know the understatement is not attributable to gross receipts.
- If the taxpayer has sufficient detailed information, summoning the loan makers or cash donors for an interview and additional documents would be appropriate. Also, summoning bank records for the specific deposits would be appropriate.
- When foreign currency is given by gift or loan, exchange rates can be found for the transfer dates. If they were not favorable, it is unlikely a friend or relative would have exchanged the currency at that time unless it was absolutely necessary. And, if it was absolutely necessary, the money would go into the bank or into the business immediately.
- If this is a loan, ask to see how the taxpayer is paying it back. The loan will have occurred in the examination year, and by now, in the current year, the taxpayer should have paid some of it back. Ask to see how repayments are made. Ask how interest is calculated. If the taxpayer is repaying by taking currency to the foreign country, ask for the same type of specific information. Get exchange receipts and copies of their passport. Does the business show enough profit to be able to pay back loans on those dates?
- In this case, a taxpayer may try to characterize an annual vacation as a trip to make a loan repayment. If only one payment is made during the year, it will necessarily be a larger than normal loan payment. Can withdrawals be found in the amount claimed to be paid back? Analyze the cash in and cash out for the week of the repayment.

- Interview the family or friend lenders, if possible, and review their tax returns, if any are filed. Ask the same questions presented to the taxpayer:
  1. What are the specific dates and amounts provided to the taxpayer?
  2. Was it foreign or US currency?
  3. Who converted the currency to US? When? Where?
  4. What records do you have to prove this?
  5. What records do you have to guarantee the money will be repaid?
  6. Have any repayments been made? When? Where? How much?
  7. If not, why not?
  8. Ask to see copies of their passports to show they traveled into the country when they say they did.
  9. Ask to see copies of their bank withdrawals if money was withdrawn to lend to your taxpayer.
  10. Ask where the money came from.
  
- It is possible that, when face to face with the examiner, the alleged lender will make statements inconsistent with the taxpayer's statements or give some evidence that they did not really have the ability to make these suggested loans.
- Examiners are required to investigate all leads the taxpayer provides. If the taxpayer says he received money from someone, the examiner is required to investigate and explain if there are facts to corroborate the taxpayer's statements. It's up to the examiner to develop enough facts to show that this is believable or unbelievable.
- Note: The Treasury Department requires anyone who transports, mails, ships or receives currency, traveler's checks, money orders or other negotiable instruments to be reported if the amount taken in or out of the US is over \$10,000. You can request FinCEN Form 105 - Report of International Transportation of Currency or Monetary Instruments, from the taxpayer or the Bureau of Customs and Border Protection.

### 3. More Considerations

- The examiner does not have to accept unsubstantiated and self serving statements as fact. The following considerations should be included when this type of testimony or evidence is evaluated:
  1. Dates and amounts of transactions: Need to scrutinize individual deposits and determine their nature, that is, cash, check, wires, cashier or travelers' checks, or foreign currency. Is it possible?

2. Poor books and records indicate reduced credibility. A taxpayer with poor records usually cannot prove excess funds did not come from the business.
  3. Identification and interview of donor/lender.
  4. Cash hoard questions.
  5. Money from foreign sources involved.
  6. Evaluate standard of living of taxpayer and any lender of monies.
  7. Results of bank deposit, Cash T, or source and application of funds.
  8. Asset acquisitions: car/house/investments.
  9. Taxpayer's detailed (or lack of) knowledge of lender/donor and transaction.
  10. Have loan repayments been made? When? What amounts?
  11. Is taxpayer's explanation questionable/credible, implausible or inconsistent?
  12. Does taxpayer have a cash business? At what percentage of total sales in cash? Cash expenses?
  13. Other areas to consider during audit:
    - a. Uncooperative taxpayer/representative
    - b. Procrastination
    - c. Credibility
    - d. Difficult/aggressive representatives
    - e. Requests to issue 30/90 day letters at early stage.
- Information Obtained from Taxpayers
    1. Obtain taxpayer's direct testimony on non-taxable source if not available through his/her representative:
      - a. Taxpayer's relationship to lender/donor
      - b. Lender/donor's source of funds/occupation/background
      - c. Cash, check, and wire transfer
      - d. If cash, how was it transported
      - e. Does taxpayer have any business overseas?
      - f. Cash hoard
        - i. Who knew about it?
        - ii. Where was cash kept?
        - iii. Denominations
      - g. Loan repayments, promissory notes
    2. Can we obtain testimony under oath?
    3. Issue summons?
    4. Did the taxpayer continue to change testimony and what does this do to the credibility of the taxpayer's statement?
  - Taxpayer's Personal and Business Records

1. The examiner should issue information document requests
2. If necessary the examiner should summons banks/brokerage firms/title companies early
  - a. Find out what was really deposited
  - b. Obtain copies of deposited items: checks, cash, traveler's checks, cashier's checks
  - c. Check for unknown accounts especially through transfers
  - d. Records of cash transactions [8300 reporting requirements]
  - e. Wire transfer documents: identification of sender and country
  - f. In-depth analysis of bank deposits
  - g. Safe deposit box records
  - h. Purchases of travelers checks/money orders
  - i. Check for exchange of foreign currency
  - j. Obtain complete, legible copies of all-important documents.
3. Analyze acquisitions of real property, jewelry, business investments, and cars not commensurate with income.

#### 4. Specific Industry Applications of Audit Techniques

<b>Industry/Omit Income</b>	<b>Possible Audit/issues Techniques</b>
Retail Liquor Industry Off-book inventory—liquor sales	<ul style="list-style-type: none"> <li>• Check for purchases outside of the liquor distributor, i.e. local wholesaler.</li> <li>• Bottle redemption</li> <li>• If needed, check with local/state beverage department for pending or completed investigations involving taxpayer and/or known suppliers of the taxpayer.</li> <li>• Check cashing</li> </ul>
Cash purchases (suppliers—check for reporting income)	<p>If necessary confirm method of payment for supplies by third party contact with suppliers.</p> <ul style="list-style-type: none"> <li>• Compare total payments by check to suppliers with total payments received by suppliers.</li> </ul>
Video Games	<ul style="list-style-type: none"> <li>• If necessary, contact vending machine</li> </ul>

<b>Industry/Omit Income</b>	<b>Possible Audit/issues Techniques</b>
	<p>companies to determine amount paid to business.</p> <ul style="list-style-type: none"> <li>• Watch out for sale/rental of bootlegged tapes/DVD's</li> </ul>
Preparation of cash deposits	Look for regularity of deposits and determine whether the taxpayer reconciles bank account. Internal control could be a concern.
Credit card sales—total omission v. partial omission	Observe whether the taxpayer has provisions for sales on credit card. Inspect bank statements and determine whether such transactions are recorded in the taxpayer's books.
Pizza Pie sales	The difference of the number of boxes sold versus number of boxes used [minus some spoilage boxes] could be additional unreported sales.
Vendor allowances	Vendor agreements that should be treated as income to the taxpayer receiving the money or fixture (that is, sales fixtures put into the store without being paid for by taxpayer).
Bartering in the 21st century	<ul style="list-style-type: none"> <li>• E-commerce – banner trading</li> <li>• Radio - free air time</li> </ul>
New Auto Dealerships	Rebates - An automobile dealer must record the cost of new automobiles in inventory reduced by the amount of a manufacturer's rebate, which represents a trade discount.
Gasoline Service Station	<ul style="list-style-type: none"> <li>• Unit Mark up method used successfully – gallons of gasoline purchases times sales price = income.</li> <li>• Imaging Reimbursement</li> <li>• Incentive Agreements</li> <li>• Accommodations</li> <li>• Blending</li> <li>• Rebates</li> </ul>

<b>Industry/Omit Income</b>	<b>Possible Audit/issues Techniques</b>
Auto Body Repair	<ul style="list-style-type: none"> <li>• Income estimated by using Mitchell Guide [or similar guide]</li> <li>• Dollars per hour charge needs to confirmed</li> <li>• Insurance money is an income issues: dividends, refunds, claims, pre-pays and accruals</li> <li>• Unethical practices - Kickbacks (rentals), finders, referral fee.</li> </ul>
Retail Gift Shops	<p>Review books for lack of:</p> <ul style="list-style-type: none"> <li>• Advertising allowance</li> <li>• Gift certificate</li> <li>• Markdown participation</li> <li>• Layaway plan:</li> </ul>
New Auto Dealerships	<ul style="list-style-type: none"> <li>• Demonstrators are employee-employer issues</li> <li>• Extended Service Contracts</li> <li>• Hold back - Revenue Ruling 72-326</li> </ul>
Used Auto Dealerships	<p>Omitted income could include:</p> <ul style="list-style-type: none"> <li>• Fee Income</li> <li>• Rebate Income</li> <li>• Warranty Contracts</li> <li>• Consignments</li> <li>• Repossessed Vehicles</li> </ul>
Restaurants & Bars	<ul style="list-style-type: none"> <li>• Rebates to Franchisees from Suppliers</li> <li>• Compare restaurant Averages (sales v. cost)</li> <li>• 4% net profit</li> <li>• Low % spillage</li> <li>• Point of Sales machines and the Zapper program issue</li> <li>• Bar Averages (pour) can be used to calculate income</li> <li>• Fortune Cookie Analysis of sales for calculation of income</li> </ul>

Industry/Omit Income	Possible Audit/issues Techniques
Grocery	<p>Numerous sources for unreported income include:</p> <ul style="list-style-type: none"> <li>• Coupon processing rebate fees</li> <li>• Cash discounts from vendors</li> <li>• Rebates from vendors</li> <li>• Receipt of high dollar promotional items from vendors</li> <li>• Vending machines (i.e. newspaper)</li> <li>• Pinball machines/arcade games</li> <li>• Bottle/can redeeming</li> <li>• Money orders</li> <li>• Credit Card Sales</li> <li>• Food Stamp Sales</li> <li>• WIC Program Sales</li> <li>• Prepaid telephone cards</li> </ul>
Boat & Yacht	<p>One method for checking income is counting the number of steering wheels used.</p> <ul style="list-style-type: none"> <li>• Every boat has to have at least one.</li> <li>• Average sale price times steering wheels used equal potential gross income.</li> </ul>

#### D. Focus Issue

#### Hobby Losses

1. Is Taxpayer Operating A Trade/Business or a Hobby?
  - a. Generally, the Code allows individuals to deduct expenses which are incurred (1) in a trade or business (Section 162); or (2) for the production or collection of income, or for the management, conservation or maintenance of property held for the production of income (Section 212).
  - b. For the expenses to be deductible under Sections 162 or 212, the taxpayer must engage in or carry on an activity to which the expenses relate with an actual and honest objection of making a profit. Keanini v. Commissioner, 94 T.C. 41 (1990) (citing Golanty v. Commissioner, 72 T.C. 411, 425 (1979), aff'd without published opinion, 647 F.2d 170(9<sup>th</sup> Cir. 1981)).

- c. If an activity is not engaged in for profit, Section 183(b) allows a taxpayer the deductions that would be allowable without regard to whether or not the activity is engaged in for profit. If the gross income derived from the activity for the taxable year exceeds these deductions, Section 183(b) also allows a taxpayer to deduct the amounts that would be allowable as deductions if the activity were engaged in for profit, to the extent of any remaining gross income.
- d. Treas. Reg. Section 1.183-1(e) provides that for purposes of Section 183, gross income includes the total of all gains from the sale, exchange or other disposition of property and all other gross receipts derived from such activity. It also provides that gross receipts from the activity may be reduced by cost of goods sold to determine gross income.
- e. Whether or not an activity is presumed to be operated for profit requires an analysis of the facts and circumstances of each case. Deciding whether a taxpayer operates an activity with an actual and honest profit motive typically involves applying the nine non-exclusive factors contained in Treas. Reg. Section 1.183-2(b). Those factors are:
  - i. The manner in which the taxpayer carried on the activity,
    - 1. The fact that the taxpayer carries on an activity in a businesslike manner and maintains complete and accurate books and records may indicate a profit motive.
      - a. While a sophisticated business plan is not necessary, a taxpayer should keep records that enable the taxpayer to make informed business decisions. Burger v. Commissioner, 809 F.2d 355, 359 (7<sup>th</sup> Cir. 1987); *aff'g* T.C. Memo. 1985-523.
      - b. Failure to maintain adequate records indicates a lack of necessary profit intent. Montagne v. Commissioner, 166 Fed. Appx. 265 (8<sup>th</sup> Cir. 2006), *aff'g* T.C. Memo. 2004-252.
    - 2. Commingling of funds indicates that an activity is more closely related to a hobby than a business. See Bush v. Commissioner, T.C. Memo. 2002-33, *aff'd*, 51 Fed. Appx. 422 (4<sup>th</sup> Cir. 2002).
    - 3. Characteristics of a businesslike operation include the preparation of a business plan.
    - 4. A taxpayer's change in operating methods or adoption of new techniques to improve profitability may indicate an overall profit motive. Treas. Reg. Section 1.183-2(b)(1).
  - ii. The expertise of the taxpayer in his or her advisers.

1. The taxpayer's expertise, research, and extensive study of an activity, as well as his or her consultation with experts, may indicate a profit motive.
  - a. The failure to consult an expert *at the outset* of the activity on the financial aspects of running a cutting horse farm indicates that they lacked a profit motive. Burger v. Commissioner, 809 F.2d 355, 359 (7<sup>th</sup> Cir. 1987), aff'g T.C. Memo. 1985-523.
- iii. The time and effort expended by the taxpayer in carrying on the activity,
  1. The taxpayer's devotion of much of his or her personal time and effort to carrying on an activity may indicate a profit motive, particularly if the activity does not involve substantial personal or recreational aspects. Treas. Reg. Section 1.183-2(b)(3).
  2. If a taxpayer spends little time and effort on the activity but hires a competent and qualified person to carry on the activity, a profit motive may still be indicated. Burrus v. Commissioner, T.C. Memo. 2003-285.
- iv. The expectation that the assets used in the activity may appreciate in value;
  1. The Tax Court can only infer a profit objective from such expected appreciation only when the appreciation exceeds operating expenses and would be sufficient to recoup the accumulated losses of prior years. Foster v. Commissioner, T.C. Memo. 2012-207; see Golanty v. Commissioner, 72 T.C. at 427-428.
  2. With respect to activities like horse breeding, the Tax Court must evaluate any profit motive in operating the farm separately from any profit motive the taxpayer had in purchasing the underlying real property. Mathis v. Commissioner, T.C. Memo. 2013-294 (citing Treas. Reg. Section 1.183-1(d)(1)).
- v. The success of the taxpayer in carrying on other similar or dissimilar activities;
  1. If the taxpayer has previously converted an unprofitable business to a profitable business may indicate that he or she is currently profit motivated.
- vi. The taxpayer's history of income or loss with respect to the activity;
  1. Although a series of losses during the initial or start-up stage of an activity may not necessarily indicate a lack of profit motive, a record of large losses over many years is persuasive evidence that the taxpayer did not have a profit motive. Golanty v.

Commissioner, 72 T.C. at 426; Foster v. Commissioner, T.C. Memo. 2012-207.

2. The current and expected losses of an activity should not be of such a magnitude that an overall profit going forward would not be possible. Besseney v. Commissioner, 45 T.C. 261, 274 (1965), aff'd, 379 F.2d 252 (2d Cir. 1967).
- vii. The amount of occasional profits, if any, which are earned;
- viii. The financial status of the taxpayer;
  1. Substantial income from sources other than the activity may indicate that the activity is not engaged in for profit. Treas. Reg. Section 1.183-2(b)(8).
  2. A taxpayer with substantial income unrelated to the activity can more readily afford a hobby. Foster v. Commissioner, T.C. Memo. 2012-207.
    - a. This is particularly true if the losses from the activity might generate substantial tax benefits. Golanty v. Commissioner, 72 T.C. at 429.
- ix. Elements of personal pleasure or recreation.
- f. No single factor controls, other factors may be considered, and the mere fact that the number of factors indicating the lack of a profit objective exceeds the number indicating the presence of a profit objective (or vice versa) is not conclusive.
  - i. Certain factors may be given more weight than others because they are more relevant to the facts. See Vitale v. Commissioner, T.C. Memo. 1999-131; aff'd without published opinion, 217 F.3d 843 (4<sup>th</sup> Cir. 2000).
  - ii. Not all factors may apply in any case. See Green v. Commissioner, T.C. Memo. 1989-436.
  - iii. Greater weight is given to objective facts over the taxpayer's subjective intent. See Engdahl v. Commissioner, 72 T.C. 659, 666 (1979).
  - iv. A profit objective in an earlier year does not automatically provide a taxpayer a blank check with regard to losses incurred in later years. See Daugherty v. Commissioner, T.C. Memo. 1983-188.
2. Safe Harbor under Section 183(d):
  - a. Allows a presumption that the taxpayer is engaged in for profit:
    - i. If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive years which ends with the taxable year exceeds the deductions attributable to such activity.
    - ii. In the case of an activity which consists in major part of the breeding, training, showing or racing of horses, the preceding sentence shall be applied by substituting "2" for "3" and "7" for "5".

- iii. This presumption rule applies only after an activity incurs a third profitable (or second) profitable year within a 5 year (or 7 year) presumption period that begins with the first profitable year.
- iv. Section 183 (e) allows the taxpayer to elect to postpone the determination as to whether the Section 183(d) presumption applies.

#### E. Inadequate Records

- All taxpayers are required by law to maintain accounting records of sufficient detail to enable the proper preparation of a tax return. If it is determined that the taxpayer has failed to maintain adequate records, then the issuance of an Inadequate Records Notice should be considered. This serves to place taxpayers on notice that their record keeping practices are deficient and must be improved to meet the requirements of the law.
- Addressing poor record keeping practices is a significant component of case quality.

An Inadequate Records Notice should be considered for a cash intensive business whenever:

- An adjustment is made using an indirect method (the existing records did not accurately reflect income)
- An adjustment is made and source documents, such as cash register tapes, receipts or invoices, were missing
- An adjustment is made and no books were maintained an adjustment is made because the taxpayer failed to disclose a source of income (for example, Internet sales or another business)

If an examiner finds that a taxpayer's books and records are inadequate, they will discuss the inadequacies with their manager. The examiner will also discuss the situation with the taxpayer and explain in detail what needs to be done to correct the problem. This must be documented in the examiners workpapers or case history. After completion of the examination, the examiner prepares letter 978 or 979 to notify the taxpayer. The contact for the letter is the PSP individual responsible for the program. The letter is signed by the examiner's manager and sent by certified mail to the taxpayer. A copy of the letter, case history and audit report go to PSP.

It is very likely the taxpayer will be examined in the future to determine if the recordkeeping practices have improved.

See IRM 4.10.4.4.2 (09-11-2007) for procedures to issue an inadequate records notice.

#### F. Proper Development of Cases

- If, during the audit, the examiner discovers a discrepancy in income between that determined by an indirect method and that reported on the return, the examiner should not assume that the discrepancy is due to fraud. The discrepancy could be an error; it is often helpful to open a previous or subsequent year for examination to see if a pattern emerges.

- If a satisfactory explanation exists, the examiner can save considerable examination time and unnecessary delays in the audit by first asking the taxpayer to explain the reason for the discrepancy.
- Responsibility for the discrepancies or errors should be determined. If a false or evasive explanation is given, the facts and circumstances should be weighed against the elements of fraud.

#### G. Fraud Considerations

- Taxpayers who knowingly understate their tax liability often leave evidence in the form of identifying earmarks (or indicators). Fraud indicators can consist of one or more acts of intentional wrongdoing on the part of the taxpayer with the specific purpose of evading tax. Fraud indicators may be divided into two categories: affirmative indications or affirmative acts. No fraud can be found in any case unless affirmative acts are present.
- Affirmative indications serve as a sign or symptom, or signify that actions may have been done for the purpose of deceit, concealment or to make things seem other than what they are. Indications in and of themselves do not establish that a particular process was done; affirmative acts also need to be present. Examples of affirmative indications include:
  - Substantial unexplained increases in net worth,
  - Substantial excess of personal expenditures over available resources,
  - Bank deposits from unexplained sources substantially exceeding reported income
  - Inadequate books and records
  - Conduct that is evasive, misleading or uncooperative
- Affirmative acts are those actions that establish that a particular process was deliberately done for the purpose of deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than what they are. Examples include:
  - Omissions of specific items where similar items are included,
  - Concealment of bank accounts or other property,
  - The use of nominees on bank accounts or other property
  - Failure to deposit receipts to business accounts
  - Hiding sources of receipts
  - Destruction of records
- Fraud is generally defined as deception, misrepresentation of material facts, or silence when good faith requires expression.

Elements common to all tax fraud cases include an understatement of tax liability, willful intent to evade taxes and a course of action demonstrating the taxpayer's intent.

1. Presence of Fraud  
Fraud implies bad faith on the part of a taxpayer, shown by acts calculated to cheat, mislead, or conceal. This can include the destruction or concealment of records relating to an income source.
2. Elements of Fraud – The Government is required to prove:
  - a. A significant understatement of tax liability.
  - b. Willfulness – an act of commission, or omission, requiring:
    1. Knowledge – consider education, experience, and participation in the acts.
    2. Intent – implied from words and action of the taxpayer.
    3. Evil Purposes – A dishonest intent to conceal or misrepresent.
3. Consideration for the Agent
  - a. Identify all bank accounts.
  - b. Issue summons as needed.
  - c. Ask taxpayer for explanation of understatement.
  - d. Refute or verify the taxpayer’s explanation.
  - e. Expand the examination to multiple years or related entities.
  - f. Consider the preparer’s involvement.
  - g. Contact third parties as needed.
  - h. Identify a likely source of income.
  - i. In an altered documents case, show that the expenses are fictitious.
  - j. Show harm to the government
  - k. Consider additional expenses that go along with unreported income.

If the examiner suspects a potentially fraudulent situation, either civil or criminal, they will discuss the case with their manager as soon as possible. If the group manager concurs, the fraud technical advisor (FTA) will immediately be contacted and both the group manager and FTA will provide guidance on how to proceed.

#### H. Cash Hoard

- With a cash intensive business, it is important to get complete information about nontaxable income as soon as possible in the examination. Question the taxpayer about any Cash T imbalances during the initial interview. If there is a cash hoard, or other nontaxable income, the examiner will want to consider this information early in the examination. It will be necessary in every indirect method case.
- Cash-on-hand should be established for the beginning of each year under audit. Also, the taxpayer’s practice of keeping cash on hand should be determined for present and prior periods to establish any accumulation of cash over the years. Cash- on- hand is defined as including all cash not in a financial institution, such as: at home, in pocket, in a safe deposit box or a safe.
- A taxpayer’s explanation about a cash hoard may change during an examination. The examiner should document the information as it is received. The documentation should include when and where the information was received, who was present, what was said, and when the documentation was prepared.

- The credibility of a cash hoard explanation should be examined. The examiner should ask to see the cash hoard and where it is kept to determine if the space is adequate. The examiner should examine the taxpayer's bill paying and borrowing habits; an individual with a cash hoard will not incur insufficient funds charges for checks written or require loans.

# Litigation of International Penalties

LIU Civil and Criminal Tax Controversy Forum  
Presented at Long Island University CW Post (Brookville, N.Y.)  
August 16, 2018

Presented by Frank Agostino, Jim Caligure, and Monica Koch

- I. Form 3520,<sup>i</sup> *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*
  - A. Preparation of Return:
    1. Who Must File: grantors of an inter vivos trust, transferors involved in reportable events (as defined), beneficiaries of a foreign trust (who have received distributions during a taxable year), and U.S. persons who have received a foreign gift amount to \$100,000 or more.
      - i. Form 3520 is unique because traditional U.S. Gift Tax Returns (Form 709) require the donor to file a return. Form 3520, however, requires the recipient of the gift to file a return, despite the reality of whether they are in possession of the required information (which the donor is presumed to be in possession).
    2. Reportable Event: for purposes of I.R.C. § 6048, a reportable event includes:
      - i. Formation of a foreign trust;
      - ii. transfer of cash or other assets into a foreign trust;
      - iii. receipt of any distributions by U.S. beneficiaries;
      - iv. the death of a U.S. citizen or resident if:
        - a. decedent was treated as an owner of any portion of a foreign trust; or
        - b. any portion of a foreign trust was included in the gross estate of decedent.
    3. Substantial Owner (Grantor Trust Rules): a filing requirement arises where the grantor of the foreign trust is considered a substantial owner of the trust. If a grantor retains any of the following rights or interests then he may be deemed a substantial owner of the foreign trust and must file a Form 3520:
      - i. Reversionary Interest (I.R.C. § 673): grantor retains a reversionary interest (of 5% or more) in the corpus or income of trust;
      - ii. Power to Control Beneficial Enjoyment (I.R.C. § 674): grantor retains power to dispose of beneficial enjoyment of the income or corpus without the consent or approval of an adverse party;

- iii. Administrative Powers (I.R.C. § 675): grantor retains sufficient administrative control where he can manipulate the benefits so they are used for grantor and not beneficiaries;
  - iv. Power to Revoke (I.R.C. § 676): grantor can revoke property from the trust and revest himself of the property;
  - v. Income For Benefit of Grantor (I.R.C. § 677): grantor receives distributions;
  - vi. Person Other Than Grantor Treated as Substantial Owner (I.R.C. § 678): non-grantors can also be deemed substantial owners if he retains sole power to distribute the corpus or income to himself or if he retains control that would consider a grantor as a substantial owner; and
  - vii. Foreign Trusts Having One or More United States Beneficiaries (I.R.C. § 679): grantors of foreign trusts with U.S. beneficiaries will automatically be deemed a substantial owner.
4. Foreign Gifts: U.S. persons receiving foreign gifts may also have a reporting requirement:
- i. Foreign Person: if a foreign person gives a gift to a U.S. person then it will generally be a non-taxable event but if it is over \$100,000 (which is considered in the aggregate) then it will require filing a Form 3520.
  - ii. Foreign Corporation or Partnership: if a U.S. person receives a gift from a foreign corporation or partnership that is above \$16,076 (the 2018 amount adjusted for inflation, per Rev. Proc. 2018-18) then they not only must report this gift but are also required to pay tax on this gift (See Treas. Reg. § 1.672(f)-4).
  - iii. Non-cash foreign gifts must be valued consistent with I.R.C. § 2512.
5. When to File: The form is due when the income tax return of the U.S. entity (individual, partnership, corporation, etc.) is due, including any extensions of time to file. The form is not filed with the tax return.
6. Exceptions to Filing: Most exceptions to filing involve foreign trusts that deal with employee compensation and/or payment plans (under I.R.C. §§ 402, 402(a), and 404A).
7. Corrective Measures: if the taxpayer has not properly filed his Form 3520, he may do so without penalty. Under the Delinquent International Information Return Submission Procedures (“DIIRSP”) the taxpayer can avoid a penalty for their failure to file if these requirements are satisfied:
- i. the taxpayer did not file one or more required information returns;
  - ii. the taxpayer has a reasonable cause for not timely filing the information return;

- iii. the taxpayer is not under a civil examination or criminal investigation by the IRS; and
- iv. the IRS has not already contacted the taxpayer regarding the delinquent return.

- B. Examination: the IRS may send Information Document Requests (“IDR”) or a Formal Document Request (“FDR”). Taxpayers that are unable or unwilling to provide information in response to a FDR will be precluded from introducing such information in a future judicial proceeding, under I.R.C. § 982. Documents can be precluded even if they are not in the taxpayer’s possession, taxpayer cannot obtain such documents, and the foreign country that houses the foreign donor or trust makes the dissemination of such information illegal.
- 1. Statute of Limitations: the statute of limitations to audit a Form 3520 is three years from filing. The statute does not begin until the Form 3520 is filed. This includes incomplete filings. Form 3520, unlike Forms 5471 and 5472, does not recognize substantial compliance.
    - i. Substantial Compliance may begin the running of the statute of limitations if there is a proper *Beard* filing. Beard v. Comm’r, 82 T.C. 766 (1984) (which the IRS does not agree with) held that a return was be valid for statute of limitations purposes if the following is provided:
      - a. possess sufficient information for the IRS to calculate the tax liability;
      - b. be filed as a purported return;
      - c. be an honest and reasonable attempt to comply with the tax laws; and
      - d. be signed under the penalties of perjury.
- C. Penalties: failure to file or provide complete and correct information can subject the taxpayer to these penalties:
- 1. I.R.C. § 6677: failure to file will lead to a penalty of \$10,000 or 35% (whichever is greater) of the gross value of the property involved in the event.
    - i. A continuation penalty also applies if the failure to file is not corrected within 90 days of being notified by the IRS. This penalty shall be \$10,000 for each 30-day period in which the failure remains uncorrected.
  - 2. I.R.C. § 6039F: failure to furnish gift information can lead to a penalty of 5% per month up to 25% of the total gift.
  - 3. I.R.C. § 6662(j): this applies to foreign financial assets in which information must be provided under I.R.C. § 6048 that is not provided.

I.R.C. § 6662(j) doubles the traditional accuracy-related penalty from 20% to 40%. I.R.C. § 6039F is not specifically referenced in I.R.C. § 6662(j).

4. **Defenses:** reasonable cause is the primary defense to a failure to file. Reasonable cause will not be considered until the taxpayer has filed the Form 3520. Reasonable cause is a facts and circumstances test and focuses upon the taxpayer's reason for failing to file, efforts made to comply with the filing requirement, and his or her ignorance of the law. Disclosure of the information being a crime in another country is not considered reasonable cause.
5. **Recharacterization:** aside from penalties being assessed, another issue that can arise is the recharacterization of foreign gifts as income. If foreign gifts are not reported or substantiated then the IRS during examination can deem the alleged foreign gift is actually unreported foreign income. By doing so they put the burden on the taxpayer to prove that the amount received constitutes a non-taxable gift as opposed to income. If the taxpayer cannot prove that property received was a gift rather than income then not only will he be liable for additional income tax liability but he will also be subject to an accuracy-related penalty under I.R.C. § 6662(a); this is besides the penalty for failing to file Form 3520. I.R.C. § 6039F(c)(1)(A) allows the IRS to determine the tax consequence of receiving such gift (or bequest) if the information is not filed timely. Unlike the late filing penalty, IRM 20.1.9.10.3 (04-22-2011) provides that the I.R.C. § 6039F(c)(1)(A) penalty is subject to deficiency procedures.

D. Appeals: Appeals hearings are the primary mediums for challenging determinations made regarding Form 3520.

1. IRM 8.11.5.6 (12-18-2015) - IRC § 6039F Notice of Large Gifts from Foreign Persons (Form 3520) – provides this penalty is an “International penalty and has post-assessed, pre-payment, penalty appeal rights.”
2. IRM 20.1.9.10.3 (04-22-2011) explains that I.R.C. § 6039F penalties are asserted on a Form 8278, Assessment and Abatement of Miscellaneous Civil Penalties.
3. Once the penalty is assessed, a CP notice will be generated and sent to the taxpayer. The IRS will send either CP 15 or CP 215 to the taxpayer. The CP 15 notice notifies the taxpayer that a penalty has been assessed and explains that, if the taxpayer wishes to appeal the assessment, he or she should submit a written request within 30 days from the date of the notice. The CP 215 notice notifies the taxpayer that, if the taxpayer wishes to appeal the penalty, he or she should send the IRS a written request to appeal within 30 days from the date of the notice.

4. If the taxpayer does not take action on the CP 15 or CP 215 notice, the IRS will send the taxpayer Letter 1058, *Notice of Intent to Levy and Notice of Your Right to a Hearing*, or LT11 *Final Notice of Intent to Levy and Notice of Your Right to a Hearing*, or Letter 3172, *Notice of Federal Tax Lien and Your Rights to a Hearing under IRC 6320*.
5. If none of the prior notices offered the taxpayer an administrative appeal then, upon the taxpayer's timely request, the Appeals Office will conduct a *de novo* review of the taxpayer's liability, including his or her reasonable cause defense. A taxpayer cannot challenge the underlying liability if he or she has had a prior opportunity for a conference with Appeals.
6. I.R.C. § 6751(b) Challenge: upon asking Appeals to verify the steps taken by Collection, one challenge that can be raised (but which should only be raised post-assessment) is the 6751(b) challenge. I.R.C. § 6751(b) provides: "No penalty under [the I.R.C.] shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate."
7. Qualified Offer: tax professionals may want to submit a qualified offer contemporaneous with their request for an Appeals conference. A qualified offer is an offer made under IRC § 7430(g). Qualified offers allow taxpayers to recoup legal and administrative fees for reasonable settlement offers refused by the Service; the Service must receive judgment in excess of the settlement offer to not be liable for costs and fees. Qualified offers can be submitted during CDP hearings if the CDP request is timely and the taxpayer is not precluded from contesting the liability under I.R.C. §§ 6330(c)(2), 6330(c)(4), or 6320(c). The Service must accept the offer within 90 days or it is deemed rejected. A qualified offer will also ensure that the IRS national office reviews the issues, which can give tax practitioners some guidance on how the Service sees certain issues.

E. Litigation:

1. Pre-payment Forum: To initiate a Tax Court case, the taxpayer (now known as petitioner) will file a petition, designation for place of trial, and a statement with the taxpayer's identification number, which will accompany a filing fee of \$60 (made payable to Clerk, United States Tax Court).
  - i. Petitions must include, among other items, facts and legal theories on why the petitioner should prevail. Any issue not contested in the petition is deemed conceded by petitioner. Also, the notice being appealed must be attached and any taxpayer identification numbers (such as social security number) must be redacted.

2. Refund Forum: Refund claims can be brought in the United States Court of Federal Claims and the United States District Court. Before commencing refund-based litigation, the taxpayer must first pay the tax and file a claim for refund from the IRS. Claims for refund must include the grounds on which a refund is claimed and facts to support those grounds, all of which must be sworn to under penalties of perjury. Refund claims are filed using Form 843, *Claim for Refund and Request for Abatement*. In most Form 3520 cases, the claim must be filed within 2 years from when the tax was paid.

II. Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner*

A. Preparation of Return:

1. Who Must File: foreign trusts with U.S. owners must file a Form 3520-A (I.R.C. § 6048). Owners of the foreign trust can be established according to the Grantor Trust rules (I.R.C. §§ 671–679). These U.S. owners must be U.S. persons for the trust to have a filing requirement under I.R.C. § 7701(a)(30)). Questions that must be answered:
  - i. Is the foreign entity a trust for U.S. tax purposes?
  - ii. If it is a trust, is it a foreign trust?
  - iii. If it is a foreign trust, is it owned by a U.S. person?
2. When to File: the Form 3520-A must be filed by the 15th day of the third month after the end of the trust's tax year. Extensions do not run with a specific tax return and a Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns*, must be filed.
3. Grantor Trust Rules: a filing requirement arises where the grantor of the foreign trust is considered a substantial owner of the trust. If a grantor retains any of the following rights or interests then he may be deemed a substantial owner of the foreign trust and must file a Form 3520:
  - i. Reversionary Interest (I.R.C. § 673): grantor retains a reversionary interest (of 5% or more) in the corpus or income of trust;
  - ii. Power to Control Beneficial Enjoyment (I.R.C. § 674): grantor retains power to dispose of beneficial enjoyment of the income or corpus without the consent or approval of an adverse party;
  - iii. Administrative Powers (I.R.C. § 675): grantor retains sufficient administrative control where he can manipulate the benefits so they are used for grantor and not beneficiaries;
  - iv. Power to Revoke (I.R.C. § 676): grantor can revoke property from the trust and re-vest himself the property;
  - v. Income For Benefit of Grantor (I.R.C. § 677): grantor receives distributions from the trust;
  - vi. Person Other Than Grantor Treated as Substantial Owner (I.R.C. § 678): non-grantors can also be deemed substantial owners if he retains sole power to distribute the corpus or income to himself or if he retains control that would consider a grantor as a substantial owner; and
  - vii. Foreign Trusts Having One or More United States Beneficiaries (I.R.C. § 679): grantors of foreign trusts with U.S. beneficiaries will automatically be deemed a substantial owner.
  - viii. Attribution rules also apply that imputes ownership by a spouse to the settler/grantor.

4. Failure to File: what makes Form 3520-A unique is that it penalizes the U.S. owners of the foreign trust for the trust's failure to file (I.R.C. § 6677(b)).
  - i. U.S. owners can insulate themselves from liability if they appoint a U.S. agent to discharge their obligations regarding the Form 3520-A. The agreement appointing the agent must be in a form substantially similar to the one approved by the IRS in Notice 97-34. Once a U.S. agent is properly appointed and authorized to act, the IRS can deal with that person to ensure that the trust complies with all of its reporting obligations.
5. Recharacterization: another issue that arises is the IRS's ability to deem any distribution from a foreign trust to be treated as an accumulated distribution, which is includable in gross income, if the taxpayer does not provide adequate records (which, once again, may not be in the possession of or accessible to the taxpayer).

B. Examination:

1. Foreign Document Requests ("FDR"): a foreign document request is similar to an information document request ("IDR") because it requests documents from the recipient. The major difference between the two is that failing to provide documents in response to an FDR can preclude you from offering these documents in future litigation. I.R.C. § 982(a) prohibits any court with jurisdiction over a civil matter from allowing the taxpayer to introduce any foreign document previously requested and not provided. This is often an issue because the taxpayer may not have the required documents and may not be able to obtain such documents.
2. Penalty Letters, Notice Letters, and Notices (IRM 20.1.9.14.2 (04-22-2011)): the delinquent filer (or owner of the foreign company that is delinquent) can expect the following letters/notices from the IRS regarding their failure to file Form 3520-A:
  - i. **Letter 3804**—This is an opening **notice letter** required to be mailed to a taxpayer under I.R.C. § 6677(a).
  - ii. **Letter 3943**—This is the closing **acceptance letter** to be utilized after a taxpayer responds and the examiner determines that no penalties will be asserted.
  - iii. **Letter 3944**—This is the closing **no response letter** to be utilized when a taxpayer either fails to respond to **Letter 3804** or when a taxpayer does not provide a statement of reasonable cause for failing to file such returns.
  - iv. **Letter 3946**—This is the closing **reasonable cause rejected letter** to be utilized after a taxpayer responds and the examiner determines that penalties will be asserted.

- v. **CP Notices**—Once a penalty is identified by the campus or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer:
  - a. **IMF**—A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **PRN 660** is generated and sent to the taxpayer.
  - b. **BMF**—A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 660** is generated and sent to the taxpayer.
  
- 3. **Penalty Assertion:** penalties are initially determined on a Form 8278.
  
- 4. **Statute of Limitations:** the statute of limitations to audit a Form 3520-A is three years from the date of filing. The statute does not begin until the Form 3520-A is filed. This includes incomplete filings. Form 3520-A, unlike Forms 5471 and 5472, does not recognize substantial compliance.
  - i. **Substantial Compliance** may begin the running of the statute of limitations if there is a proper *Beard* filing. Beard v. Comm’r, 82 T.C. 766 (1984) (which the IRS rejects) held that a return was be valid for statute of limitations purposes if the following is provided:
    - a. possess sufficient information for the IRS to calculate the tax liability;
    - b. be filed as a purported return;
    - c. be an honest and reasonable attempt to comply with the tax laws; and
    - d. be signed under the penalties of perjury.
  
- C. **Penalties:** the U.S. owner is subject to a penalty equal to 5% of the gross value of the portion of the trust’s assets treated as owned by the U.S. person at the close of that year (or \$10,000 if higher).
  - 1. Continuation penalty will also apply if the failure to file is not corrected within 90 days of the IRS sending the U.S. owner notice. Continuation penalty will be \$10,000 per 30-day-period after the IRS notifies the taxpayer and taxpayer has not corrected failing to file within the 90-day period.
  - 2. Criminal penalties can also apply (See I.R.C. §§ 7203, 7206, and 7207).
  - 3. I.R.C § 6662(j) penalties can also apply if there was an understatement of tax arising from an undisclosed foreign financial asset. Such penalty shall be 40% instead of 20%.
  - 4. **Defenses:** If failing to file Form 3520-A was due to reasonable cause and not willful neglect, no penalty may be imposed. That a foreign jurisdiction

would impose a civil or criminal penalty either on the taxpayer or any other person for disclosing the required information is specifically defined by the statute as not constituting reasonable cause. Refusal of a foreign trustee to provide information for any other reason, including (1) the difficulty in producing the required information or (2) provisions in the trust instrument that prevent disclosure of required information, are not considered reasonable causes by the IRS.

D. Appeals:

1. Like Form 3520, Form 3520-A penalties have post-assessment pre-payment penalty appeal rights (IRM 8.11.5.9(3) (12-18-2015)).
2. Once the penalty is assessed, a CP notice will be generated and sent to the taxpayer. The IRS will send either CP 15 or CP 215 to the taxpayer. The CP 15 notice notifies the taxpayer that a penalty has been assessed and explains that, if the taxpayer wishes to appeal the assessment, he or she should submit a written request within 30 days from the date of the notice. The CP 215 notice notifies the taxpayer that, if the taxpayer wishes to appeal the penalty, he or she should send the IRS a written request to appeal within 30 days from the date of the notice.
3. If the taxpayer does not take action on the CP15 or CP 215 notice, the IRS will send the taxpayer Letter 1058, *Notice of Intent to Levy and Notice of Your Right to a Hearing*, or LT11, *Final Notice of Intent to Levy and Notice of Your Right to a Hearing*, or Letter 3172, *Notice of Federal Tax Lien and Your Rights to a Hearing under IRC 6320*.
4. Qualified Offer: tax professionals may want to consider submitting a qualified offer contemporaneous with their request for an Appeals conference. A qualified offer is an offer made under IRC § 7430(g). Qualified offers allow taxpayers to recoup legal and administrative fees for reasonable settlement offers -refused by the Service; the Service must receive judgment in excess of the settlement offer to not be liable for costs and fees. Qualified offers can be submitted during CDP hearings if the CDP request is timely and the taxpayer is not precluded from contesting the liability under IRC §§ 6330(c)(2), 6330(c)(4), or 6320(c). The Service must accept the offer within 90 days or it is deemed rejected. A qualified offer will also ensure that the IRS national office reviews the issues, which can give tax practitioners some guidance on how the Service sees certain issues.

E. Litigation:

1. Pre-payment Forum: To initiate a Tax Court case, the taxpayer (now known as petitioner) will file a petition, designation for place of trial, and

a statement with the taxpayer's identification number, which will accompany a filing fee of \$60 (made payable to Clerk, United States Tax Court).

i. Petitions must include, among other items, facts and legal theories on why the petitioner should prevail. Any issue not contested in the petition is deemed conceded by petitioner. Also, the notice being appealed must be attached and any taxpayer identification numbers (such as social security number) must be redacted.

2. Refund Forum: Refund claims can be brought in the United States Court of Federal Claims and the United States District Court. Before commencing refund-based litigation, the taxpayer must first pay the tax and file a claim for refund from the IRS. Claims for refund must include the grounds on which a refund is claimed and facts to support those grounds, all of which must be sworn to under penalties of perjury. Refund claims are filed using Form 843, *Claim for Refund and Request for Abatement*.

III. Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*

A. Preparation of Return:

1. Who Must File (I.R.C. § 6046): there are five categories of filers but only four are still required to file (Categories 2–5).
  - i. Category 1 Filer: inapplicable because repealed by American Jobs Creation Act of 2004.
  - ii. Category 2 Filer:
    - a. U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired stock that represents 10% or more of the total value or voting power of the foreign corporation; or
    - b. U.S. Citizen or resident who is an officer or director of a foreign corporation in which a U.S. person has acquired an additional 10% or more of the outstanding stock of the foreign corporation.
      - (1) A U.S. person has acquired stock in a foreign corporation when that person has an unqualified right to receive the stock, even though the stock is not actually issued. See Treas. Reg. § 1.6046-1(f)(1).
      - (2) The Category 2 Filer need not own any shares herself for a filing obligation to arise.
  - iii. Category 3 Filer:
    - a. U.S. person who acquires stock in a foreign corporation during the tax year and after the acquisition owns 10% or more of the total value or voting power of the foreign corporation;
    - b. A U.S. person who acquires stock which, without regard to stock already owned on the date of the acquisition, meets the 10% stock ownership requirement regarding the foreign corporation;
    - c. A person treated as a U.S. shareholder under I.R.C. § 953(c) with regard to the foreign corporation;
    - d. A person who becomes a U.S. person while meeting the 10% stock ownership requirement with respect to the foreign corporation; or
    - e. A U.S. person who disposes of sufficient stock in the foreign corporation to reduce his interest to less than the stock ownership requirement (10%).
    - f. For Category 2 or 3, a U.S. person includes
      - (1) A citizen or resident of the United States;
      - (2) A domestic partnership;
      - (3) A domestic corporation; and

- (4) Most estates and trust (specifically those which aren't considered foreign estates or trusts under I.R.C. § 7701(a)(31)).
- g. Exceptions to U.S. person definition (Treas. Reg. § 1.6046-1(f)(3)):
  - (1) Regarding an individual who is a bona fide resident of Puerto Rico, the term United States person has the meaning assigned to it by Treas. Reg. § 1.957-3 except that the rules of Treas. Reg. § 1.937-2(g)(1) will apply; and
  - (2) Regarding an individual who is a bona fide resident of any IRC § 931 possession, as defined in Treas. Reg. § 1.931-1(c)(1), the term United States person has the meaning assigned to it by Treas. Reg. § 1.957-3.
  - (3) An individual for whom an election under IRC §6013(g) or (h) is in effect will, subject to the exceptions in paragraph (f)(3)(ii), be considered a United States person for purposes of IRC § 6046 and Treas. Reg. § 1.6046-1(f)(3).
- iv. Category 4 Filer: U.S. persons who control a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the foreign corporation.
  - a. U.S. Person:
    - (1) A citizen or resident of the United States;
    - (2) A non-resident alien for whom an election is in effect under IRC § 6013(g) to be treated as a resident of the United States;
    - (3) An individual for whom an election is in effect under IRC § 6013(h), relating to non-resident aliens who become residents of the United States during the tax year and are married at the close of the tax year to a citizen or resident of the United States;
    - (4) A domestic partnership;
    - (5) A domestic corporation; and
    - (6) An estate or trust that is not a foreign estate or trust defined in IRC § 7701(a)(31).
  - b. Exceptions to U.S. Person (Treas. Reg. § 1.6038-2(d)):
    - (1) Regarding an individual who is a bona fide resident of Puerto Rico, the term United States person has the meaning assigned to it by Treas. Reg. § 1.957-3 except that the rules of Treas. Reg. § 1.937-2(g)(1) will apply.
    - (2) Regarding an individual who is a bona fide resident of any IRC § 931 possession, as defined in Treas. Reg. § 1.931-1(c)(1), the term United States person

has the meaning assigned to it by Treas. Reg. § 1.957-3 (essentially, American Samoa).

- (3) An individual for whom an election under IRC §6013(g) or (h) is in effect will, subject to the exceptions in paragraph (d)(2) of Treas. Reg. § 1.6038-2, be considered a United States person for purposes of I.R.C. § 6038.

c. Control: A person shall be deemed in control of a foreign corporation if at any time during that person's taxable year she owns stock possessing over 50% of the total combined voting power of all classes of stock entitled to vote, or over 50% of the total value of shares of the foreign corporation.

- (1) If a person owns over 50% of a foreign corporation that owns over 50% of the combined voting power or value of another corporation, then that person shall also be deemed as being in control of such other corporation.
- (2) Attribution rules under I.R.C. § 318(a) shall apply for determining control.

v. Category 5 Filer: U.S. shareholders who own 10% or more of the stock of a controlled foreign corporation ("CFC") for an uninterrupted period of at least 30 days in any tax year of the foreign corporation.

a. U.S. Shareholder (I.R.C. § 951(b)): any U.S. person who owns or is considered as owning 10% or more of the total combined voting power of all classes of stock or of the total value of shares of all classes of stock in a foreign corporation.

b. U.S. Person (I.R.C. § 957(c)): U.S. person means the same as it does under I.R.C. § 7701(a)(30) except that:

- (1) Regarding a corporation organized under the laws of the Commonwealth of Puerto Rico, the term United States person does not include an individual who is a bona fide resident of Puerto Rico, if a dividend received by such individual during the taxable year from such corporation would, for purposes of I.R.C. § 933(a), be treated as income derived from sources within Puerto Rico, and
- (2) Regarding a corporation organized under the laws of Guam, American Samoa, or the Northern Mariana Islands:
  - (i) 80% or more of the gross income of which for the 3 year period ending at the close of the taxable year (or for such part of such period as such corporation or any

predecessor has existed was derived from sources within such a possession or was effectively connected with the conduct of a trade or business in such a possession, and

- (ii) 50% or more of the gross income of which for such period (or part) was derived from the active conduct of a trade or business within such a possession.

c. **Controlled Foreign Corporation (I.R.C. § 957(a)):** a CFC is any foreign corporation if over 50% of the total combined voting power of all classes of stock of such corporation entitled to vote or the total value of stock of such corporation is owned or considered owned (under I.R.C. § 958(a) & (b)) by U.S. shareholders on any day during the taxable year of such foreign corporation.

vi. **Dormant or Inactive Corporations: Revenue Procedure 92-70** allows dormant inactive corporations to file an abridged version of the Form 5471. Corporations that qualify as dormant inactive foreign corporations in a tax year can utilize a summary filing procedure for that tax year. This summary filing procedure allows the taxpayer to file only page one of the Form 5471, with the necessary identification information. Filing a summary return must include a label in the top margin stating: "Filed Pursuant to Rev. Proc. 92-70 for Dormant Foreign Corporations." A CFC will be a dormant foreign corporation if, during the annual accounting period:

- a. The foreign corporation conducted no business and owned no stock in any other corporation other than another dormant foreign corporation;
- b. No shares of the foreign corporation (other than directors' qualifying shares) were sold, exchanged, redeemed, or otherwise transferred, nor was the foreign corporation a party to a reorganization;
- c. No assets of the foreign corporation were sold, exchanged, or otherwise transferred, except for de minimis transfers described in (4) and (5) below;
- d. The foreign corporation received or accrued no more than \$5,000 of gross income or gross receipts;
- e. The foreign corporation paid or accrued no more than \$5,000 of expenses;
- f. The value of the foreign corporation's assets as determined under U.S. generally accepted accounting principles (but not reduced by any mortgages or other liabilities) did not exceed \$100,000;
- g. No distributions were made by the foreign corporation; and



- ii. Consolidated Groups: Category 4 Filers do not need to file for a corporation defined in I.R.C. § 1504(d) that files a consolidated return for the tax year.
- iii. Constructive Ownership:
  - a. A person from either Category 3, 4, or 5 need not file if:
    - (1) The U.S. person does not own a direct interest in the foreign corporation;
    - (2) The U.S. person must furnish the information requested solely because of constructive ownership (as determined under Regulations section 1.958-2, 1.6038-2(c), or 1.6046-1(i)) from another U.S. person; and
    - (3) The U.S. person through whom the indirect shareholder constructively owns an interest in the foreign corporation files Form 5471 to report the required information.
  - b. A Category 2 Filer need not file if:
    - (1) Immediately after a reportable stock acquisition, three or fewer U.S. persons own 95% or more in value of the outstanding stock of the foreign corporation and the U.S. person making the acquisition files a return for the acquisition as a Category 3 filer; or
    - (2) The U.S. person(s) for whom the Category 2 filer must file Form 5471 does not directly own an interest in the foreign corporation but must furnish the information solely because of constructive stock ownership from a U.S. person and the person from whom the stock ownership is attributed furnishes the required information.
  - c. A Category 4 or 5 Filer need not file if the shareholder:
    - (1) Does not own a direct or indirect interest in the foreign corporation; and
    - (2) Must file Form 5471 solely because of constructive ownership from a nonresident alien.
- iv. Domestic Corporations: foreign insurance companies that elect to be treated as a domestic corporation (under I.R.C. § 953(d)) and have filed an income tax return need not file Form 5471.

B. Examination:

- 1. Foreign Document Requests (“FDR”): a foreign document request is similar to an information document request (“IDR”) because it requests documents from the recipient. The major difference between the two is that failing to provide documents in response to an FDR can preclude you from offering these documents in future litigation. I.R.C. § 982(a)

prohibits any court with jurisdiction over a civil matter from allowing the taxpayer to introduce any foreign document previously requested and not provided. This is often an issue because the taxpayer may not have the required documents and may not have the ability to obtain such documents.

2. Penalty Letters, Notice Letters, and Notices (IRM 20.1.9.3.2 (11-30-2015)): the delinquent filer (or owner of the foreign company that is delinquent) can expect the following letters/notices from the IRS regarding their failure to file Form 5471:
  - i. **CP Notices**—Once a penalty is identified by the campus or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the taxpayer:
    - a. **IMF**—A CP 15, *Notice of Penalty Charge*, for penalties assessed on **MFT 55** with **PRN 623** is generated and sent to the taxpayer.
    - b. **BMF**—A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 623** is generated and sent to the taxpayer.
3. Penalty Assertion: penalties are initially determined on Form 8278.
4. Statute of Limitations: the statute of limitations to audit a Form 5471 is three years from the date of filing. The statute does not begin until the Form 5471 is filed.
  - i. Substantial Compliance may begin the running of the statute of limitations if there is a proper *Beard* filing. *Beard v. Comm’r*, 82 T.C. 766 (1984) (which the IRS rejects) held that a return was be valid for statute of limitations purposes if the following is provided:
    - a. possess sufficient information for the IRS to calculate the tax liability;
    - b. be filed as a purported return;
    - c. be an honest and reasonable attempt to comply with the tax laws; and
    - d. be signed under the penalties of perjury.

C. Penalties:

1. Failure to File: failure to file any information required under I.R.C. § 6038(a) will lead to a \$10,000 penalty for each annual accounting period regarding which such failure exists.
2. Continuation Penalty: if any failure to furnish information continues for more than 90 days after the IRS has sent notice to the taxpayer there will be a continuation penalty of \$10,000 per 30-day period during which such failure continues, not to exceed \$50,000.

3. Foreign Tax Credit Reduction: taxpayers that do not provide the information will also be subject to a reduction of available foreign tax credit, which will be diminished by 10%.
  - i. This diminution also has a continuation component; if notice is sent to the taxpayer and the failure continues 90 days or more after such notice, then an additional 5% will be reduced for every 3-month period in which a taxpayer's failure continues. The limitation for this penalty shall be the greater of \$10,000 or the income of the foreign business entity for its annual accounting period to which the failure occurs.
4. Undisclosed Foreign Financial Assets (I.R.C. § 6662(j)): for any underpayment attributable to any undisclosed foreign financial asset understatement, the taxpayer shall be subject to a heightened accuracy-related penalty of 40%.
  - i. Undisclosed foreign financial asset is defined as any asset regarding which information had to be provided under I.R.C. §§ 6038, 6038B, 6038D, 6046A, or 6048 but was not so provided.
  - ii. I.R.C. § 6662(j) penalties, unlike I.R.C. § 6038 penalties, give rise to a notice of deficiency and the traditional pre-assessment Appeals forum. International penalties do not give rise to a notice of deficiency and traditionally only involve post-assessment pre-payment Appeals conferences.
5. Defenses: Reasonable cause is a defense for failure to file. This is a facts and circumstances analysis that will focus upon the taxpayer's ordinary business care and prudence when attempting to file the return (See IRM 20.1.1.3.2(1)(11-21-2017); *Flume v. Comm'r*, T.C. Memo 2017-21).

D. Appeals:

1. Form 5471 penalties have post-assessment pre-payment penalty appeal rights.
2. Form 5471 penalties are also eligible for Accelerated Appeals Consideration (IRM 8.11.5.14.1(12-18-2015)).
3. Once the penalty is assessed, a CP notice will be generated and sent to the taxpayer. The IRS will send either CP 15 or CP 215 to the taxpayer. The CP 15 notice notifies the taxpayer that a penalty has been assessed and explains that, if the taxpayer wishes to appeal the assessment, he or she should submit a written request within 30 days from the date of the notice. The CP 215 notice notifies the taxpayer that, if the taxpayer wishes to appeal the penalty, he or she should send the IRS a written request to appeal within 30 days from the date of the notice.

4. If the taxpayer does not take action on the CP 15 or CP 215 notice, the IRS will send the taxpayer Letter 1058, *Notice of Intent to Levy and Notice of Your Right to a Hearing*, or LT11, *Final Notice of Intent to Levy and Notice of Your Right to a Hearing*, or Letter 3172, *Notice of Federal Tax Lien and Your Rights to a Hearing under IRC 6320*.
5. **Qualified Offer:** tax professionals may want to submit a qualified offer contemporaneous with their request for an Appeals conference. A qualified offer is an offer made under IRC § 7430(g). Qualified offers allow taxpayers to recoup legal and administrative fees for reasonable settlement offers refused by the Service; the Service must receive judgment in excess of the settlement offer to not be liable for costs and fees. Qualified offers can be submitted during CDP hearings if the CDP request is timely and the taxpayer is not precluded from contesting the liability under IRC §§ 6330(c)(2), 6330(c)(4), or 6320(c). The Service must accept the offer within 90 days or it is deemed rejected. A qualified offer will also ensure that the IRS national office reviews the issues, which can give tax practitioners some guidance on how the Service sees certain issues.

E. Litigation:

1. **Pre-payment Forum:** To initiate a Tax Court case, the taxpayer (now known as petitioner) will file a petition, designation for place of trial, and a statement with the taxpayer's identification number, which will accompany a filing fee of \$60 (made payable to Clerk, United States Tax Court).
  - i. Petitions must include, among other items, facts and legal theories on why the petitioner should prevail. Any issue not contested in the petition is deemed conceded by petitioner. Also, the notice being appealed must be attached and any taxpayer identification numbers (such as social security number) must be redacted.
2. **Refund Forum:** Refund claims can be brought in the United States Court of Federal Claims and the United States District Court. Before commencing refund-based litigation, the taxpayer must first pay the tax and file a claim for refund from the IRS. Claims for refund must include the grounds on which a refund is claimed and facts to support those grounds, all of which must be sworn to under penalties of perjury. Refund claims are filed using Form 843, *Claim for Refund and Request for Abatement*.

IV. Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

A. Preparation of Return:

1. I.R.C. §§ 6038A & 6038C: I.R.C. § 6038A requires domestic corporations with 25% foreign ownership to file information returns and to maintain adequate books and records (the books and records must be sufficient to determine the correct treatment of transactions with related parties). I.R.C. § 6038C requires foreign corporations engaged in trade or business in the U.S. to file information returns and maintain adequate books and records.
2. Who Must File: reporting corporations must file if they engaged in a reportable transaction with a foreign or domestic related party. Also, each foreign and domestic related party engaged in a reportable transaction with the reporting corporation must also file.
  - i. Disregard Entities: as of 2018, domestic disregarded entities which are wholly-owned by a foreign person must also file Form 5472. The Form 5472s should be submitted with a pro forma Form 1120. Disregarded entities cannot file Form 5472 electronically.
  - ii. Each foreign shareholder is responsible for filing unless they file a consolidated return (discussed below).
3. When and How to File: Form 5472 should be filed on the due date of the corporation's return and should be attached to the return.
4. Reportable Transactions: reportable transactions are related-party transactions (Treas. Reg. § 1.6038A); transactions will not be a reportable transaction if neither party to the transaction is a U.S. person and the transaction does not generate gross income from or is effectively connected to the U.S.
5. Related Parties: reportable transactions focus upon related parties; parties are related if:
  - i. they are a 25% foreign shareholder of the reporting corporation;
  - ii. they are related to the reporting corporation or a shareholder under I.R.C. §§ 267(b) or 707(b)(1); or
    - a. I.R.C. § 267(b): defines the different relationships, ranging from family members to fiduciaries to S-Corporations owned by the same person.
    - b. I.R.C. § 707(b)(1): relationship between a partnership and another partnership, with similar owners, or between a member of the partnership and the partnership.

- iii. they are related to the reporting corporation under I.R.C. § 482 (which involves two or more organizations, trades, or businesses owned or controlled by the same interests).
6. Record Maintenance Requirement: unlike other foreign information returns, Form 5472 filers are also required to keep adequate books of account or records as required under I.R.C. § 6001, which must be sufficient to establish the correctness of the reporting corporation's federal income tax liability.
7. Exceptions to Filing: there are several filing exceptions, including:
- i. There were no reportable transactions of the types listed in Section IV and VI of the form;
  - ii. A U.S. person in control of the foreign related corporation filed Form 5471 for the same tax year. The U.S. person must fill out Schedule M of Form 5471 (this exception does not apply to disregarded entities);
  - iii. The related corporation qualifies as a foreign sales corporation and files a Form 1120FSC (also does not apply to foreign owned disregarded entities);
  - iv. Foreign corporation without a permanent establishment in the U.S. under an applicable income tax treaty and it files a Form 8833;
  - v. Foreign corporation whose gross income is exempt under I.R.C. § 883 and it satisfies the filing requirements found in I.R.C. §§ 883 and 887;
  - vi. Both the corporation and related party are not U.S. persons, under I.R.C. § 7701(a)(30), and:
    - a. Will not generate gross income from sources within the U.S. or income effectively connected with the conduct of trade or business within the U.S.; or,
    - b. Will not generate any expenses, losses, or other deductions that is allocable or apportionable to such income;
  - vii. If a reporting corporation is a member of an affiliated group and they file a consolidated income tax return. If so, the parent company must attach a schedule stating the members filing the consolidated return to the Form 5472.

B. Examination:

1. Foreign Document Requests ("FDR"): a foreign document request is similar to an information document request ("IDR") because it requests documents from the recipient. The major difference between the two is that failing to provide documents in response to an FDR can preclude you from offering these documents in future litigation. I.R.C. § 982(a) prohibits any court with jurisdiction over a civil matter from allowing the taxpayer to introduce any foreign document previously requested and not

provided. This is often an issue because the taxpayer may not have the required documents and may not be able to obtain such documents.

2. Penalty Letters, Notice Letters, and Notices (IRM 20.1.9.5.2 (11-30-2015)): the delinquent filer (or owner of the foreign company that is delinquent) can expect the following letters/notices from the IRS regarding their failure to file Form 5472:
  - i. **CP Notices**—Once a penalty is identified by the campus or a penalty case is closed by the field and the Form 8278 is processed, a CP notice is generated and sent to the foreign corporation as follows:
    - a. **BMF**—A CP 215, *Notice of Penalty Charge*, for penalties assessed on **MFT 13** with **PRN 625** is generated and sent to the taxpayer.
3. Penalty Assertion: penalties are initially determined on Form 8278.
4. Statute of Limitations: the statute of limitations to audit a Form 5472 is three years from the date of filing. The statute does not begin until the Form 5472 is filed.
  - i. Substantial Compliance may begin the running of the statute of limitations if there is a proper *Beard* filing. *Beard v. Comm’r*, 82 T.C. 766 (1984) (which the IRS rejects) held that a return was be valid for statute of limitations purposes if the following is provided:
    - a. possess sufficient information for the IRS to calculate the tax liability;
    - b. be filed as a purported return;
    - c. be an honest and reasonable attempt to comply with the tax laws; and
    - d. be signed under the penalties of perjury.
  - ii. Substantial Compliance Factors: the IRS has provided guidance on what constitutes “substantially complete” and “substantial compliance.” Whether the under or over-reporting of an item will make that return substantially incomplete depends upon an analysis of these factors:
    - a. the magnitude of the under/over-reporting compared to the actual total amount of the transaction;
    - b. whether there are other correctly reported reportable transactions, other than the erroneously reported transaction, with the same related party;
    - c. the magnitude of the erroneous reported transaction in relation to the other reportable transactions as correctly reported;

- d. the magnitude of the erroneous reported transaction in relation to the reporting corporation's volume of business and overall financial situation;
      - e. the significance of the erroneously reported transaction regarding the reporting corporation's business;
      - f. whether the erroneously reported transaction occurs in a significant ongoing transactional relationship with the related party; and
      - g. whether the erroneously reported transaction is reflected in the determination and computation of the reporting corporation's taxable income.
  5. Recharacterization: aside from the penalties, I.R.C. § 6038A(e)(3) disallows the taxpayer's deductions for a failure to provide adequate books and records. Taxpayers who do not properly or timely file their Form 5472 can be subjected to not only concurrent \$25,000 per-month-penalties but will also have their deductions disallowed.
  6. Attribution: Forms 5471 and 5472, unlike Forms 3520 and 3520-A, also apply the attribution rules found in I.R.C. § 318.
- C. Penalties: Failure to file Form 5472 will result in a penalty of \$25,000.00 per year (was \$10,000.00 prior to 2018). There is also a continuation penalty, in which an additional \$25,000.00 penalty will be assessed for each 30-day period if the taxpayer fails to rectify the failure to file within 90 days of being notified by the Service. Unlike other continuation penalties there is no limit to the continuation penalty for a failure to file Form 5472.
1. Failure to maintain adequate records: a failure to maintain adequate records can also subject the taxpayer to a \$25,000 penalty and a continuation penalty. These penalties can run concurrently and do not have a maximum.
  2. All penalties determined must be approved by a manager prior to being assessed (I.R.C. § 6751(b)). Every taxpayer should ask for the 6751(b) memo and should do a Freedom of Information Act (FOIA) request to determine if the memo exists.
  3. Defenses: like the other failure to file penalties for international information returns, reasonable cause will eliminate the penalty. Reasonable cause will only apply to the period for which there was proper reasonable cause (so if there is only cause for one month out of a three month delinquency then the taxpayer still must pay a penalty on the other two months). Taxpayer must submit the reasonable cause statement under the penalty of perjury and must make an affirmative showing of every fact alleged to establish reasonable cause.

- i. Small Corporation Exception: small corporations, being those with \$20,000,000 or less in gross receipts, must still file a Form 5472 but there shall be no penalty for a failure to maintain adequate books and records and reasonable cause should be applied liberally to small corporations (Treas. Reg. §§ 1.6038A-1(h) & 1.6038A-4(b)(2)(ii)). To satisfy the small corporation exception, the taxpayer must show:
  - a. It is a small corporation (gross receipts less than \$20 million);
  - b. It did not know of the duty to file Form 5472 or to maintain adequate books and records;
  - c. Has limited presence and contact with the U.S.; and
  - d. Promptly and fully complies with all IRS requests to file Form 5472 or to furnish books and records
- ii. A reasonable cause decision tree can be found as Exhibit 21.8.2-2 of the I.R.M.
- iii. Although a facts and circumstances analysis, the IRS has provided certain situations that may indicate reasonable cause (Treas. Reg. § 1.6038A-4(b)(2)(iii):
  - a. an honest misunderstanding of fact or law that is reasonable in light of the experience and knowledge of the taxpayer;
  - b. Isolated computational or transcriptional errors;
  - c. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable;
  - d. if the taxpayer has a reasonable belief that it is not owned by a 25-percent foreign shareholder; and
  - e. for not treating a foreign corporation as a related party where the foreign corporation is a related party solely by reason of § 1.6038A-1(d)(3) (under the principles of section 482), and the taxpayer had a reasonable belief that its relationship with the foreign corporation did not meet the standards for related parties under section 482.
- iv. Other Defenses: there are other exceptions and defenses which can be utilized, including:
  - a. Reasonable Estimate: if an amount reported on the Form 5472 is within 25% then it is considered a reasonable estimate (75% to 125% of actual amount).
  - b. Small Amounts: if the amount to be reported does not exceed \$50,000 then the reporting corporation should state so on the Form 5472 itself.
  - c. First Time Penalty Abatement I.R.M. 20.1.9.3.5(3)(07-08-2015): taxpayer may be eligible for a first time penalty abatement, which is administrative relief, if a related

abatement on a Form 1120 was filed with the Form 5472 if the taxpayer had no similar penalties for the three years prior.

D. Appeals:

1. Form 5472 penalties have post-assessment pre-payment penalty appeal rights.
2. Once a penalty is identified by the campus or a penalty case is closed by the field and the Form 8278 is processed, a **BMF** CP 215, *Notice of Penalty Charge*, is generated and sent to the taxpayer.
3. If the taxpayer does not take action on the CP 215 notice, the IRS will send the taxpayer Letter 1058, *Notice of Intent to Levy and Notice of Your Right to a Hearing*, or LT11, *Final Notice of Intent to Levy and Notice of Your Right to a Hearing*, or Letter 3172, *Notice of Federal Tax Lien and Your Rights to a Hearing under IRC 6320*.
4. Qualified Offer: tax professionals may want to submit a qualified offer contemporaneous with their request for an Appeals conference. A qualified offer is an offer made under IRC § 7430(g). Qualified offers allow taxpayers to recoup legal and administrative fees for reasonable settlement offers refused by the Service; the Service must receive judgment in excess of the settlement offer to not be liable for costs and fees. Qualified offers can be submitted during CDP hearings if the CDP request is timely and the taxpayer is not precluded from contesting the liability under IRC §§ 6330(c)(2), 6330(c)(4), or 6320(c). The Service must accept the offer within 90 days or it is deemed rejected. A qualified offer will also ensure that the IRS national office reviews the issues, which can give tax practitioners some guidance on how the Service sees certain issues.

E. Litigation:

1. Pre-payment Forum: To initiate a Tax Court case, the taxpayer (now known as petitioner) will file a petition, designation for place of trial, and a statement with the taxpayer's identification number, which will accompany a filing fee of \$60 (made payable to Clerk, United States Tax Court).
  - i. Petitions must include, among other items, facts and legal theories on why the petitioner should prevail. Any issue not contested in the petition is deemed conceded by petitioner. Also, the notice being appealed must be attached and any taxpayer identification numbers (such as social security number) must be redacted.

2. Refund Forum: Refund claims can be brought in the United States Court of Federal Claims and the United States District Court. Before commencing refund-based litigation, the taxpayer must first pay the tax and file a claim for refund from the IRS. Claims for refund must include the grounds on which a refund is claimed and facts to support those grounds, all of which must be sworn to under penalties of perjury. Refund claims are filed using Form 843, *Claim for Refund and Request for Abatement*.

I. Litigating the FBAR Penalty

a. Venue

- i. Can a taxpayer petition the U.S. Tax Court with respect to FBAR penalties?
  1. Because FBAR penalties are not Title 26 Penalties subject to deficiency procedures, the Tax Court does not have jurisdiction over the FBAR penalty.
- ii. Other international penalties (Sections 6038, 6677, 6679) are not subject to deficiency procedures and do not have a prepayment forum.
  1. Tax Court does have jurisdiction by way of Collection Due Process hearings.
    - a. IRC § 6702 Penalties
      - i. *Youssefzadeh v. Commissioner*, No. 14868-14 (Nov. 6, 2015).
      - ii. *Callahan v. Commissioner*, 130 T.C. 130 (2008).
      - iii. *Rice v. Commissioner*, T.C. Memo. 2009-169.
    - b. IRC § 3707A Penalties
      - i. *Yari v. Commissioner*, 143 T.C. 157 (2014).
    - c. IRC § 6672 Penalty
      - i. *Mason v. Commissioner*, 132 T.C. 44 (2009).
    - d. IRC § 6700 Penalties
      - i. *Harry v. Commissioner*, T.C. Memo. 2009-206.

Tax court Jurisdiction

<u>Code</u>	<u>Description</u>	<u>Form</u>	<u>Deficiency Proceedings</u>
IRC 6038(b)	Information Reporting With Respect to Certain Foreign Corporations and Partnerships – Penalty for Failure to Furnish Information	Form 5471, Form 8858, or Form 8865	No
IRC 6038(c)	Penalty Reducing Foreign Tax Credit Plus Continuation Penalty	Form 5471, Form 8858, or Form 8865	Yes
IRC 6038A(d)	Information Reporting for Foreign-Owned Corporations	Form 5472	No

IRC 6038B(c)	Failure to Provide Notice of transfers to Foreign Persons	Form 926 or Form 8865 Schedule O	No for Penalty. Yes for tax on gain
IRC 6038C (c)	Information with Respect to Foreign Corporations Engaged in U.S. Business	Form 5472	No
IRC 6038D	Failure to Provide Information With Respect to Specified Foreign Financial Assets	Form 8938	No
IRC 6039F(c)	Gifts from Foreign Persons	Form 3520	Yes if IRC 6039F(c)(1)(A). No if IRC 6039F(c)(1)(B)
IRC 6039G	Expatriation Reporting Requirements	Form 8854, Form W-8CE	No
IRC 6677(a)	Failure to File a Foreign Trust Information Return	Form 3520	No
IRC 6677(b)	Failure to File an Information Return With Respect to U.S. Owners of a Foreign Trust	Form 3520-A	No
IRC 6679	Return of U.S. Persons With Respect to Certain Foreign Corporations and Partnerships	Form 5471 Schedule O, Form 8865 Schedule P, or Form 5471 Schedule N	No
IRC 6688	Reporting for Residents of U.S. Possessions	Form 5074, Form 8689 or Form 8898	Yes
IRC 6689	Failure to File Notice of Foreign Tax Redetermination	Form 1116 or Form 1118 (Attach Form 1040X or Form 1120X)	No
IRC 3712	Failure to Disclose Treaty-Based Return Position	Form 8833	No

## II. FBAR Penalties

### a. Overview

- i. The FBAR requirement and applicable penalty have their origins in the BSA requiring “certain reports or records where they have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.” 31 U.S.C. § 5311; *United States v. Chabot*, 793 F.3d 338, 344 (3d Cir. 2015) (explaining that government agencies use information secured by the Bank Secrecy Act “for tax collection, development of monetary policy, and conducting intelligence activities”).
- ii. Among the issues Congress sought to address in the BSA were “[s]ecret foreign financial facilities” that offered the wealthy a

“convenient avenue of tax evasion.” H.R. Rep. No. 91-975 at 13 (1970), *reprinted in* 1971-1 C.B. 559, 561.

- iii. In 2001, Congress required Treasury to study compliance with the FBAR requirement. In response to Treasury’s findings that there may be hundreds of thousands of taxpayers still hiding assets offshore to avoid tax, Congress increased the penalty for willful FBAR violations.
- b. FBAR Requirements and Penalties
- i. 31 USC 5314(a) – Filing Requirement (31 CFR 1010.350).
  - ii. 31 USC 5321(a) – Penalties for violations (before applying Federal Civil Penalties Inflation Adjustment Act of 1990, 28 USC 2461, *see* 31 CFR 1010.821).
    - Negligence (only against financial institutions and nonfinancial trades or business) – penalty not to exceed \$500 (5321(a)(6), 31 CFR 1010.820(h)).
    - Nonwillful – penalty not to exceed \$10,000 (5321(a)(5)(B)).
    - Willful – penalty not to exceed greater of \$100,000 or 50% of balance in the account at the time of the violation (5321(a)(5)(C) and (D)).
      - a. Penalty now capped at \$100,000 under holding in *United States v. Colliot*. See recent developments below.
    - Pattern of negligent activity – (only against businesses and penalty not to exceed \$50,000 (5321(a)(6)(B)).
    - Reasonable cause is a defense.
    - A civil penalty can be imposed for any violation notwithstanding the fact that a criminal penalty is imposed for the same violation – 31 USC 5321(d).
  - iii. 31 CFR 1010.820 is the primary penalty regulation and addresses civil penalties arising from violations of the BSA reporting and recordkeeping requirements.
- c. Title 31 Civil International Penalties
- i. Failure to report a transaction with foreign financial agency, 31 USC 5315, or not complying with injunction under 31 USC 5320 enforcing compliance with section 5315.
    - Civil penalty not to exceed \$10,000, 31 USC 5321(a)(3).
  - ii. Failure to report a transaction with foreign financial agency required by regulations under the authority of 31 CFR 1010.360 for violations occurring after 10/22/2004.
    - Civil penalty is the greater of \$100,000 or 50% of the amount of the transaction, 31 USC 5321(a)(5), 31 CFR 1010.820(g).
  - iii. Failure to comply with due diligence requirements for financial institutions having private banking or correspondent account for foreign person set forth at 31 USC 5318(i) or prohibition of managing a correspondent account with a foreign shell corporation 31 USC 5318(j) and 31 CFR 1010.605-630.



Act of 2004, Pub. L. No. 108-357, § 821, 118 Stat. 1418 (2004).

6. Under the revised statute, the civil monetary penalties for willful failure to file an FBAR increased to a minimum of \$100,000 and a maximum of 50 percent of the balance in the unreported account at the time of the violation. 31 U.S.C. § 5321(a)(5)(C).
  7. Despite the change, the regulations remained unchanged.
  8. The Court held that, as written, the subsequent legislation did not implicitly repeal the regulation as written which capped the penalty at \$100,000.
  9. Rules issued via notice-and-comment rulemaking must be repealed via notice-and-comment rulemaking.
  10. Therefore, the regulation remained in place when the FBAR penalties in question were assessed. The Court held that the IRS acted arbitrarily and capriciously when it failed to apply the regulation to cap the penalties assessed against Colliot.
  11. In essence, for the time being, this has created a \$100,000 cap on the FBAR willful penalty.
- e. Reasonable Cause Defense
- i. 31 U.S.C. § 5321(a)(5)(B)(ii) states that “No penalty shall be imposed under subparagraph (A) with respect to any violation if-
    1. such violation was due to reasonable cause, and
    2. the amount of the transaction in the account at the time of the transaction was properly reported.
  - ii. The reasonable cause defense does not apply to willful violations. 31 U.S.C. § 5321(a)(5)(C)(ii).
  - iii. Reasonable cause is not defined in the BSA or in the regulations.
  - iv. In 1985, the Supreme Court noted that the meaning of the terms “reasonable cause” and “willful neglect” had become clear over the near-70 years of their presence in the Statutes. *United States v. Boyle*, 469 U.S. 241, 245 (1985).
    1. The court in *Boyle* also stated that the regulations defined “reasonable cause” for purposes of § 6651(a)(1), and that the relevant treasury regulation calls on the taxpayer to demonstrate that he exercised ordinary business care and prudence but nevertheless was unable to file the return within the prescribed time.
  - v. In *Moore v. U.S.*, the Western District of Washington found that there is no reason to think that Congress intended the meaning of “reasonable cause” in the Bank Secrecy Act to differ from the meaning ascribed to it in tax statutes. The court held that a person has “reasonable cause” for an FBAR violation when he committed the violation despite an exercise of ordinary business care and prudence. *Moore v. United States*, 2015 WL 1510007.

### III. The Tucker Act and the Little Tucker Act

- a. Two prerequisites to bring an action against the United States

- i. The court must have subject matter jurisdiction; and
  - ii. There must be a waiver of sovereign immunity.
- b. Tucker Act – 28 U.S.C. § 1491
  - i. The United States Court of Federal Claims shall have jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort. For the purpose of this paragraph, an express or implied contract with the Army and Air Force Exchange Service, Navy Exchanges, Marine Corps Exchanges, Coast Guard Exchanges, or Exchange Councils of the National Aeronautics and Space Administration shall be considered an express or implied contract with the United States.
- c. Little Tucker Act – 28 U.S.C. § 1346(a)(2)
  - i. Any other civil action or claim against the United States, not exceeding \$10,000 in amount, founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort, except that the district courts shall not have jurisdiction of any civil action or claim against the United States founded upon any express or implied contract with the United States or for liquidated or unliquidated damages in cases not sounding in tort which are subject to sections 7104(b)(1) and 7107(a)(1) of title 41. For the purpose of this paragraph, an express or implied contract with the Army and Air Force Exchange Service, Navy Exchanges, Marine Corps Exchanges, Coast Guard Exchanges, or Exchange Councils of the National Aeronautics and Space Administration shall be considered an express or implied contract with the United States.
- d. Do the statutes or regulations upon which the claim is founded create substantive rights to monetary damages:
  - i. *United States v. Bormes*, 568 U.S. 6 (2012).
    - 1. Sovereign immunity shields the United States from suit absent a consent to be sued that is “‘unequivocally expressed.’ ” *United States v. Nordic Village, Inc.*, 503 U.S. 30, 33–34, 112 S.Ct. 1011, 117 L.Ed.2d 181 (1992) (quoting *Irwin v. Department of Veterans Affairs*, 498 U.S. 89, 95, 111 S.Ct. 453, 112 L.Ed.2d 435 (1990); some internal quotation marks omitted). The Little Tucker Act is one statute that unequivocally provides the Federal Government's consent to suit for certain money-damages claims. *United States v. Mitchell*, 463 U.S. 206, 216, 103 S.Ct. 2961, 77 L.Ed.2d 580 (1983) (*Mitchell II*). Subject to exceptions not relevant here, the Little Tucker Act provides that “‘district courts shall have original jurisdiction, concurrent with the United States Court of

Federal Claims,” of a “civil action or claim against the United States, not exceeding \$10,000 in amount, founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contract with the United States, or for liquidated or unliquidated damages in cases not sounding in tort.” 28 U.S.C. § 1346(a) (2). The Little Tucker Act and its companion statute, the Tucker Act, § 1491(a)(1),<sup>2</sup> do not themselves “creat[e] substantive rights,” but “are simply jurisdictional provisions that operate to waive sovereign immunity for claims premised on other sources of law.” *United States v. Navajo Nation*, 556 U.S. 287, 290, 129 S.Ct. 1547, 173 L.Ed.2d 429 (2009).

- ii. The Court of Appeals for the Federal Circuit has long recognized two types of non-contract damage claims that are cognizable under the Tucker Act:
  1. That under which the plaintiff has paid money over to the government, directly or in effect, and seeks return of all or part of that sum, and
  2. Those demands in which the money has not been paid but the plaintiff assert that he is nevertheless entitled to payment from the treasury.
- iii. What is an Illegal Exaction?
  1. An “illegal exaction,” as that term is generally used, involves money that was “improperly paid, exacted, or taken from the claimant in contravention of the Constitution, a statute, or a regulation.” *Eastport S.S. Corp. v. United States*, 178 Ct.Cl. 599, 372 F.2d 1002, 1007 (1967). The classic illegal exaction claim is a tax refund suit alleging that taxes have been improperly collected or withheld by the Government. See, e.g., *City of Alexandria v. United States*, 737 F.2d 1022, 1028 (Fed. Cir. 1984). An illegal exaction involves a deprivation of property without due process of law, in violation of the Due Process Clause of the Fifth Amendment to the Constitution.

See, e.g., *Casa de Cambio Comdiv*, 291 F.3d at 1363. The Court of Federal Claims ordinarily lacks jurisdiction over due process claims under the Tucker Act, 28 U.S.C. §1491, see *Murray v. United States*, 817 F.2d 1580, 1582 (Fed. Cir. 1987), but has been held to have jurisdiction over illegal exaction claims “when the exaction is based upon an asserted statutory power.” *Aerolineas Argentinas v. United States*, 77 F.3d 1564, 1573 (Fed. Cir. 1996); see also *Eastport*, 372 F.2d at 1008 (Court of Claims had jurisdiction over exaction “based upon a power supposedly conferred by a statute”). To invoke Tucker Act jurisdiction over an illegal exaction claim, a claimant must demonstrate that the statute or provision causing the exaction itself provides, either expressly or by “necessary implication,” that “the remedy for its violation entails a return of money unlawfully exacted.” *Cyprus Amax Coal Co. v. United States*, 205 F.3d 1369, 1373 (Fed. Cir. 2000) (concluding that the Tucker Act provided jurisdiction over an illegal exaction claim based upon the Export

Clause of the Constitution because the language of that clause “leads to the ineluctable conclusion that the clause provides a cause of action with a monetary remedy”)

iv. Applicability of the Tucker and Little Tucker Acts to the FBAR Penalty

1. “[t]he prototypical illegal exaction claim is ‘a tax refund suit alleging that taxes have been improperly collected or withheld by the government.’” A person can maintain a cause of action for illegal exaction by alleging that he paid money to the Federal Government and seeks the return of all or a part of that sum because it was “improperly paid, extracted or taken from the claimant in contravention of the Constitution, a statute or regulation.” *Briggs*, DC-CA, 564 FSupp2d 1087, 1092 (2008) (allegations that a tax refund had been improperly offset to collect a debt was sufficient to state a cause of action under the Little Tucker Act).
2. A person who has paid money toward an FBAR assessment and who claims that the assessment was illegal is seeking to recover an illegal exaction from the Government. She can, therefore, maintain an action to recover the payment in either district court (if the amount the plaintiff seeks to recover is \$10,000 or less) or the CFC. Because the FBAR penalty is not a tax but, instead, a civil penalty under Title 31, the long established rule in *Flora* (holding that to maintain an action for refund of income tax under title 26, a taxpayer had to pay the full amount of the tax plus any penalties and interest) should not apply. The inapplicability of the rule in *Flora* is illustrated by several recent decisions of the CFC.

IV. Authority to Assess and Collect

a. Authority to assess and collect

- i. IRS is authorized to assess FBAR penalties, Delegation Order 25-13, 31 CFR 1010.810(g), but is not authorized to collect. IRM 5.21.6.4(2) (11-27-2013).
- ii. Upon assessment, IRS makes notice and demand for payment by sending a Letter 3708 via certified mail to taxpayer and POA. IRM 4.26.17.4.4(4)(05-05-2008).
- iii. Interest does not accrue until assessment and is due only if not paid within 30 days. IRM 8.11.6.1(12) (02-02-2015); 31 CFR 5.5(a) and (b).
- iv. 6% delinquency penalty on amount unpaid 90 days after assessment. 31 USC 3717; IRM 4.26.17.4.3(6) (05-05-2008).
- v. At least 60 days before referring an assessed FBAR penalty to BFS for collection, IRS sends notice to the debtor (31 CFR 5.9(b)):
  1. The nature, amount and facts giving rise to the debt
  2. How and when interest, penalties and costs are added
  3. Opportunity to discuss alternative payment arrangements

4. Deadline to avoid enforcement (offset, private collection agency, credit bureau, admin. wage garnishment, litigation, referral to BFS)
  5. Right to inspect and copy records
  6. Right to/process for review/hearing (\*) and stay admin wage garnishment
  7. Other rights and consequences of nonpayment
- b. Transfer to Bureau of Fiscal Service
- i. BFS was established in 2012 after consolidation of Financial Management Service and Bureau of Public Debt. *See* Treasury Order 136-01 (Pub. Date: May 14, 2013).
  - ii. IRS sends information to BFS, responsible for collecting all non-tax debts including FBAR penalties. IRM 5.21.6.7 (02-18-2016); 31 USC 3711(g)(4) (IRS may refer nontax claim to debt collection center (BFS), private collection contractor, or DOJ).
  - iii. IRS will transfer eligible non-tax debt more than 120 days delinquent to BFS for debt collection services (known as “cross-servicing”) and administrative offset. 31 USC 3711(g); 31 CFR 5.4(a)(7), 5.9, 5.10, 285.5(a), and 285.12(c); *see also* 31 USC 3716(c)(6).
  - iv. For accounting and reporting purposes, the debt remains on the books and records of the agency that transferred the debt to BFS.
  - v. Under 31 CFR 285.12(d), no mandatory transfer to BFS for cross-servicing if the debt is:
    1. In litigation or foreclosure
    2. Scheduled for sale
    3. At a private collection contractor
    4. At a debt collection center
    5. Being collected by internal offset (anticipates full collection w/in 3 years)
    6. Covered by an exemption
  - vi. Upon referral, BFS must take appropriate action to collect or compromise the debt (or suspend or terminate collection action) in accordance with any requirements and authorities applicable to the debt and collection action to be taken. 31 CFR 5.9 and 285.12(b); 31 USC 3711(g)(9) (government must take all appropriate steps to collect).
  - vii. “Appropriate action includes, but is not limited to, contact with the debtor, referral of the debt to the Treasury Offset Program (TOP), private collection agencies or the Department of Justice, reporting of the debt to credit bureaus, and administrative wage garnishment.” 31 CFR 5.9.

## V. Statute of Limitations

### a. Overview

- i. There is no statute of limitations for collection using administrative offset or administrative collection tools. 31 USC 3716 (e)(1)

(“Notwithstanding any other provision of law, regulation, or administrative limitation, no limitation on the period within which an offset may be initiated or taken pursuant to this section shall be effective.”); 31 CFR 285.5(d)(3)(v) (“Debts may be collected irrespective of the amount of time the debt has been outstanding.”); IRM 8.11.6.3.1.1 (11-13-2014).

- ii. The government has two (2) years to file a civil action to recover an FBAR penalty beginning on the later date penalty was assessed or date any judgment becomes final in a criminal action involving the same transaction that resulted in the penalty. IRM 5.21.6.6 (02-18-2016); IRM 8.11.6.3.1.1 (11-13-2014).

b. Interplay Between IRC § 6038D and IRC § 6501 and the Six Year SOL

- i. The Internal Revenue Service (IRS) must assess tax within three years of the date a tax return was due, without extensions, or the date the return was actually filed, whichever is later, subject to certain exceptions. Sec. 6501.

- 1. Section 6501(e)(1)(A)(ii) provides that the IRS may assess tax within six years after a return is filed “[i]f the taxpayer omits from gross income an amount properly includible therein and \* \* \* such amount (I) is attributable to one or more assets with respect to which information is required to be reported under section 6038D \* \* \*, and (II) is in excess of \$5,000”.

- ii. Section 6038D in turn requires reporting of additional information relating to “specified foreign financial assets”. Section 6038D also has a dollar threshold of \$50,000 that is disregarded for purposes of section 6501(e)(1)(A)(ii).

- 1. Section 6038D was added to the Internal Revenue Code by the Hiring Incentives To Restore Employment Act of 2010 (HIRE Act), Pub. L. No. 111–147, sec. 511(a), 124 Stat. at 109, and is effective for taxable years beginning after March 18, 2010 (the date of its enactment). Section 6501(e)(1)(A)(ii) was added by HIRE Act sec. 513(a)(1) and (d), 124 Stat. 111, 112, but has a different effective date, applying to returns filed after March 18, 2010, and also to “returns filed on or before \* \* \* [March 18, 2010] if the period specified in section 6501 of the Internal Revenue Code of 1986 (determined without such regard to such amendments) for assessment of such taxes has not expired as of such date.” *Id.* sec. 513(d).

- iii. *Rafizadeh v. Commissioner*, 150 T.C. No. 1 (2018).

- 1. In determining the meaning of a statutory provision, “we look first to its language, \* \* \* giving the ‘words used’ their ‘ordinary meaning’.” [Moskal v. United States](#), 498 U.S. 103, 108, 111 S.Ct. 461, 112 L.Ed.2d 449 (1990) (first quoting [United States v. Turkette](#), 452 U.S. 576, 580, 101 S.Ct. 2524, 69 L.Ed.2d 246 (1981); then quoting [Richards v. United States](#), 369 (U.S. 1, 9, 82 S.Ct. 585, 7 L.Ed.2d 492 1962)). It is

a well-accepted canon of construction “that ‘a statute ought, upon the whole, to be so construed so that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant’ ”. See [Duncan v. Walker](#), 533 U.S. 167, 174, 121 S.Ct. 2120, 150 L.Ed.2d 251 (2001) (quoting [Market Co. v. Hoffman](#), 101 U.S. 112, 115–116, 25 L.Ed. 782 (1879)); [Vetco Inc. & Subs. v. Commissioner](#), 95 T.C. 579, 592 (1990). Furthermore, “[s]tatutes of limitation sought to be applied to bar rights of the Government, must receive a strict construction in favor of the Government.” [Badaracco v. Commissioner](#), 464 U.S. 386, 391, 104 S.Ct. 756, 78 L.Ed.2d 549 (1984) (quoting [E.I. Dupont de Nemours & Co. v. Davis](#), 264 U.S. 456, 462, 44 S.Ct. 364, 68 L.Ed. 788, 1924)).

2. The Court concluded that the wording of the effective date for [section 6501\(e\)\(1\)\(A\)\(ii\)](#) limits its application to years for which the reporting requirement of [section 6038D](#) also is effective. “[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there. \* \* \* When the words of a statute are unambiguous, then, this first canon is also the last: ‘judicial inquiry is complete’.” [Conn. Nat’l Bank v. Germain](#), 503 U.S. 249, 253–254, 112 S.Ct. 1146, 117 L.Ed.2d 391 (1992) (quoting [Rubin v. United States](#), 449 U.S. 424, 430, 101 S.Ct. 698, 66 L.Ed.2d 633 (1981)). The Court must give effect to all of the words in the key phrase before us—“assets with respect to which information is required to be reported under [section 6038D](#)”. While the effective date of [section 6038D](#) was not imported by the cross-reference to [section 6038D](#), the Court concluded that the most natural reading of this phrase is that the six-year statute of limitations applies only when there is a [section 6038D](#) reporting requirement (or would be barring an exception that is to be disregarded). [Section 6501\(e\)\(1\)\(A\)\(ii\)](#) does not simply incorporate the definition of assets in [section 6038D](#); it also specifies that the assets are subject to the reporting requirement (or would be but for an exception that is disregarded). The Court agree with petitioner that had Congress intended simply to incorporate the definition in [section 6038D](#) of the assets to be covered, Congress could have used other more straightforward wording, such as the defined term itself. Cf. [Leslie v. Commissioner](#), 146 F.3d 643, 650–651 (9th Cir. 1998) (limiting cross-reference in [section 6621\(c\)\(3\)\(A\)\(iii\)](#) to “any straddle (as defined in [section 1092 \\* \\* \\*](#))” to the definition of straddle in [section 1092](#), and declining to import the effective date of [section 1092](#) as well), [aff’g T.C. Memo. 1996-86](#). The addition of the cross-reference to [section 6038D](#) to [section 6501\(c\)\(8\)](#) does not

undercut the Court's interpretation. [Section 6501\(c\)\(8\)](#) provides that in the case of failures to comply with certain information reporting provisions, the limitations period does not expire until three years after the required information is provided. HIRE Act [sec. 513\(b\)\(3\)](#), 124 Stat. at 112, added information reporting under [section 6038D](#) to the other information reporting provisions. Respondent stretches to argue that the incorporation of that reporting requirement into [section 6501\(c\)\(8\)](#) shows that Congress did not intend to make the separate six-year statute of limitations in [section 6501\(e\)\(1\)\(A\)\(ii\)](#) dependent on a taxpayer's failure to satisfy [section 6038D](#). The trigger in [section 6501\(c\)\(8\)](#) is the failure to report, and that failure results in a different limitations period. By contrast the trigger for the six-year limitations period in [section 6501\(e\)\(1\)\(A\)\(ii\)](#) is the omission of gross income from assets that are subject to the [section 6038D](#) reporting requirement (or would be but for an exception thereto), and it extends the period to six years. Thus, the contrast between the wording in the two provisions does not tell us any more about how to read the latter than the words of the statute. And we find the legislative history of the effective date cited by respondent no more illuminating than the statute itself because the legislative history tracks the statute, as respondent acknowledges. *See, e.g.*, General Explanation of Tax Legislation Enacted in the 111th Congress 234 (JCS-2-11, March 2011). The Court does not assume the effective date was a mistake; its analysis applies the statute as written.

## VI. Federal Debt Collection Procedures

- a. Collection Alternatives & The Authority to Compromise
  - i. Treasury entities may accept payment of debt in regular installments. 31 CFR 5.6; 31 CFR 901.8 (generally focused on full payment within 3 years).
  - ii. Treasury entities may compromise debt in accordance with 31 CFR 902. *See* Treasury Directive 34-02 (Credit Management and Debt Collection); 31 CFR 5.7.
  - iii. Assessed FBAR penalties in excess of \$100,000 cannot be compromised without DOJ approval. 31 USC 3711(a)(2), 31 CFR 902.1(a),(b); IRM 8.11.6.1(6) (02-02-2015).
  - iv. Although the IRS does not have the power to collect, the IRM directs taxpayers who have questions or need to pay an FBAR penalty to write to: IRS, Detroit Federal Building, POB 33115, Detroit, MI 48232. IRM 5.21.6.7 (02-18-2016).

## VII. Collection Tools

- a. Intro to Administrative Offsets

- i. Administrative offset may be used only after there has been an attempt to collect the amount owed from the debtor directly under 31 USC 3711(a) and debtor is given notice and opportunities under 31 USC 3716(a).
  - ii. At least 60 days before referring FBAR penalty to TOP, IRS sends notice to the debtor (31 CFR 5.10(a)(2)) (same notice required under 31 CFR 5.9(b) before sending to BFS).
  - iii. If centralized administrative offset is not available/appropriate, the government may collect debts using non-centralized administrative offset. 31 CFR 5.10 (and non-centralized offset can occur in conjunction with administrative offset – for example, the Social Security Administration offsetting a social security benefit payment to collect an overpayment of social security).
  - iv. Federal payments eligible for offset include, but are not limited to, tax refunds, salary, travel advances and reimbursements, retirement and vendor payments, and Social Security and other benefit payments. 31 CFR 285.5(e)(1).
  - v. Federal agencies compare payment records with records of debts submitted to BFS for collection by administrative offset. A match occurs when the taxpayer's identification number (TIN) and the name of the payee are the same as the TIN and the name of the debtor on a debt record. 31 CFR 285.4(c).
  - vi. Debt collection procedures may be used separately or in conjunction with offset collection procedures. 31 CFR 285.2(b)(5).
  - vii. The disbursing official conducting the offset will notify the debtor of any offsets.
  - viii. The creditor agency must notify BFS immediately of any payments credited by the agency to the debtor's account (other than those received by offset) after a debt is submitted to BFS. 31 CFR 285.7(d)(5).
- b. Exemptions from Administrative Offsets
- i. Even federal benefit programs that statutorily proscribe levy of benefits are subject to administrative offset *unless* there is a statutory proscription against offset. 31 USC 3716(c)(3)(A)(i); 31 CFR 285.5(e)(2)(v). The only benefit explicitly *exempt* from offset by statute is payable under the Higher Education Act of 1965. 31 USC 3716(c)(1)(C).
  - ii. Treasury further exempts (1) Black Lung Benefits Act Part C or RRB tier 2 benefit payments, (2) payments under US tariff laws, (3) VA benefit payments to extent exempt from offset under 38 USC 5301, (4) payments under Title IV of the Higher Education Act of 1965, and (5) federal loan payments other than travel advances. 31 CFR 285.5(e)(2).
  - iii. The first \$9,000 a debtor receives in a 12-month period as benefits under the Social Security Act, part B of the Black Lung Benefits Act, or any law administered by the Railroad Retirement Board, the first \$9,000 a debtor is exempt from offset. 31 USC 3716(c)(3)(A)(ii).

- iv. Treasury may exempt payments under means-tested or other programs where justification is provided by the head of the respective agency. 31 USC 3716(c)(3)(B); 31 CFR 285.5 (e)(7).
- c. Administrative Offsets: Tax Refunds
  - i. To pursue tax refund offsets (as well as other types of debts), the creditor agency must certify that (31 USC 3720A(b); 31 CFR 285.2(d)):
    - 1. Debt is at least \$25, past-due, and legally enforceable
    - 2. Collections will be applied to debt
    - 3. Reasonable efforts have been made to obtain payment (unique to tax refunds)
    - 4. Debtor has been notified that debt is past due, and unless repaid within 60 days, will be referred to BFS
    - 5. The debtor has been given at least 60 days to present evidence that all or part of the debt is not past-due or legally enforceable, considered that evidence, and the agency determined that the debt is past due and legally enforceable
      - a. if BFS makes this determination, debtor has 30 days from date of determination to request review by the creditor agency unless debtor has been afforded that opportunity prior to referral to BFS.
  - ii. With joint tax returns where only one spouse is liable, non-liable spouse may secure share of a tax refund from which an offset was made. 31 CFR 285.2(f).
- d. Administrative Offsets: Federal Benefit Payments
  - i. BFS can offset covered benefit payments including amounts payable under SSA (other than SSI payments), part B of the Black Lung Benefits Act, or any law administered by the Railroad Retirement Board (other than payments that such Board determines to be tier 2 benefits). 31 CFR 285.4(c).
  - ii. Before offsetting a covered benefit payment, disbursing official will notify the payee in writing (“the warning notice”) of the date the offset will commence. 31 CFR 285.4(f).
  - iii. The notice shall inform the payee of:
    - 1. the type of payment that will be offset
    - 2. the identity of the creditor agency
    - 3. a contact point within the creditor agency.
  - iv. Non-receipt by the debtor of these notices does not impair legality of offset.
  - v. Offsets of covered benefit payments are subject to limitations. 31 CFR 285.4(e). The amount offset from a monthly covered benefit payment will be the lesser of:
    - 1. The amount of debt, including any interest, penalties and administrative costs;
    - 2. An amount equal to 15% of the monthly covered benefit payment; or

3. The amount, if any, by which the monthly covered benefit payment exceeds \$750.
- e. Administrative Offsets: Federal Salary Payments
    - i. Creditor agencies may collect any debt through federal salary offset. 5 USC 5514(a)(1); 31 CFR 5.12; 31 CFR 285.7.
    - ii. Referred to as “centralized salary offset,” and conducted through centralized salary offset computer matching. 31 CFR 285.7(a).
    - iii. Salary deductions are made from a federal employee’s basic pay, special pay, incentive pay, retired pay, retainer pay or other authorized pay from federal employment. 5 USC 5514(a)(1); 31 CFR 5.12; 31 CFR 285.7(d)(3)(iii).
    - iv. Government may withhold up to 15% of the debtor’s disposable pay, meaning the wages remaining after legally-mandated withholdings are deducted. 5 USC 5514(a)(1)-(5)(A); 31 CFR 5.12(g)(3); 31 CFR 285.7(g).
    - v. Before offsetting a salary payment, the disbursing official shall notify the federal employee in writing of the start date and amount of the deductions. 31 CFR 285.7(i)(1).
    - vi. After each offset, the disbursing official shall notify the federal employee in writing that an offset has occurred including a description and amount of the offset, as well as the identity of the creditor agency and contact at the agency that will address concerns unless that information was previously provided. 31 CFR 285.7(i)(2).
    - vii. The disbursing official will advise each creditor agency of the names, mailing addresses, and TINs of the debtors from whom amounts of past-due, legally enforceable debt were collected and of the amounts collected. 31 CFR 285.7(i)(3).
  - f. Administrative Wage Garnishments
    - i. The federal government may garnish wages of non-government employees to collect any debt owed, pursuant to 31 USC 3720D(a). 31 CFR 285.11(d). Treasury entities may use administrative wage garnishment to collect a delinquent Treasury debt unless the debtor is making timely payments under an agreement to pay the debt in installments. 31 CFR 5.13(a) (referencing 31 CFR 5.6).
    - ii. At least 30 days before garnishment (31 CFR 285.11(e) and 31 CFR 5.13 (citing 31 CFR 5.4)), the agency (or BFS) shall notify the debtor in writing of the:
      1. Nature and amount of the debt.
      2. Intent to initiate proceedings to collect through deductions from pay until debt is satisfied.
      3. Explanation of rights (right to inspect/copy agency records, enter into repayment agreement, and hearing on existence or amount of debt, or the terms of proposed repayment schedule).
    - iii. The debtor must submit a written request for a hearing (31 CFR 285.11(f))
      1. The hearing may be oral (in-person or by phone) or written.

2. If the request is received within 15 business days of the date the notice is mailed, the withholding order will not be issued until a hearing is held and decision rendered.
  3. If the request is untimely the debtor is entitled to a hearing but the withholding order will be issued unless the agency determines that the delay was caused by factors beyond the debtor's control or believes that delay is justified.
- iv. Agency has burden of proof as to existence and amount of debt; debtor must prove by preponderance that debt does not exist, amount is incorrect, repayment schedule is unlawful, or would cause financial hardship.
  - v. Hearing official shall issue a written opinion not later than 60 days after request for hearing was received by the agency; if agency cannot meet this deadline, any withholding order must be suspended until a decision is rendered.
  - vi. The decision will be a final agency action for purposes of judicial review under the Administrative Procedures Act.
  - vii. Agency will send a withholding order to the debtor's employer:
    1. Within 30 days after the debtor fails to make a timely request for hearing, or
    2. If a timely request for hearing is made, within 30 days after a final decision is made, or
    3. As soon as reasonably possible thereafter.
  - viii. Withholding order shall contain the signature (or image of the signature of) the head of the agency or his/her delegate. The order shall contain only the information necessary for the employer to comply with the withholding order (name, address, SSN, and instructions).
  - ix. Garnished amount shall be the **lesser of** (31 USC 3720D(a); 31 CFR 285.11(i):
    1. The amount on the garnishment order up to 15% of disposable pay, or
    2. The amount set forth in 15 USC 1673(a)(2) (restriction on garnishment) – the amount by which disposable pay exceeds amount equivalent to 30 times minimum wage.
  - x. Government may not garnish wages if debtor is involuntarily separated from employment until debtor has been reemployed continuously for at least 12 months. 31 CFR 285.11(j).
  - xi. In the case of financial hardship, the agency must decrease amount garnished to reflect the debtor's financial condition. 31 CFR 285.11(k).
  - xii. Employer liable for failure to comply with withholding order (amount withheld, attorneys' fees, costs, and, in the court's discretion, punitive damages).
- g. Private Collection Agencies

- i. The government may also contract with a third party for collection services to recover any debt owed to the U.S. 31 USC 3718(a); 31 CFR 5.15; 31 CFR 285.12(c)(2).
  - ii. BFS maintains a list of approved private collection agencies.
  - iii. A debt collection contract may provide for a fee payable to the collection agent from the amount recovered. 31 USC 3718(d).
- h. Consumer Reporting Agencies
  - i. Delinquent debts are reported to credit bureaus pursuant to 31 USC 3711(e), 31 CFR 901.4, 31 CFR 285.12(c)(2) and 31 CFR 5.14.
  - ii. The government must send notice to the debtor at least 60 days prior to reporting a delinquent debt to a consumer reporting agency. 31 CFR 5.14, 5.4.
  - iii. Delinquent debts are reported to credit bureaus pursuant to 31 USC 3711(e), 31 CFR 901.4, 31 CFR 285.12(c)(2) and 31 CFR 5.14.
  - iv. The government must send notice to the debtor at least 60 days prior to reporting a delinquent debt to a consumer reporting agency. 31 CFR 5.14, 5.4.

## VIII. Summons Enforcement

### a. In General

- i. The United States' system of taxation relies on self-assessment and the good faith and integrity of each taxpayer to disclose completely and honestly all information relevant to his tax liability. Nonetheless, "it would be naive to ignore the reality that some persons attempt to outwit the system." *United States v. Bisceglia*, 420 U.S. 141, 145 (1975). Thus, Congress has charged the Secretary of the Treasury and the Commissioner of Internal Revenue with the responsibility of administering and enforcing the Internal Revenue Code. See I.R.C. §§7601 and 7602; *Madison v. United States*, 758 F.2d 573, 574 (11th Cir. 1985).
- ii. Section 7601 of the Code directs the Secretary to make inquiries into the tax liability of every person who may be liable to pay any internal revenue tax. *Codner v. United States*, 17 F.3d 1331, 1332 (10th Cir. 1994). In turn, Section 7602 authorizes the Secretary to examine books, papers, records, or other data, to issue summonses, and to take testimony for the purpose of: (1) "ascertaining the correctness of any return," (2) "making a return where none has been made," (3) "determining the liability of any person for any internal revenue tax . . .," (4) "collecting any such liability," or (5) "inquiring into any offense connected with the administration or enforcement of the internal revenue laws." See, e.g., *United States v. Euge*, 444 U.S. 707, 710-11 (1980); *United States v. LaSalle Nat'l Bank*, 437 U.S. 298, 308 (1978); *United States v. Rockwell Int'l*, 897 F.2d 1255, 1261 (3d Cir. 1990).
- iii. The summons statutes, I.R.C. §§ 7602-7613, provide the IRS with an investigative device that is to be interpreted broadly in favor of the IRS. See *Euge*, 444 U.S. at 714-15 (holding that the language of §

7602 includes authority to summons some physical evidence, and upholding a summons for handwriting exemplars). Congress's intent was to foster effective tax investigations by giving the IRS expansive information-gathering authority. See *United States v. Arthur Young & Co.*, 465 U.S. 805, 816 (1984) (citing *Bisceglia*, 420 U.S. at 146); *United States v. Norwest Corp.*, 116 F.3d 1227, 1231-32 (8th Cir. 1997).

- iv. Restrictions on the summons power are to be avoided, absent unambiguous Congressional direction. See *Arthur Young*, 465 U.S. at 816; *Euge*, 444 U.S. at 715. See also *United States v. Stuart*, 489 U.S. 353, 364 (1989); *Robert v. United States*, 364 F.3d 988, 996 (8th Cir. 2004). The Supreme Court has cautioned against restricting the summons authority absent express legislative direction. See *Tiffany Fine Arts, Inc. v. United States*, 469 U.S. 310, 318 (1985); *United States v. Barter Sys., Inc.*, 694 F.2d 163, 167 (8th Cir. 1982); *United States v. Clement*, 668 F.2d 1010, 1013 (8th Cir. 1982).
- v. The validity of an IRS summons may come before a district court in one of two ways.
  - 1. First, because a summons is not self-enforcing, the Government may bring an enforcement proceeding seeking a court order directing compliance with the summons.
  - 2. Second, in the case of a third-party summons, certain persons may be entitled to bring a proceeding to quash the summons.
  - 3. Under no circumstance, however, is a summoned party entitled to bring a proceeding to quash the summons.
- b. Burdens of Production and Persuasion
  - i. However a summons proceeding is initiated, the standard and burden of proof is the same.
    - 1. In either case, the Government bears the ultimate burden of persuasion. S. Rep. No. 97-494, vol. 1, at 283 (1982), reprinted in 1982 U.S.C.C.A.N. 781, 1029 (“[a]lthough an action to quash the summons must be instituted by the taxpayer, the ultimate burden of persuasion with respect to its right to enforcement of the summons will remain on the Secretary, as under current law”); see *Crystal v. United States*, 172 F.3d 1141, 1143-44 (9th Cir. 1999) (stating that the Government must make the same showing whether to “defeat a petition to quash, or to enforce a summons”).
- c. *Powell* Requirements
  - i. The Supreme Court established the framework for judicial review of a summons in *United States v. Powell*, 379 U.S. 48 (1964). In that case the Court held that the IRS did not have to satisfy any standard of probable cause in order to issue a valid summons. All that the Government must show is that the summons (1) is issued for a legitimate purpose; (2) seeks information that may be relevant to that purpose; (3) seeks information that is not already within the IRS's

possession; and (4) satisfies all administrative steps required by the Internal Revenue Code. *Powell*, 379 U.S. at 57-58.

d. Fifth Amendment Privilege

i. A person summoned to answer questions from an IRS agent is entitled to assert the Fifth Amendment right not to testify against oneself, where appropriate. The assertion of the privilege, however, is subject to the same limitations that obtain in other situations. “The witness is not exonerated from answering merely because he declares that in so doing he would incriminate himself – his say-so does not of itself establish the hazard of incrimination. It is for the court to say whether his silence is justified.” *Hoffman v. United States*, 341 U.S. 479, 486 (1951); *accord Fisher v. United States*, 425 U.S. 391, 410 (1976). “It is well established that the privilege protects against real dangers, not remote and speculative possibilities.” *Zicarelli v. New Jersey State Comm’n of Investigation*, 406 U.S. 472, 478 (1972); *see also Kastigar v. United States*, 406 U.S. 441, 444-45 (1972) (holding that the Fifth Amendment “protects against any disclosures which the witness reasonably believes could be used in a criminal prosecution or could lead to other evidence that might be so used”).

ii. Required Records Exception

1. The “required records” exception to the Fifth Amendment applies to the disclosure of documents that the Government requires persons in a regulated industry to maintain. *See generally In re Grand Jury Proceedings*, 601 F.2d 162, 168 (5th Cir. 1979). There are several reasons for this rule, notably that “the public interest in obtaining such information outweighs the private interest opposing disclosure and the further rationale that such records become tantamount to public records.” *Id.* (internal citations omitted). Additionally, courts have held that production of such records is “in a sense consented to as a condition of being able to carry on the regulated activity involved.” *Id.* at 171.
2. The premises of the doctrine, as it is described in *Shapiro*, are evidently three: first, the purposes of the United States’ inquiry must be essentially regulatory; second, information is to be obtained by requiring the preservation of records of a kind which the regulated party has customarily kept; and third, the records themselves must have assumed “public aspects” which render them at least analogous to public documents.
3. Six circuit courts have held that the required-records exception applies to foreign bank account records that a taxpayer is required to keep under the Bank Secrecy Act, 31 U.S.C. §§ 5311–25. *In re Grand Jury Subpoena Dated February 2, 2012*, 741 F.3d 339, 347 (2d Cir. 2013) (gathering the five other circuit court cases). In addition, several district courts have held that the exception applies to income tax return preparers

who are compelled by I.R.C. § 6107(b) to retain and disclose tax returns. See *United States v. Bell*, 217 F.R.D. 335, 341 (M.D. Pa. 2003); *United States v. Mayer*, 2003 WL 21791155 (M.D. Fla. 2003); *United States v. Nordbrock*, 217 F. Supp. 908, 909 (D. Ariz. 1990), *rev'd on other grounds* 941 F.2d 947 (9th Cir. 1991); *United States v. Bohannon*, 628 F. Supp 1026, 1028-29 (D. Conn.), *aff'd without opinion*, 795 F.2d 79 (2d Cir. 1985).

4. The Seventh Circuit, on the other hand, has held that “[a] statute that merely requires a taxpayer to maintain records necessary to determine his liability for personal income tax is not within the scope of the required-records doctrine.” *Smith v. Richert*, 35 F.3d 300, 303 (7th Cir. 1994) (addressing Indiana tax statute); *accord United States v. Porter*, 711 F.2d 1397, 1404-05 (7th Cir. 1983) (making the same ruling with respect to the records-maintenance requirement in Treas. Reg. §1.6001-1(a)). In *In re M.H.*, 648 F.3d 1067, 1078 (9th Cir. 2011), *cert. denied*, 133 S. Ct. 26 (2012), the Ninth Circuit harmonized *Smith v. Richert* with its holding that the required-records exception applied to documents required to be kept under the Bank Secrecy Act, chiefly on the ground that an individual voluntarily chooses to participate in offshore banking activities (with its attendant heavy regulation), whereas “the decision to become a taxpayer cannot be thought voluntary.” *Id.* at 1078 (quoting *Smith v. Richert*). *Accord In re Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011*, 691 F.3d 903, 908-09 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 2338 (2013).
- iii. Summons to Entities Located in the United States for Records Located Abroad
    1. A person or entity located in the United States may have control over documents located abroad that the IRS wants to review in connection with an investigation. For example, a foreign bank might have a United States branch and the IRS may seek documents located at the bank’s foreign headquarters. *E.g.*, *In re Grand Jury Proceedings (Bank of Nova Scotia)*, 691 F.2d 1384 (11th Cir. 1982). Similarly, the IRS may want to review documents of a foreign accounting firm that is controlled by an accounting firm located in the United States. *Cf. In re Parmalat Sec. Litigation*, 594 F. Supp. 2d 444 (S.D.N.Y. 2009) (holding in a tort suit that Deloitte & Touche USA had not established that it was entitled to summary judgment based upon its claim that it did not control an Italian accounting firm which was a member of the same accounting group as Deloitte & Touche USA). See also *United States v. Vetco Inc.*, 691 F.2d 1281 (9th Cir. 1981) (affirming

order enforcing summonses issued to U.S. company and to its U.S. auditing firm for records maintained in Switzerland by the company's Swiss subsidiary and the auditing firm's Swiss affiliate).

iv. Formal Document Requests

1. Formal document requests (FDR) under I.R.C. § 982 supplement the IRS's administrative summons power where a summons may not be an effective means of obtaining production of documents held abroad. Under § 982(a), if a taxpayer fails to substantially comply with a request for foreign-based documentation relating to an item under examination within 90 days of the mailing of the request, the taxpayer is prohibited from introducing the foreign-based documentation into evidence in any civil proceeding in which the tax treatment of the item under examination is at issue.

a. An FDR is defined in I.R.C. § 982(c)(1) as:

- i. any request (made after the normal request procedures have failed to produce the requested documentation) for the production of *foreign-based documentation* which is mailed by registered or certified mail to the taxpayer at his last known address and which sets forth—
  1. the time and place for the production of the documentation,
  2. a statement of the reason the documentation previously produced (if any) is not sufficient,
  3. a description of the documentation being sought, and
  4. the consequences to the taxpayer of the failure to produce the documentation described in subparagraph (C).

b. Foreign Based Documentation

- i. Defined as “any documentation which is outside the United States and which may be relevant or material to the tax treatment of the examined item.” I.R.C. § 982(d)(1).

c. Tax Division Involvement in FDRs

- i. The Government then can seek to compel compliance with the FDR in the proceeding to quash.
- ii. The second situation arises when a taxpayer fails to substantially comply with an FDR. In that event, the Government can file a motion invoking the exclusionary rule in I.R.C. § 982(a) in any appropriate civil proceeding.

1. If a non-complying taxpayer does not file a petition to quash, the Government's remedy is to invoke the exclusionary rule if the taxpayer later attempts to introduce foreign-based documents subject to the FDR in a civil proceeding.
2. The exclusionary rule is subject to a reasonable-cause exception provided in I.R.C. § 982(b)(1). Section 982(b)(2), however, states that "the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause."

IX. Suits to Collect - Tax Division, U.S. Department of Justice

a. Overview

- i. The IRS (Office of Chief Counsel) refers FBAR penalty assessments to the Tax Division (DOJ) to file complaints to reduce the assessments to judgment before the applicable statute of limitations expires.
- ii. The referral includes the IRS's materials regarding the assessment.
- iii. DOJ reviews the referral and will work with the IRS if there are any questions about the referral.
- iv. If there is time, DOJ might issue a pre-suit letter if there is sufficient time left before the statute of limitations on filing suit expires.
- v. DOJ can draft and file complaints relatively quickly if necessary, so assessed persons should not think that just because the SOL is about to expire and no case has been filed that the Government will miss the deadline.
- vi. In *U.S. v. Garrity*, (DC CT, 4/3/2018) 121 AFTR 2d ¶2018-629, the IRS filed suit to collect and reduce FBAR penalties to judgment. 31 USC 5321(b).
- vii. Court held that IRS may prove that failure to timely file a FBAR by a preponderance of the evidence rather than by a higher, clear and convincing evidence standard. The court also determined that IRS could show willfulness on the taxpayer's part by proof of his reckless conduct and did not need to show that he intentionally violated a known legal duty. The case is scheduled for trial in June 2018.
- viii. Courts that have considered the burden of proof issue with regard to FBAR have held that the preponderance of the evidence standard governs suits by IRS to recover civil FBAR penalties. *Bedrosian v. U.S.*, (DC PA 9/20/2017) 120 AFTR 2d 2017-5832; *U.S. v. Bohanec*, (DC CA 2016) 118 AFTR 2d 2016-6757; *U.S. v. McBride*, (DC UT 2012) 110 AFTR 2d 2012-6600; *U.S. v. Williams*, (2010, DC VA) 106

AFTR 2d 2010-6150, *rev'd on other grounds, U.S. v. Williams*, (CA 4 2012) 110 AFTR 2d 2012-5298.

- ix. Courts have found that willfulness in the civil FBAR context includes reckless conduct. (*U.S. v. Williams, supra; U.S. v. Kelley-Hunter*, (D.D.C. 2017) 120 AFTR 2d 2017-6778; *U.S. v. Katwyk*, (C.D. Cal. 10/23/2017) 120 AFTR 2d 2017-6380; *Bedrosian v. U.S., supra; U.S. v. Bohanec, supra; U.S. v. Bussell*, (C.D. Cal. 12/8/2015) 117 AFTR 2d 2016-439; *U.S. v. McBride, supra; U.S. v. Williams, supra*.)
- b. Use of Expert Testimony – Can willfulness element be overcome by expert testimony?
  - i. Can a defendant in a suit to reduce a civil penalty assessed under 31 U.S.C. §5321(a)(5) use expert testimony regarding intent?
    1. F.R.E. 702: provides that a “witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if...the expert’s scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue,” among other requirements. The Court must determine whether the proposed “expert testimony is relevant, i.e., whether it has any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence.
    2. In *U.S. v. Garrity*, (DC CT, 4/3/2018) 121 AFTR 2d ¶2018-629, the defendant sought to introduce expert testimony on the following issues:
      - i. General reporting requirements as they related to Foreign Financial Accounts and Foreign Trusts; and
      - ii. General guidance published by the IRS, the Dept. of Treasury, and FINCEN explaining the rules and reporting requirements to taxpayers and practitioners relating to such vehicles for the year the subject penalty is assessed.
      - iii. The state of published guidance and public awareness of foreign account reporting requirements so as to provide an objective backdrop or perspective;
      - iv. How such guidance evolved in the years before and after the subject year [i.e., 2005], and how, in that climate, international tax compliance has been viewed and understood by practitioners and taxpayers; and
      - v. Whether an individual taxpayer could have been aware of his filing foreign income and asset reporting requirements.

- b. The court felt that the jury may be lead to incorrectly conclude that willfulness depends on the degree to which the IRS enforced, publicized or explained the reporting obligations, or the degree to which other were aware of it.
  - c. 8th Amendment-Excessive Fine Clause
    - i. The Supreme Court has declined to review a Ninth Circuit decision in a foreign bank account reporting penalty case and denied review of other petitions challenging tax liabilities, penalties, and IRS collection actions.
    - ii. Letantia Bussell petitioned the Supreme Court to review a Ninth Circuit decision that affirmed a district court's grant of summary judgment to the government and upheld a \$ 1.2 million penalty against her for violating FBAR requirements.
    - iii. Bussell was assessed with the penalty for failing to disclose her financial interests in a Swiss bank account. In her petition (*2018 TNT* 28-25), Bussell argued that the penalty violates the Eighth Amendment excessive fines clause.
    - iv. Bussell also claimed that the government improperly used information obtained under the Swiss-U.S. tax treaty in determining her FBAR violation.
    - v. The Court denied review April 30. *Bussell v. United States*, Sup. Ct. Dkt. No. 17-1052 (2018), No. 16-55272 (2017-93309) (9th Cir. 2017).

## X. Collection of Judgments

- a. Collecting Judgments Pursuant to Federal Debt Collection Procedures Act, 28 USC 3001-3308.
  - i. FDCPA provides three remedies for enforcing civil judgments: execution, garnishment, and installment payment orders. Courts can issue any other writs under 28 USC 1651 to support these remedies.
    - 1. When application is made for a writ of execution, a writ of garnishment, or an installment payment order, the government must prepare a notice to debtor for service by the clerk of the court. 28 USC 3202(b).
    - 2. The notice advises debtor property has been seized, identifies debt owed, describes potential exemptions, explains procedure and time (20 days) to request hearing, and gives notice of intent to sell the property.
    - 3. 28 USC 3014(a)(2)(A) - rule for determining which state's exemption law applies.
    - 4. The debtor can only claim exemptions, object to procedural defects, or for default judgments, argue validity of claim and good cause to set aside.
- b. Collecting Judgments Pursuant to Federal Debt Collection Procedures Act Execution - Selling Property
  - i. 28 USC 3007 - Sale of Perishable Property

- ii. 28 USC 3010 - Co-owned Property
- iii. 28 USC 3015 - Discovery as to debtor's financial condition
- iv. 28 USC 3201 – Judgment Liens
- v. 28 USC 3202(e) – property subject to sale may be sold by judicial sale under 28 USC 2001, 2002 and 2004, or by execution sale under 28 USC 3203(g)
- vi. 28 USC 3203 – Execution (real and personal property)
- c. Collecting Judgments Pursuant to Federal Debt Collection Procedures Act Garnishments
  - i. Government must file application for writ of garnishment in accordance with 28 USC 3205 that includes balance due under judgment and a belief that garnishee possesses property in which the debtor possesses a substantial nonexempt interest.
  - ii. A wage garnishment is limited to 25% of disposable income (75% of disposable income is exempt). A garnishment writ has continuing effect. 28 USC 3205; 28 USC 3002(9).
  - iii. Writ is issued *ex parte* with notice given to garnishee and debtor.
  - iv. Writ directs garnishee to withhold property and file answer, and gives instructions to debtor about filing objections and requesting hearing.
- d. Collecting Judgments Pursuant to Federal Debt Collection Procedures Act Court-Ordered Installment Payments
  - i. Court-ordered installment payments under 28 USC 3204 are particularly effective against self-employed debtors - lawyers, doctors, accountants, and consultants often immune from garnishments.
  - ii. Government must file a motion demonstrating debtor has substantial earnings from self-employment, or is diverting or concealing earnings.
  - iii. An installment payment order cannot be obtained if there is a writ of garnishment on the same earnings and based on the same debt.
  - iv. Government can request monthly or shorter period payments.
  - v. Government can request a specific amount, payment of all earnings in excess of a floor amount, or percentage of earnings.
  - vi. Parties can seek modification under 28 USC 3204(b) for change in financial circumstances or discovery of previously undisclosed assets.
  - vii. Failure to comply can result in fines or conditional imprisonment for civil contempt.

## XI. Suits to Challenge FBAR Penalty

- a. Taxpayer Suits to Challenge FBAR Penalties
  - i. Taxpayers can pay penalty or wait until government collects by administrative means (e.g., offsets) and then file a suit for money damages under the Tucker Act (28 USC 1491) in the Court of Federal Claims, or under the Little Tucker Act (28 USC 1346(a)(2)) (for claims not exceeding \$10,000) in the U.S. District Courts (concurrent jurisdiction with the Court of Federal Claims).
  - ii. Tucker Act and Little Tucker Act waive sovereign immunity for claims for money damages against the U.S. for “illegal exaction,”

defined as money improperly paid, exacted, or taken from the claimant in contravention of the Constitution, a statute, or a regulation.”

*Norman v. United States*, 429 F.3d 1081, 1095 (Fed. Cir. 2005).

- iii. A cause of action in a Tucker Act suit accrues as soon as all events have occurred that are necessary to enable plaintiff to bring suit; in other words, “when all events have occurred to fix the government's alleged liability, entitling claimant to demand payment and sue for his money.” *Martinez v. United States*, 333 F.3d 1295 (Fed. Cir. 2003).
- iv. FBAR penalty is not assessed or collected under the internal revenue laws, so the full payment rule of *Flora v. United States*, 362 U.S. 145 (1958) does not apply. *Greene v. United States*, 124 Fed. Cl. 636, 641 (2015) (noting that illegal exaction claim does not require the taxpayer to first fully pay the tax liability).
- v. Taxpayer has 6 years after “claim first accrues” to file suit under the Tucker Act (28 USC 1491) in the U.S. Court of Federal Claims. *See* 28 USC 2501.
- vi. Taxpayer has 6 years after “the right of action first accrues” to file suit in either U.S. Court of Federal Claims or District Court under the Little Tucker Act (28 USC 1346(a)(2)). *See* 28 USC 2401(a).
- vii. There is no right to a jury trial in the U.S. Court of Federal Claims, and no right to a jury trial for an action to recover money from the United States in the U.S. District Court, except in tax refund suits. 28 USC 2402.
- viii. There is a right to a jury trial in an action brought by United States to impose a civil penalty. *See Tull v. United States*, 481 U.S. 412 (1987) (right to jury trial in suit by government to assess penalties under Clean Water Act). Thus, if the government sues or countersues to collect the FBAR penalty in the U.S. District Court, the taxpayer has the right to demand trial by jury.
- ix. Administrative Procedure Act (APA) Challenges
  1. In *Kentera v. United States*, (E.D.WI. 2017), the court noted that the “APA provides a waiver of sovereign immunity when two prerequisites are met. First, the action in question must ‘see[k] relief other than money damages and stat[e] a claim that an agency or an officer or employee thereof acted or failed to act in an official capacity or under color of legal authority.’ *See* 5 U.S.C. 702. Second, the plaintiff must show that (1) review of the agency action in question is authorized by a substantive statute or (2) review is made of a ‘final agency action for which there is no other adequate remedy in a court.’ *Id.* § 704; *Bowen v. Massachusetts*, 487 U.S. 879, 891-93 (1988).”
  2. The government argued that the Kenteras had adequate remedies outside the instant suit because they can pay some or all of the penalties and then file a refund suit, which would allow them to raise a reasonable cause defense. Alternatively, if the Kenteras declined to pay the penalties, they could assert

the reasonable cause defense during a suit brought by the government to reduce the penalties to judgment pursuant to 31 U.S.C. 5321(b)(2).

3. The court held that the Kenteras failed to prove that sovereign immunity had been waived because they had an adequate alternative to this lawsuit in either the Tucker Act or the Little Tucker Act, even though an APA claim may be more advantageous in the short term.

## XII. Bankruptcy Procedures re: FBAR Penalties-IRM 5.9.4.21 (12-18-2017)

- a. *Delegated authority*: Delegation Order 25-13 effective April 11, 2012 authorizes bankruptcy specialists grade 9 and above to prepare and file proofs of claim for FBAR penalties and to take appropriate action to protect the government's interest in bankruptcy, state and federal receiverships, and other state and federal insolvency actions.
- b. *Systemic tracking*: FBAR penalties are maintained on a database at the Enterprise Computing Center – Detroit (ECC-DET) and can only be checked by IRS personnel in Detroit. *FBAR cases are not loaded onto AIS or IDRS because FBAR cases are not tax cases.*
- c. *Interagency agreement*: The IRS has entered into an agreement with BFS to prepare proofs of claim in cases when a debtor with an FBAR penalty assessment has filed bankruptcy. When debtors report FBAR penalties as debts in their bankruptcy petition and schedules, clerks of bankruptcy courts send notices to BFS in Birmingham, Ala. BFS forwards bankruptcy notices to the ECC-DET.
- d. *ECC-DET duties*: When the ECC-DET receives bankruptcy notices, it inputs the bankruptcy indicator on the FBAR penalty database. All FBAR bankruptcy penalty cases are processed by and assigned to the Los Angeles Field Insolvency office. ECC-DET provides the following account information to the FBAR penalty bankruptcy caseworker in the Los Angeles Insolvency office:
  - i. Debtor name and address and SSN.
  - ii. Balance(s) due for both the penalty and statutory additions.
  - iii. Assessment date and CSED.
- e. *CSED*. Currently, the IRS has no procedures for soliciting a waiver of this two-year statute of limitations. Filing a bankruptcy petition does not suspend the running of the collection statute expiration date. However, if the FBAR collection statute has not expired upon the date of filing of the bankruptcy petition, 11 USC 108(c) extends the time to file an FBAR collection suit until the later of the end of the two year collection period, or 30 days after notice of the termination or expiration of the stay under 11 USC 362, 922, 1201, or 1301, as the case may be, with respect to the claim.
- f. *Creditor Name*. IRS Insolvency prepares manual FBAR proofs of claim listing the creditor as the BFS at the following address:
  - i. *US Treasury  
Bureau of the Fiscal Service*

P.O. Box 830794  
ATTN: Debit Services Branch  
Birmingham, AL 35283-0794

- g. *Claim Calculations.* FBAR claims are always classified as unsecured general and include the FBAR penalty amount and interest. Insolvency may have to coordinate with BFS or the ECC-DET to determine the appropriate interest to report on a claim, because the interest rate on these penalties is subject to change. Also, a late payment penalty may be assessed under Title 31, and collection costs may be assessed.
- h. *Claim Distribution.* The FBAR bankruptcy caseworker files the FBAR proof of claim with the bankruptcy court and must provide copies of the FBAR claim to the ECC-DET, the Insolvency Territory Manager, BFS, the debtor, and debtor's counsel. In addition, all FBAR cases must be referred to local Counsel along with a copy of the proof of claim.
- i. *FBAR Plan Review.* Associate Area Counsel is responsible for reviewing bankruptcy plans as to the treatment of the unsecured general claim for the FBAR penalty. If the IRS is a creditor for unpaid federal taxes or statutory additions to taxes under the same docket number as the FBAR penalty, the assigned FI caseworker will process the non-FBAR assessments following established procedures for the chapter under which the bankruptcy has been filed.
- j. *Payments on FBAR Accounts.* FBAR payments received from the bankruptcy proceedings must be mailed for processing to BFS at the address given in paragraph (10) above.
- k. *FBAR Case Monitoring.* The ECC-DET will:
  - i. Record payments if the bankruptcy indicator is on the account;
  - ii. Process abatements;
  - iii. Process full payment of the debt;
  - iv. Reverse the bankruptcy indicator; and
  - v. Return the account to regular collection status if appropriate.
- l. *Dischargeability of the FBAR Penalty.* The FBAR penalty is excepted from discharge in individual Chapter 7 and 11 cases under 11 USC § 523(a)(7). Counsel should be consulted if questions arise concerning the FBAR penalty and dischargeability.

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<sup>i</sup> Tax professionals representing clients with international information return filing requirements should make sure to put the specific form (i.e. 3520, 5472) on the Form 2848, *Power of Attorney and Declaration of Representative*, even if the form attaches to the income tax return. A representative will not be notified regarding forms that accompany an income tax return unless such form is specifically included on their Form 2848, including penalties associated with such return. I.R.S. Chief Couns. Memo. 36021 (Sep. 8, 2017).



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**New York Field Office**

**Justin Campbell, Assistant Special Agent in  
Charge (ASAC)**





# Today's Mission



- Overview of CI
  - CI as a Federal Law Enforcement Agency
  - History of CI
  - CI Compared to Other IRS Business Units
  - Field Operations and the New York Field Office
- Investigative Priorities
- Hot Topic – Employment Tax Fraud
- Case Examples



# CI as a Federal Law Enforcement Agency



- ❑ **CI special agents** - full range of law enforcement duties (making arrests, executing search and seizure warrants, and performing undercover operations)
  - ❑ Four year degree plus at least 15 credit hours of accounting - unique among federal law enforcement
  - ❑ 24 weeks of intensive law enforcement and financial investigation training at FLETC
- ❑ **CI has 21 field offices nationwide and 10 foreign posts**
  - ❑ We work closely with the Department of Justice, Tax Division and 94 United States Attorney's Offices
  - ❑ Partner with numerous federal, state and local law enforcement agencies on tax and non-tax investigations





# History of CI



## **Founded in 1919:**

- Created to investigate widespread allegations of tax fraud
- Early high profile investigations
  - ✓ Al Capone
  - ✓ The Lindbergh baby kidnapping

## **Present Day:**

- Only agency that investigates criminal tax violations
- Investigations span the globe (10 foreign posts)
- Tax fraud, terrorist financing, transnational organized crime, public corruption, and cyber crimes are all priority program areas
- Twenty percent decline in agent staffing over decade



## **CI in the Future:**

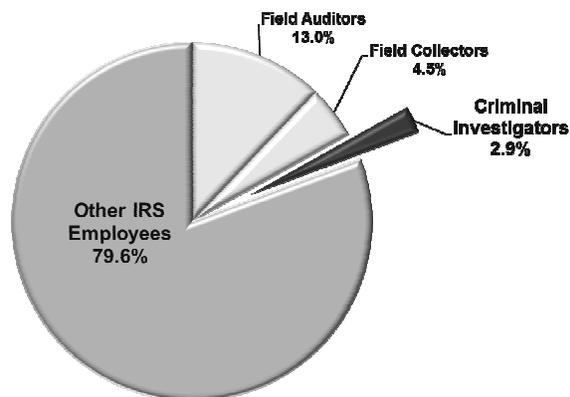
- Data analytics investments will help us to serve US taxpayers more efficiently and effectively



# CI Compared to Other IRS Business Units



**Field Compliance Resources at IRS as FYE2017**

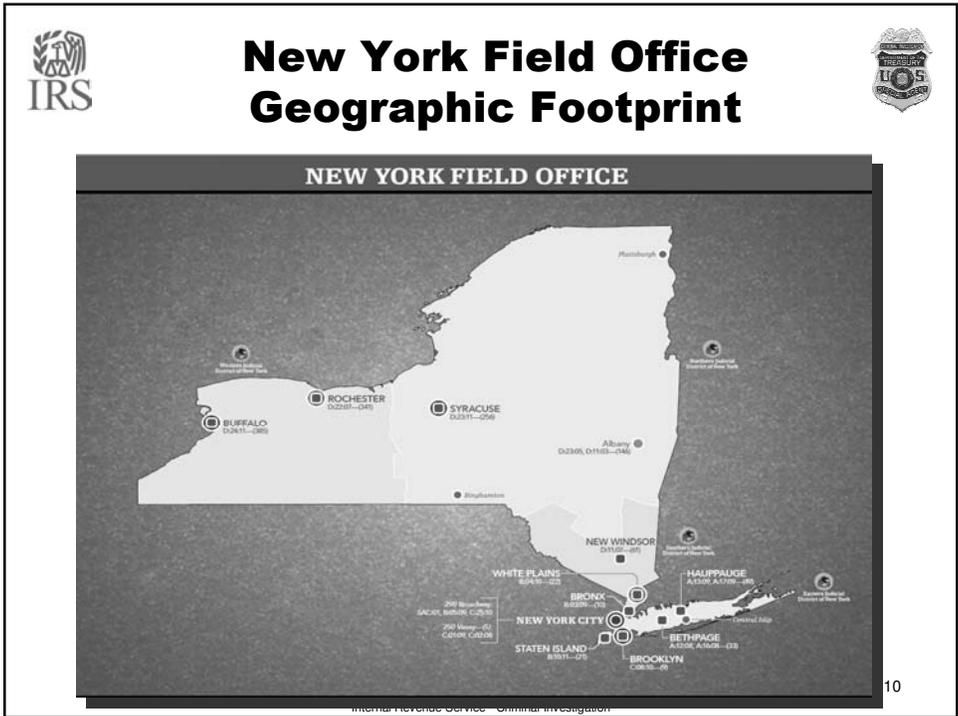




# CI Field Operations



# New York Field Office Geographic Footprint





# Investigative Priorities



## Legal Source Tax Crimes

CI's primary resource commitment and focus is on Title 26 violations such as:

- Tax evasion, employment tax fraud, aiding in filing of a false tax return

## Illegal Source Tax Crimes

Income stemming from illegal sources, such as:

- Fraud schemes, public corruption, ID Theft

## Counter-terrorism Financing

CI participates in FBI's National Joint Terrorism Task Force (NJTTF) and regional Joint Terrorism Task Forces (JTTF)

## Narcotics-related Financial Crimes

Federal Prosecutors utilize CI's investigative expertise to disrupt and dismantle drug traffickers and cartels

## Transnational Organized Crime

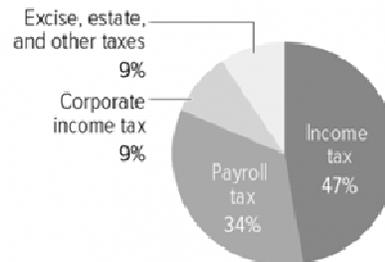
CI targets TOC perpetrated by cybercriminals and cartels in partnership with other federal law enforcement counterparts



# Employment Tax



- Primary Criminal Statute is Title 26 USC § 7202
- Priority area for CI and DOJ
- Average restitution exceeds \$2 million per case
- Average sentence is 24 months



Note: "Other Taxes" category includes profits on assets held by the Federal Reserve. Figures do not total 100% due to rounding.

Source: Office of Management and Budget

CENTER ON BUDGET AND POLICY PRIORITIES | CBPP.ORG



## Case Example - Employment Tax Fraud

FOR IMMEDIATE RELEASE

Wednesday, August 1, 2013

### Owner of Long Island Commercial Check Cashing Companies Indicted for Financial Fraud

#### John Drago Also Charged with Tax Fraud for Paying Employees Off the Books Through His Management Company, Hogwarts Inc.

An eight-count indictment was unsealed today in federal court in Central Islip charging John Drago, the owner and compliance officer of the Kayla Companies, with multiple criminal violations of the Bank Secrecy Act, including failure to file required Currency Transaction Reports ("CTRs") for customers receiving in excess of \$10,000. Drago is also charged in the indictment with failure to collect and pay taxes. Drago was arrested today, and arraigned this afternoon before United States Magistrate Judge A. Kathleen Tomlinson. Drago was released on a \$500,000 bond.

Internal Revenue Service - Criminal Investigation  
Internal Revenue Service - Criminal Investigation

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## Case Example - Filing a False Tax Return

FOR IMMEDIATE RELEASE

Wednesday, August 1, 2013

### Former Suffolk County Legislator Fred Towle, Jr., Pleads Guilty to Making a False Tax Return

#### Towle Failed to Report More Than \$1 Million in Consulting and Expediting Fees

Earlier today, in federal court in Central Islip, Fred Towle, Jr., pleaded guilty to making and subscribing a false tax return for the calendar year 2012 that underreported business income in order to avoid paying the proper tax owed. The guilty plea was entered before United States Magistrate Judge A. Kathleen Tomlinson. When sentenced, Towle faces a statutory maximum of three years in prison and a fine of up to \$250,000. As part of his plea, Towle has agreed to pay \$307,427 in restitution, the full amount of his tax liabilities.

Internal Revenue Service - Criminal Investigation

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# Case Example – ConEd Bribery Scheme



## PRESS RELEASE

### CON ED CONTRACTOR SENTENCED TO 48 MONTHS' IMPRISONMENT FOR BRIBERY AND TAX EVASION CHARGES

#### Defendant Concealed and Then Deducted Bribe Payments to Con Ed Supervisors as Business Deductions on His Companies' Tax Returns

Yesterday, in federal court in Brooklyn, Rodolfo Quiambao, the former President and Chief Executive Officer of the engineering and electrical design firm Rudell & Associates, Inc. (Rudell), was sentenced to 48 months' imprisonment for federal programs bribery and tax evasion in connection with his scheme to pay bribes and kickbacks to supervisors at Consolidated Edison of New York (Con Ed) in exchange for receiving lucrative contracts and other benefits from the public utility services provider. Quiambao was also sentenced to pay a \$125,000 fine and more than \$4.5 million in restitution to the IRS. At the time of his guilty plea in March 2016, Quiambao agreed to forfeit \$1 million in criminal proceeds. Yesterday's sentencing took place before United States District Judge Allyne R. Ross

Internal Revenue Service - Criminal Investigation  
Internal Revenue Service - Criminal Investigation

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## Civil vs Criminal Tax

### The Life Cycle of an Investigation

What do IRS-CI Special Agents focus on when investigating allegations of Criminal Behavior & the role of Defense Counsel, Investigator and Forensic Accountant.

**Moderator:** Thomas E. Bishop, Senior Manager | NT IRS Practice and Procedures, Baker Tilly Virchow Krause, LLP

#### **Panelists:**

Alan Katz, CPA, CFF, Guidepost Solutions, LLC

Michael Sardar, Esq., Kostelanetz & Fink, LLP

Jim Robnett, Special Agent in Charge, New York Field Office, IRS Criminal Investigation, New York, NY



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## How Do Criminal Investigations Begin at the IRS?

**Agency Referrals** – Law enforcement agencies, federal or state agencies, or other divisions of the Internal Revenue Service.

**Financial Reporting Forms** – The filing or the failure to file financial forms such as CTRs, SARs, and Forms 8300.

**Independent Criminal Investigations** – Agents review of Media and Public Records.

**Informants** – Often disgruntled employees, ex-wives, ex-business partners, etc.

**Whistleblowers** – Similar to Informants, often with significant evidence and maybe rewarded for information provided.

**Request to Join a GJ Investigation** at the U.S. Attorney's Office.

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## Overview of Crimes IRS-CI Investigates

### **The Internal Revenue Code**

Title 26 USC § 7201 – Evasion

Title 26 USC § 7202 – Failure to Collect or Pay Over

Title 26 USC § 7203 – Failure to File

Title 26 USC § 7206 – Filing a False Return, etc.

Title 26 USC § 7212 – Corrupt or Forcible Interference

### **The Bank Secrecy Act**

Title 31 USC § 5324(a)(1) – Fail to file report

Title 31 USC § 5324(a)(2) – File a false report

Title 31 USC § 5324(a)(3) – Structuring

### **The Money Laundering Control Act**

Title 18 USC § 1956(a)(1)(A)(i) – Promotion

Title 18 USC § 1956(a)(1)(B)(i) – Concealment

Title 18 USC § 1957 – Spending > \$10,000

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## The Life Cycle of a Criminal Investigation

**Allegation of Criminal Behavior**– CI receives a “Lead” describing alleged criminal behavior relating to the tax liability of an individual or business.

**Review of Information**– Lead is assigned to a Special Agent (SA), where the SA thoughtfully, discretely, quietly reviews the information. Careful consideration is given to the source and credibility of the lead.

*Note - SAs are very cognizant not to take overt steps during the evaluation in order to protect taxpayers reputation from frivolous and unfounded accusations.*

**Result of the Review** – If the allegations prove to be credible and have significant merit, an investigation is authorized by management and overt steps are taken.

**The Investigation** – This is a lengthy process, where the SA follows a methodical plan of action in order to obtain evidence to prove or disprove the allegations. Experience will guide the investigator, however, the body of evidence (not opinion) proves or disproves the allegation of tax fraud.

**Legal Representation** – This can occur at any stage of the investigation.

**Government Prosecutors**– Collaboration with government prosecutors and SAs can occur at any stage of the investigation, either in a GJ setting or after the investigation is completed and charges are approved by the DOJ Tax Division.

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## The Life Cycle of a Criminal Investigation

**Cooperation by Subject** – In most cases, the Subject becomes aware they are being investigated prior to an Indictment. Depending on the investigative strategy and legal representation, there are opportunities for the cooperation by the Subject.

**Indictment/Information** – Evidence collected is presented to the Federal Grand Jury by the government prosecutor. If the members of the GJ believe the evidence supports the criminal charge, the GJ will issue a True Bill. This is only a formal accusation that a person has committed a crime. It’s the burden of the government to prove beyond a reasonable doubt and obtain a unanimous verdict from a 12 person trial jury.

**Arrest** – An arrest warrant is issued by a US Magistrate Judge and the IRS Agents conduct the arrest. The subject appears before the judge and answers the charge.

**Discovery**– The government provides all the evidence gathered in the investigation to the subject and his/her legal representatives.

**Legal Proceedings** – Depending on the complexity and legal issues, there can be a number of pre-trial hearings.

**Pleading/Trial** – Legal Representatives review the evidence gathered and consider the best options for their client. This will result in either a voluntary pleading of guilty to one or more of the indicted charges or a trial; where it’s the governments burden to prove the charges “beyond a reasonable doubt”.

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## Willfulness (all crimes of the IRC)

Must prove the state of mind – more than just an **INTENT-ional** act

1. Voluntary
2. Intentional
3. Violation Of a Known Legal Duty
4. Conscious and knowing decision to do (or fail to do) something
5. Deliberate Acts
6. Specific **INTENT** To Violate the Law

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## Willfulness is NOT

- An honest mistake
- An accident
- A good faith act
- Reliance on a CPA, attorney, etc.

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**United States v. Kovel, 296 F.2d 918  
(2d Cir. 1961)**

**“Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases.”**

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## Kovel

- “[T]he presence of an accountant . . . while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege.”
- “What is vital to the privilege is that the communication be made in confidence for the purpose of obtaining legal advice from the lawyer. If the advice sought is not legal advice but only accounting service . . . , or if the advice sought is the accountant’s rather than the lawyer’s, no privilege exists.”

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# Kovel

- The burden of establishing the essential elements of the *Kovel* attorney-client privilege falls on the party claiming that the privilege applies
- The two essential elements to prove application of *Kovel* are:
  - that the purported *Kovel* expert was engaged *specifically* to assist counsel in rendering *legal advice* to a *particular client*
  - that the services of the purported *Kovel* expert were *necessary to translate, interpret or explain* communications between the client and attorney that the attorney would not otherwise fully comprehend

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# Kovel

- **Psychiatrists**
  - For example, a psychiatrist “employed by counsel for a defendant to assist him in preparing a defense” fell within privilege
    - *Ursry v. State*, 428 So.2d 713, 714-15 (Fla. Dist. Ct. App. 4th Dist. 1983)
- **Patent agents**
  - For example, communications with a patent agent “acting to assist an attorney to provide legal services” were privileged
    - *Golden Trade, S.r.L v. Lee Apparel Co.*, 143 F.R.D. 514, 518 (S.D.N.Y. 1992)
- **Polygraph examiners**
  - For example, a defendant’s communications with a polygraph examiner hired by the defendant’s attorney were privileged
    - *State v. Rickabaugh*, 361 N.W.2d 623, 625 (S.D. 1985)

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# Tax Evasion and Abusive Tax Schemes

### Oil Investor Zukerman Gets Almost Six Years for Tax Evasion

By Christian Berthelein  
March 21, 2017 12:29 PM Updated on March 21, 2017 12:29 PM

- Amended returns show income \$17 million more than U.S. knew
- Defense lawyers sought minimal sentence, citing age and health

Oil industry investor Morris Zukerman was sentenced to 70 months in prison and \$45 million in taxes, a scam that included a bogus \$1 million charitable deduction on his own accountants. He was also fined \$10 million.

"I recognize and profoundly regret the criminal offenses I committed," Zukerman said in a prepared statement. "This is painful to acknowledge."

Zukerman's schemes were even more robust than those uncovered by prosecutors. In his guilty plea last year, Zukerman admitted claiming millions of dollars in deductions, providing false information and documents and failing to report undeclared income that was more than \$17 million higher than what the government's indictment, prompting prosecutors to argue that Zukerman doesn't deserve a lenient sentence.

In his guilty plea last year, Zukerman admitted claiming millions of dollars in deductions, providing false information and documents and failing to report undeclared income that was more than \$17 million higher than what the government's indictment, prompting prosecutors to argue that Zukerman doesn't deserve a lenient sentence.

Authorities alleged that part of Zukerman's tax evasion involved his art dealer's million worth of Old Masters paintings shipped to addresses in Delaware and New York to avoid New York state sales tax. The paintings almost immediately ended up in his Park Avenue duplex. He also agreed to pay New York state \$4.6 million.

In support of their sentencing position, prosecutors submitted emails between Zukerman and others coordinating the delivery of art to his New York apartment after it was shipped to Delaware, and emails in which he openly discussed profits from the art that he didn't declare to tax authorities.

... and are views expressed by the government participants, and do not necessarily represent official DOJ or IRS policy.

### Ex-Electrical Engineer at Los Alamos Gets Prison in Tax Case

A former electrical engineer who worked at New Mexico's Los Alamos National Laboratory for almost 30 years has been sentenced to 33 months in federal prison for filing false tax returns.

AP

ALBUQUERQUE, N.M. (AP) — A former electrical engineer who worked at New Mexico's Los Alamos National Laboratory for almost 30 years has been sentenced to 33 months in federal prison for filing false tax returns.

Prosecutors say 62-year-old Darryl Gutierrez of Santa Fe also was ordered Tuesday to pay more than \$174,000 in restitution to the Internal Revenue Service.

Gutierrez was indicted in November 2015 on one count of obstructing and impeding the due administration of the internal revenue laws and 10 counts of making and subscribing to false tax returns.

A jury convicted him on all 11 counts in March 2017.

Prosecutors say that between November 2010 and January 2011, Gutierrez filed 10 false federal income tax returns for tax years 2000 to 2009 seeking a refund when he owed the IRS about \$125,000.

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## Tax Implications of Bitcoins IRS Notice 2014-21

- Virtual Currency - treated as property and not as currency for federal tax purposes
- Receipt of virtual currency as payment for goods or services is includible in income at its fair market value at the date of receipt
- Virtual currency received by an independent contractor or an employee constitutes income
- Constitutes self-employment income or wages
- A taxpayer who "mines" virtual currency realizes gross income upon receipt
- If "mining" constitutes a trade or business, and the taxpayer is not an employee, the taxpayer is subject to self-employment tax on the income

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## Cyber & Dark Web Enforcement

### IRS & IRS CI's Approach & Investment in this Area

IRS Security Summit - a formal public-private partnership

Establishment of a National Cyber Crimes Unit – Connects CI to Enterprise IRS on emerging issues brought from special agents in the field.

Nationally Coordinated Investigations Unit (NCIU) – A Data Driven national effort and heavy data analytics component of CI, to better identify and develop areas of non-compliance

East & West Coast Field Office Cyber Crime Units – Special Investigative Groups with the skill-set to identify Cyber enabled vs dependent crime

Field Office Computer Investigative Specialists/Special Agents – support field operations by securing digital evidence

Special Agents Embedded with Law Enforcement Partners

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## Cyber & Dark Web Enforcement

### Investigations to date have revealed the following criminal conduct:

- Selling/buying of PII on the internet
- Data intrusion/exfiltration
- Compromise of PII databases through the internet
- Dark web marketplace owners/administrators/large vendors
- Business e-mail compromise in regards to money laundering
- Bank account takeovers
- Phishing as it effects the integrity of the U.S. tax system
- Terrorist financing
- Virtual currency money launderers and exchangers to facilitate money laundering
- Tax evasion through the use of virtual currency/embezzlement
- Virtual currency use to conceal political corruption/illegal campaign contributions

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# Cyber & Dark Web Enforcement

**The New York Times**

**The Tax Sleuth Who Took Down a Drug Lord**

By HARVARDL POKER 2017-06-29



Gary L. Alford was running on adrenaline when he arrived for work on a Monday in June 2013, at the Drug Enforcement Administration office in the Chelsea neighborhood of Manhattan. A tax investigator, he had spent much of the weekend in the living room of his New Jersey townhouse, scrolling through arcane chat rooms and old blog posts, reading on well after his fiancée had gone to sleep.

The work had given Mr. Alford what he believed was the answer to a mystery that had confounded investigators for nearly two years: the identity of the mastermind behind the online drug bazaar known as Silk Road — a criminal known only by his screen name, Dread Pirate Roberts.

When Mr. Alford showed up for work that Monday, he had a real name and a location. He assumed the news would be greeted with excitement. Instead, he says, he got the brushoff.

He recalls asking the prosecutor on the case, out of frustration, "What about what I said is not compelling?"

U.S. indicts suspected Russian 'mastermind' of \$4 billion bitcoin laundering scheme

Jack Stubbs, Karolina Tagaris, Anna Izcera 4 MIN READ

NEW YORK/ATHENS-MOSCOW (Reuters) - A U.S. jury indicted a Russian man on Wednesday as the operator of a digital currency exchange he allegedly used to launder more than \$4 billion for people involved in crimes ranging from computer hacking to drug trafficking.

Alexander Vinnik was arrested in a small beachside village in northern Greece on Tuesday, according to local authorities, following an investigation led by the U.S. Justice Department along with several other federal agencies and task forces.

U.S. officials described Vinnik in a Justice Department statement as the operator of BTC-e, an exchange used to trade the digital currency bitcoin since 2011.

They alleged Vinnik and his firm "received" more than \$4 billion in bitcoin and did substantial business in the United States without following appropriate protocols to protect against money laundering and other crimes.

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# Counterterrorism & Terrorist Financing

## Manhattan Skyscraper Linked to Iran Can Be Seized by U.S., Jury Finds

By Vivian Wang  
June 29, 2017



The tower at 650 Fifth Avenue can be seized by the United States government and sold, with proceeds going to the families of victims of terrorism connected to Iran, a jury found on Thursday.

Justin Lane/European Pressphoto Agency

The government can seize a skyscraper in Midtown Manhattan that it says is controlled by Iran, a jury concluded on Thursday, allowing federal prosecutors to complete what they called the largest terrorism-related civil forfeiture in United States history.

The jury, which deliberated for one day after a month of testimony, found that the Alavi Foundation, which owns 60 percent of the 36-floor skyscraper at 650 Fifth Avenue, violated United States sanctions against Iran and engaged in money laundering through its partnership with Assa Corporation, a shell company for an Iranian state-controlled bank that had owned the remaining 40 percent.

Defense lawyers had argued that Alavi did not know of Assa's ties to the Iranian government after the United States imposed sanctions in 1995.

The government has agreed to distribute proceeds from the building's sale, which could bring as much as \$1 billion, to the families of victims of terrorism, including the Sept. 11 attacks, where Iran has been found to have had some culpability. The office tower is highly coveted real estate; Nike recently signed a 15-year deal to rent seven of its 36 floors.

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## Reports On Cash Payments General Information

**Form 8300** - Cash Payments over \$10,000, FinCEN Form 8300/IRS  
Form 8300 31 U.S.C. § 5331/26 U.S.C. § 6050I  
Single, Related and Multiple Transactions

**Anti Structuring Laws** – No Person shall:

1. Cause or attempt to cause a trade or business to fail to file a Form 8300
2. Cause or attempt to cause a trade or business to file a Form 8300 that contains a material omission or misstatement of fact
3. Structure or assist in structuring, or attempt to structure or assist in structuring, any transaction with one or more trades or businesses, to avoid the Form 8300 reporting requirement
  - 26 USC § 6050I(f)(1)      31 USC § 5324(b)

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## Reports On Cash Payments General Information

**Suspicious Activity Report(SAR)** – file a SAR with respect to

1. Criminal violations aggregating \$5,000 or more when a suspect can be identified.
2. Criminal violations aggregating \$25,000 or more regardless of a potential suspect.
3. Transactions conducted or attempted by, at, or through the bank (or an affiliate) and aggregating \$5,000 or more, if the bank or affiliate knows, suspects, or has reason to suspect that the transaction:
  - May involve potential money laundering or other illegal activity (e.g., terrorism financing). FinCEN issued guidance identifying certain BSA expectations for banks offering services to marijuana-related businesses, including expectations for filing SARs. FIN-2014-G001, February 14, 2014.
  - Is designed to evade the BSA or its implementing regulations.<sup>55</sup> Refer to Appendix G ("Structuring") for additional guidance.
  - Has no business or apparent lawful purpose or is not the type of transaction that the particular customer would normally be expected to engage in.....

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## IRS Phone Scam – Still Victimizing US Taxpayers

The screenshot shows the 'IRS Impersonation Scam Reporting' form. It includes a header with the Treasury Inspector General for Tax Administration logo and navigation links. The main content area contains the following sections:

- IRS Impersonation Scam Reporting:** A heading with a sub-heading 'If you believe you have been a victim of an IRS Impersonation Scam, please fill out the form below.' and a small image of a person on a phone.
- What kinds of things should you report?:** A section with a link to a press release.
- ONLINE FORM:** A section with a heading 'Information regarding the IRS Impersonation Scam(s) you wish to report' and several questions:
  - Date of incident: Month and Year dropdowns.
  - Did you suffer a financial loss? Yes/No radio buttons.
  - If Yes, enter amount: Text input field.
  - How did you pay the impersonator? Other, enter method: Text input field.
  - Did you provide the impersonator with any personal or sensitive information? Yes/No radio buttons.
  - How did the impersonator contact you? Text input field.
- Personal Information:** A section with a heading 'Please enter your name, city, state of residence, ZIP code or mail address, and/or your telephone number below. This will never be given need to get in touch with you for additional information.' and fields for Name, City of Residence, State of Residence, ZIP Code, Email Address, and Telephone.

- If you know you owe taxes or you think you might owe taxes, call the IRS at 1.800.829.1040.
- If you know you don't owe taxes or have no reason to think that you owe any then call and report the incident to the Treasury Inspector General for Tax Administration at 1.800.366.4484.
- If you've been targeted by this scam, you should also contact the Federal Trade Commission and use their "FTC Complaint Assistant" at FTC.gov. Please add "IRS Telephone Scam" to the comments of your complaint.

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## Questions?



KOSTELANETZ & FINK, LLP



Candor. Insight. Results.

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# New York State Criminal Tax Update

## LIU Civil and Criminal Tax Controversy Forum

Malinda Sederquist, Esq.  
Agostino & Associates, P.C.

Bernard S. Mark, Esq.  
Scott Kestenbaum, Esq.  
Kestenbaum & Mark, LLP

Joseph T. Conley III  
Attorney-in-Charge  
Tax Crimes Unit  
Suffolk County District  
Attorney's Office

## Agenda

- New York State Criminal Tax Laws
- Identifying and Developing Criminal Cases
- Securing Records
- "Accountant Client Privilege"
- Application of Kovel in Criminal Investigations
- Current Trends in Criminal Tax Prosecutions

## Law Prior to April 7, 2009

Taxpayer willfully <i>and</i> with an intent to evade tax failed to file for 3 consecutive years	FELONY
Taxpayer failed to file for 1 year	MISDEMEANOR <i>regardless of amount of tax</i>
Taxpayer filed false tax return by failing to report income	Possible Class E FELONY <i>even if small amounts of \$\$\$</i>

### Tax Law § 1801(a)

#### Willful Failure to File a Return or Other Required Document

- **Tax Law § 1801(a)** creates a new crime, that of “tax fraud” which applies to all forms of tax evasion, whether accomplished by non-filing, false filing or other fraudulent scheme.
- **New Law** creates 8 categories of tax fraud
  - **Class A Misdemeanor** → **Class B Felony**

## What is Willful?

- **Under Prior Law**, taxpayers were required to have acted “willfully” to have committed a crime
- **Under New Law**, willfully has been defined
- **Tax Law § 1801(c)**, adopting the federal standard defines the term “willfully” as *acting with either an intent to defraud, intent to evade the payment of taxes or intent to avoid a requirement of the tax law, a lawful requirement of the commissioner or a known legal duty*

### Tax Law §1801(a)(1)

#### Willful Failure to File a Return or Other Required Document

Old Tax Law	New Tax Law
The failure to file income or corporate tax returns constituted a felony only if the taxpayer failed to file for three (3) consecutive years.	A felony liability arises if the taxpayer (i) fails to file (even for a single year); (ii) intends to evade tax; and (iii) underpays in an amount that meets the monetary threshold.

**Tax Law §1801(a)(2),(3)**  
**Willfully and Knowingly Making or Filing a False Return or Report or Supplying False Information**

•**Tax Law §1801(a)(2) - Filing of False Documents**

- Tax fraud occurs when a person *willfully*, while *knowing* that a return, report, statement or other document under this chapter contains any materially false or fraudulent information, or omits any material information, files or submits that return, report, statement or document with the state or any political subdivision of the state.

•**Tax Law §1801(a)(3) - Submission of False Information to DTF**

- Applies if a person *willfully* and *knowingly* supplies or submits materially false or fraudulent information in connection with any return, audit, investigation, or proceeding or fails to supply information within the time required by or under the provisions of [the tax law or regulations].

•**Tax Law §1801(a)(2) and (3) include oral submissions**

•**Tax law §1832(b):** tax professionals who *knowingly* provide false documents or make false assertions on behalf of taxpayers during audit will be subject to the same penalties as the taxpayer.

**Tax Law §1801(a)(2),(3)**  
**Willfully and Knowingly Making or Filing a False Return or Report or Supplying False Information**

Old Tax Law	New Tax Law
<ul style="list-style-type: none"> <li>• Knowingly filing a false income/ corporate tax return with intent to evade tax</li> </ul> <p style="text-align: center;">↓</p> <ul style="list-style-type: none"> <li>• Class E felony if the filing resulted in a “substantial understatement” of tax.</li> </ul>	<ul style="list-style-type: none"> <li>• Threshold for a substantial understatement was <i>increased</i> from \$1,500 to \$3,000.</li> <li>• Felony liability will arise in <i>all</i> cases where a materially false submission has been made with an intent to evade a tax or to defraud where the false submission results in a tax evasion &gt;\$3,000.</li> </ul>

## Tax Law complements Penal Law

- It should be noted that the current provisions of the Tax Law complement, but do not supersede, existing Penal Law provisions.
- **Under the Penal Law:**
  - **Misdemeanor:** Knowingly filing a false document with any public office or public servant
  - **Felony:** if the false filing is *made with an intent to defraud* the state or any political subdivision.
  - No minimum monetary threshold applies to the Penal Law statute.
- Taxpayer who files a false income tax return which defrauds New York of less than \$3,000
  - **Under Tax Law** = Misdemeanor
  - **Under Penal Law** = Felony

### Tax Law §1801(a)(4)

#### Willfully Engaging in a Scheme to Defraud the State in Connection With Any Matter Under the Tax Law

- **§1801(a)(4):** provides that a person (not necessarily a taxpayer) commits tax fraud when he *willfully* engages in any scheme to defraud the state or a political subdivision . . . by false or fraudulent pretense, representations or promises as to any material matter, in connection with any tax imposed. . .
  - Tax Law is *more strict* than its Penal Law counterpart in that it *does not* require a “systemic ongoing course or conduct”, as does the Penal Law.
  - Tax Law is *less strict* than the Penal Law in that false representations must be with respect to a “material” matter.

### Tax Law §1801(a)(5)

#### Willfully Failing to Remit Taxes Collected on Behalf of the State

- **Trust Fund Taxes:** Withholding taxes collected from employees and sales taxes collected from customers.
- **Under Penal Law:** Fiduciaries who misappropriate these funds have always been subject to prosecution for larceny.

Old Tax Law	→	New Tax Law
<ol style="list-style-type: none"> <li>1. Prosecution for employers who failed to remit employment taxes was <i>limited to a misdemeanor</i> regardless of the amount of payroll taxes collected and not remitted</li> <li>2. The failure of a tax vendor to remit collected sales tax was <i>not</i> a criminal act under the Tax Law</li> </ol>		<ul style="list-style-type: none"> <li>• Under Tax Law §1801(a)(5), tax fraud occurs when a person <i>willfully</i> "fails to remit any tax collected in the name of the state or on behalf of the State . . . when such collection is required under this chapter."</li> </ul>

- Therefore, the Penal Law and Tax Law are both available to prosecutors to seek filing charges for crimes involving failure to remit sales or withholding taxes.

### Tax Law §1801(a)(6)

#### Willfully Failing to Collect a Sales, Excise or Withholding Tax That is Required to be Collected

Old Tax Law	→	New Tax law
<ul style="list-style-type: none"> <li>• <b>§1817(c):</b> the failure of employers to collect employment tax, and the failure of vendors to collect sales tax, constituted a misdemeanor.</li> <li>• <b>§1817(c)(2):</b> the failure to collect \$10,000 in sales tax or the failure to collect \$100 in sales tax on 10 or more occasions constituted a class E felony.</li> </ul>		<ul style="list-style-type: none"> <li>• <b>Tax Law §1801(a)(6):</b> the willful failure to collect tax when required constitutes tax fraud. <ul style="list-style-type: none"> <li>• If taxes not collected &gt;\$3,000 in 1 year, felony liability attaches.</li> <li>• Otherwise, the tax fraud constitutes a misdemeanor.</li> </ul> </li> </ul>

### **Tax Law §1801(a)(7)**

#### **Willfully and With an Intent to Evade any Tax, Failing to Pay a Tax Due**

- **Under new Tax Law §1801(a)(7)**: the taxpayer who willfully and with intent to evade tax fails to pay such tax commits tax fraud.
- **Stricter Standard than Former Law:**
  1. **Willful AND**
  2. **With an Intent to Evade Tax**
    - Taxpayers who file but cannot pay the tax will not be subject to criminal liability.
    - Felony liability may attach if the amount of the underpayment meets the monetary limits in the felony tax fraud sections → exceeding \$10,000

### **Tax Law §1801(a)(8)**

#### **Issuing False Exemption Certificates**

- **Tax Law §1801(a)(8)**: provides that a tax fraud act includes one where a party *willfully* issues an exemption certificate, inter distributor sales certificate, resale certificate or any other document capable of evidencing a claim that taxes do not apply to a transaction, which he or she does not believe to be true and correct as to any material matter, which omits any material information, or which is false, fraudulent, or counterfeit.
- **Changes from Old Tax Law:**
  - **Willful** omission constitutes a violation of law
  - Felony liability can attach → previously only misdemeanor liability arose

## The Degrees of the Tax Crime

- **Tax Law § 1802:** a person is guilty of Criminal Tax Fraud in the Fifth Degree under NY Tax Law 1802 if one commits a tax fraud act. A person could be subject to a misdemeanor punishable by up to 1 year in jail.
- **Tax Law § 1803:** A person is guilty of Criminal Tax Fraud in the Fourth Degree under NY Tax Law § 1803 if he or she commits a “tax fraud act” with the intent to evade certain taxes. Additionally, one must defraud the State during a time frame not exceeding 1 year out of more than \$3,000, but not greater than \$10,000, less than the tax liability that is due.
- **Tax Law § 1804:** A person is guilty of criminal Tax Fraud in the Third Degree under NY Tax Law § 1804 if he or she commits a “tax fraud act” with the intent to defraud. Assuming the conduct has established these elements, one must have defrauded New York during a 1 year period in an amount greater than \$10,000, but less than \$50,000.

## The Degrees of the Tax Crime

- **Tax Law § 1805:** the more common New York Tax crime that results in incarceration for those convicted. This “C” felony, punishable by up to **fifteen years in prison** for an individual with absolutely no criminal history.
  - Criminal Tax Fraud in the Second Degree is similar, in part, to Grand Larceny in the Second Degree (NY Penal Law 155.40) in that the theft or value of the tax fraud, must be **greater than \$50,000**, but no more than \$1,000,000. Beyond this, however, one is guilty of Criminal Tax Fraud in the Second Degree if he or she commits one of the “tax fraud acts” noted above.
- **Tax Law § 1806:**
  - No more debilitating and onerous white collar crime one can face, in terms of potential sentences and collateral consequences, than Criminal Tax Fraud in the First Degree.
  - A “B” felony, Tax Law 1806, is punishable by a **mandatory prison sentence**. Without a prior criminal history, if convicted of Tax Law 1806, one would face a minimum of 1 to 3 years in prison and a maximum of 8.3 to 25 years.
  - If one has a prior felony in the past 10 years, then he or she would face a minimum of 4.5 to 9 nine years in prison and a maximum of 12.5 to 25 years.
  - The distinction between Tax Law 1806 and the lesser degree offenses is that the value or amount either underpaid to or overpaid from the State must be in excess of \$1,000,000.

## Tax Law Factors (*Mens Rea*)

- To elevate a tax fraud act to a felony, 2 facts must be established.
  1. **Willfully AND With Intent:** With the addition of this *mens rea*, tax law felonies can be committed only when the defendant acts both **willfully and with the intent** to evade or defraud the state or political subdivision. The additional mental element of intent is designed to ensure that felony liability under the Tax Law applies only to those who deliberately evade their responsibilities and not to those who may have failed to comply with a tax obligation (and who may owe substantial taxes as a result) but who have not acted with criminal intent to evade paying those taxes.
  2. **Monetary Threshold:** A tax fraud act is a felony only when the tax evaded reaches the monetary thresholds set out in new Tax Law §1803 (tax fraud in the 4<sup>th</sup> degree) to §1806 (tax fraud in the 1<sup>st</sup> degree). Under the current law, the felony grades of tax fraud are defined in monetary terms where the degree of the crimes and the severity of punishment turn on the amount of loss to the state.

## Venue

- The current law expands the county venue provisions for false filing tax offenses by creating a new subsection (m) to N.Y. Criminal Procedure Law §20.40(4).
- The new provision recognizes that taxpayers are often involved in economic activity in one county that gives rise to a tax liability reflected in a tax return that happens to be filed in a different county.
- The new provision enables the prosecutor in the county where the economic activity **took place** to prosecute the resultant tax crimes.

## Statute of Limitations

- The Statute of Limitations on criminal liability *begins to run from the date the offense was committed.*
- Similar to larceny crimes, the current Tax Law provides for a 5 year Statute of Limitations.

## Criminal Exposure

- Penal Law

B Felony	≥ \$1,000,000.00	25 years
C Felony	≥ \$50,000.00	15 years
D Felony	≥ \$3,000.00	7 years
E Felony	≥ \$1,000.00	4 years
A Misdemeanor	Any amount	1 year
- Tax Law

B Felony	≥ \$1,000,000.00	25 years
C Felony	≥ \$50,000.00	15 years
D Felony	≥ \$10,000.00	7 years
E Felony	≥ \$3,000.00	4 years
A Misdemeanor	Any amount	1 year

## Identifying Subjects

- Sales Tax
  - Charging cash only
  - Sales tax returns v. Corp. returns
  - Claiming refunds
  - Third party databases
- PIT
  - Check cashing



## Corporate v. Personal Liability

- False Documents
  - Who filed or caused to be filed
- Follow the Money
  - Personal use
  - Payroll
- Ownership and Control
  - Penal Law §20.20
    - Board of Directors,
    - High Managerial Agent, or
    - Agent



## Fiduciary

- Sales tax vendors are required to collect sales tax as a “trustee for and on account of the state”
  - §1132(a)(1)
- Personally liable for collected and not collected sales tax
  - §1133(a)



## Obtaining Records

- Three Methods
  - Search Warrants
  - Grand Jury Subpoena
  - Voluntarily turning over



## Search Warrants

- Criminal Procedure Law Article 690
- Probable cause to believe evidence of a crime is at the location to be searched
- Locations to be searched:
  - Businesses
  - Houses
  - Storage facilities
  - Accountants offices



## Required Records

### TL §1135(a)(1)

- Responsible to maintain accurate records of sales tax collected and to remit the sales tax to the Tax Department, along with sales tax returns.
- Record of every sale
  - Must include:
    - Amount paid
    - Tax separately stated
    - Location where sale or delivery was made
    - Exemption certificate

## Grand Jury Subpoena

- Criminal Procedure Law Article 190
- Used to seek evidence relevant to the Grand Jury Investigation
- Who is subpoenaed:
  - Corporations
  - Subject of investigation
  - Banks
  - Accountants



## Immunity

- Absent a waiver, Criminal Procedure Law 190.40 grants immunity to witnesses who give evidence before a Grand Jury
- Subpoena to custodian of records
  - CPL 190.40(2)(c)
  - Matter of Altman v. Bradley, 184 A.D.2d 131 (1<sup>st</sup> Dept. 1992) “a witness appears solely in his capacity as an official who has actual or constructive possession of an entity’s documents, he possesses no privilege against self-incrimination with respect to these records.”

## Non-Compliance

- Failure to comply with Grand Jury Subpoena can lead to criminal contempt charge
- Can adversely effect TP liability



## Tax Preparer/Accountant Liability

- Penal Law Article 20
  - When one person engages in conduct which constitutes an offense, another person is criminally liable for such conduct when, acting with the mental culpability required for the commission thereof, he solicits, requests, commands, importunes, or intentionally aids such person to engage in such conduct.
- Tax Law Article 37
  - Willfully engaging in an act or acts or willfully causing another to engage in an act or acts pursuant to which a person.
    - files false or fraudulent reports or returns;
    - supplies or submits materially false or fraudulent information or fails to supply information;
    - scheme to defraud the state or a political subdivision

## Record Keeping

- “Life is good if your target’s Tax Preparer is a Certified Public Accountant because: They are required to keep their work papers for 7 years pursuant to AICPA.”



## Required Records

- 26 USC 6107(b): The preparer shall:
  - Retain a completed copy of the return or claim for refund; or
  - Retain a record, by list, the name, taxpayer identification number, and taxable year of the taxpayer for whom the return or claim for refund was prepared, and the type of return or claim for refund prepared;
  - The material shall be retained and kept available for inspection for the 3 year period following the close of the return period during which the return or claim for refund was presented for signature to the taxpayer.

## Am I Privileged

- Short answer, No
- There is no common law privilege for accountants and clients
- Absent a privilege, accountant's work is discoverable in criminal cases
- IRC 7525 creates a privilege in limited circumstances
  - Does not apply to criminal cases

## Kovel

- United States v. Kovel, 296 F.2d 918 (2d Cir. 1961)
  - Created a privilege for accountants in limited circumstances
  - Privilege protects accountants work product from discovery during criminal investigation

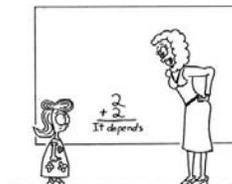
## Timing is everything

- Kovel accountants work for the attorney
- Use of prior accountants should be avoided
  - Information from work performed by prior accountant is not protected



## Legal advice v. Accounting services

- Accountant as an interpreter
- In furtherance of litigation
- Presence of accountant is necessary
- Accounting services are not covered



"Suzie, this is math, not the law."

## Suggested practices

- Utilize engagement letter
- Attorney provides services to the client
- Accountant provides services to the attorney
- Label reports “privileged” or “confidential”
- Work product flows through attorney
- Work product belongs to attorney
- Invoice the attorney, not the client

## Latest Trends

- Personal Income Tax
- Sales Tax
- Withholding Tax
- Excise Tax



Questions?

BREAK

LIU's Civil and Criminal Tax Controversy Forum

**NEW YORK STATE COLLECTION ENFORCEMENT:  
DRIVER'S LICENSE SUSPENSION**

August 16, 2018

Speaker: Yvonne R. Cort

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## What are collateral consequences?

- Nonmonetary sanctions for individuals who do not comply with the tax laws
- Goal is to encourage voluntary compliance
  - Federal: passport; deportation
  - States: licenses; permits

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August 16, 2018

## NYS Driver's Licenses

- Suspension for \$10,000 or more of tax, interest and penalties
- Exceptions
  - commercial driver's license
  - bankruptcy
  - innocent spouse
  - wage garnishment already in place
    - for unpaid taxes
    - for past-due child support



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**August 16, 2018**

## NYS Driver's Licenses

- Sixty-day letter sent to the taxpayer from the NYS Dept. of Taxation and Finance
  - Includes notice of the past-due liabilities
  - Includes info on how to avoid suspension
- Fifteen-day letter sent from the DMV
  - Contact NYS DTF to resolve liability
  - Contact DMV for restricted license if no other resolution

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## Pertinent Cases



- ***Matter of Balkin***, TAT Feb. 10, 2016: New collection vehicle for old taxes is “merely a ministerial administrative act” and does not violate due process standards.
- ***Matter of Jacobi***, TAT May 12, 2016, *aff’d*, 156 A.D.3d 1154 (3rd Dep’t 2017): Pending OIC does not avoid suspension of DL, and rejected OIC is not reviewable by the Tribunal.

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## NYSBA Report

### Proposals:

- Hardship exemption
  - automatic exemption for low income taxpayers
  - hardship exemption for any taxpayer who can demonstrate undue economic hardship
- Increase threshold to \$50,000; adjust for inflation
- No threshold if taxpayer affirmatively seeks to evade or avoid collection
- Discretion to waive suspension based on equity

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## Proposed Budget 2018-2019

- Intended to limit the effect of driver's license law on those suffering economic hardship
- Increase threshold to \$20,000; adjust for inflation
  - No threshold if affirmatively evade or avoid collection
- Low income? No suspension!
- Discretion to waive suspension based on equity
  
- Not passed!

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## NYS Alternatives

- Installment Payment Agreement
  - Must pay in full
  - Direct debit preferred
  - Interest continues to accrue
  - Financial info may be required
  
- No NYS Partial Pay Installment Agreements
- No Currently Not Collectible designation



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## NYS Alternatives

- Income Execution
  - First Service
  - Second Service
  - 10% wage garnishment
  - No warrant needed



- Offer in Compromise

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## NYS Voluntary Disclosure & Compliance Program

- For nonfilers – individuals and businesses
  - No penalties assessed
  - No referral for criminal charges
  - May be eligible for 3 or 6 year limited lookback
- NOT eligible:
  - Under audit or rec'd a bill
  - Under criminal investigation by NY
  - Tax Shelters
- Must pay in full – but can pay over time
- Must stay current, or VDA may become void

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August 16, 2018

# Questions?

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LIU Post Civil and Criminal Tax Controversy Forum  
August 16, 2018

## New York State Tax Collections

*Presented by:*

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- Federal and NYS Collection Issues
- Liens, Levies and Seizures
- Offers in Compromise
- Installment Agreements
- Innocent Spouse Claims
- IRS Appeals
- NYS Residency Audits
- Sales and Use Taxes
- Non-Filers
- Trust Fund Recovery Penalties

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## NYS Driver's License Suspensions

- Law enacted in March 2013
- Suspend NYS driver's license if
  - Owe \$10,000 or more in tax, penalty, and interest
  - Without collection resolution in place:
    - Installment Payment Agreement
    - Income Execution
    - Offer in Compromise
- Over \$780M collected resulting from the program



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## NYS Driver's License Suspensions

- NYS notifies taxpayer that license will be suspended in 60 days.
- If not resolved in 60 days, DTF advises DMV of delinquent taxpayer
- DMV sends taxpayer notice of impending suspension, which goes into effect 15 days after date of same
- Exceptions
  - Garnishment for child support or unpaid taxes
  - Commercial driver's license
  - Bankruptcy
  - Innocent Spouse

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## Driver's License Compact

- Interstate information exchange
- 45 States plus DC participate
- Only non-members:
  - Georgia
  - Maine
  - Michigan
  - Tennessee
  - Wisconsin



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## NYS Outside Collection Agencies

- NYS now uses an outside collection agency
- NYS has contracted with one agency:
  - Performant Recovery Inc.



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## NYS vs. Federal Tax Liens

- IRS's "silent" lien takes priority over NYS Warrant
- NYS Warrant: No collection appeal rights
- Federal Tax Lien: CDP and CAP rights
  - **Collection Due Process** rights after filing
  - **Collection Appeal Program** in advance of filing lien



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## NYS Tax Warrants

- Public record of judgment and perfected lien
  - Warrant search available online at [www.dos.state.ny.us/corps/tax\\_warrant\\_earch.html](http://www.dos.state.ny.us/corps/tax_warrant_earch.html)
- In effect until liability is fully satisfied or warrant expires
  - 10 years against real property
  - 20 years against personal property
- Liability is unenforceable 20 years after the first date a warrant could have been filed



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## NYS Income Execution

- Limited to 10% of taxpayer's gross earnings
- Effective until liability satisfied in full
- First Service
  - Issued to Taxpayer
  - Voluntary payments
  - 20 days to respond with payment
- Second Service
  - Payments from taxpayer's employer
- Not pursue other collection while IE in place
  - NYS will continue to keep refunds
- No warrant required: Extended until April 2020



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## NYS Levy Action

- Bank levy
  - No notice in advance of levy action
  - Lasts for 90 days
- Third-party levy
  - e.g.) against customers or tenants
- Income Execution
- Seizure and Sale
- Offsets and Refunds



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## Collateral Sanctions

- NYS may refuse to issue a Sales Tax Certificate of Authority
- NYS may revoke an existing Sales Tax Certificate of Authority
- A Sales Tax Certificate of Authority is prerequisite for:
  - Lottery license
  - Liquor license
  - Cigarette license



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## NYS Installment Payment Agreements

- If a taxpayer owes \$20,000 or less, they can enter into an Installment Payment Agreement for over 3 years
- State tax refunds applied to reduce liability
- May need to provide **Form DTF-5** Statement of Financial Condition depending on the amount of the liability and term of the agreement
- May need to set up payments via direct debit depending on the amount of the liability

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## NYS Installment Payment Agreements

- Must pay in full
  - No partial payment
- Direct debit is preferred
- Financial information may be required
- Interest continues to accrue during term of IPA



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## NYS Offers in Compromise

- Offer in Compromise
  - Doubt as to Collectibility or Liability
  - NYS now can take economic hardship into consideration – effective 2011
- **Form DTF-5**, Statement of Financial Condition
- **Form DTF-4.1** – Fixed/final liability
- **Form DTF-4.0** – Non-fixed/final liability



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## NYS Voluntary Disclosure Program

- Benefits:
  - Reduce liability by qualifying for a 3- or 6-year limited look back period and penalty abatement
  - No referral for criminal
- Burdens:
  - Increased scrutiny, application not anonymous
  - Must stay compliant
- Apply on NYS website:
  - <http://www.tax.ny.gov/enforcement/vold/>

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# IRS Collection Update Part I

LIU Civil and Criminal Tax Controversy  
Forum

August 16, 2018

Moderator: Frank Agostino, Esq., *Agostino & Associates*

Panelists: Monica Koch, Esq., *IRS-Office of Chief Counsel*

Darol Tucker, *IRS- Brooklyn LTA*

Chris Morell, *Local Taxpayer Advocate*

# Passport Revocation

FA

## IRC § 7345

**What does the non-payment  
of tax have to do with  
passports?**

FA

IRC § 7345-Revocation or denial of passport  
in case of certain tax delinquencies

- (a) In general. If the Secretary receives certification by the Commissioner of Internal Revenue that an individual has a **seriously delinquent tax debt**, the Secretary shall transmit such certification to the Secretary of State for action with respect to **denial, revocation, or limitation of a passport** pursuant to section 32101 of the FAST Act.

FA

## What Tax Debts Could Result in the IRS Certifying a Taxpayer as Seriously Delinquent?

MK

### IRC 7345 (b)-Seriously delinquent tax debt

- (1) In general. For purposes of this section, the term "**seriously delinquent tax debt**" means an unpaid, **legally enforceable** Federal tax liability of an individual-
  - (A) which has been assessed,
  - (B) which is **greater than \$50,000**, and
  - (C) with respect to which-
    - (i) a notice of lien has been filed pursuant to section 6323 **and the administrative rights under section 6320 with respect to such filing have been exhausted or have lapsed**, or
    - (ii) **a levy is made pursuant to section 6331.**

MK

## IRC 7345(b)(2)-Exceptions

- Such term shall not include-
  - (A) a debt that is being paid in a timely manner pursuant to an **agreement to which the individual is party under section 6159 or 7122**, and
  - (B) a debt with respect to which collection is suspended with respect to the individual-
    - (i) because a **due process hearing under section 6330 is requested or pending**, or
    - (ii) because **an election under subsection (b) or (c) of section 6015 is made or relief under subsection (f) of such section is requested**.

MK

## IRM 5.19.1.5.19.4 (12-26-2017) Discretionary Certification Exclusions

- IRC 7345 provides the IRS the discretion to exclude categories of tax debt from certification, even if the debt meets the criteria in IRM 5.19.1.5.19.2, Seriously Delinquent Tax Debt. The following categories of tax debt will be excluded from the determination of seriously delinquent tax debt of the IRS:
  - A. Debt that is determined to be currently not collectible (CNC) due to hardship,
  - B. Debt that resulted from identity theft,
  - C. Taxpayers in a Disaster Zone,
  - D. Debt of a taxpayer in bankruptcy
  - E. Debt of a deceased taxpayer,
  - F. Debt that is included in a pending OIC,
  - G. Debt that is included in a pending IA, &
  - H. Pending claim; resulting adjustment is expected to result in no balance due.

MK

### 5.19.1.5.19.2 (12-26-2017) Seriously Delinquent Tax Debt

- Unless otherwise listed (statutory or discretionary exclusions) a seriously delinquent tax debt includes, but is not limited to, tax assessments made under an individual taxpayer's identification number (SSN or EIN) such as U.S. individual income taxes, trust fund recovery penalties, business taxes for which the individual is liable and other civil penalties. This does not include other non-tax liabilities such as:
  - ACA assessments, Individual SRP modules,
  - Employer Shared Responsibility Payments,
  - Criminal Restitution assessments,
  - Child Support Obligations, or
  - Report of Foreign Bank and Financial Accounts (FBAR) assessments.

MK

### **Why Doesn't Passport Revocation Violate the Taxpayer's Right to Travel?**

FA

## Right to Travel

- In the context of passport denial for unpaid child support, courts have found the statute meets due process requirements because it **provides for notice and an opportunity to be heard prior to the state agency certifying** the unpaid child support to the federal government.
- *Weinstein v. Albright*, 261 F.3d 127 (2nd Cir. 2001), aff'g 2000 WL 1154310 (S.D.N.Y. 2001).

FA

**How Will the IRS Notify a Taxpayer That it Has Certified the Taxpayer's Seriously Delinquent Tax Debt to the State Department?**

MK

### 7345(d)-Contemporaneous Notice to Individual

- The Commissioner shall **contemporaneously** notify an individual of any **certification** under subsection (a), **or any reversal of certification** under subsection (c), with respect to such individual. Such notice shall include a description in simple and nontechnical terms of the right to bring a civil action under subsection (e).

MK

### Taxpayer Notification - Notice CP 508C

- The IRS is required to notify the taxpayer in writing at the time the IRS certifies seriously delinquent tax debt to the State Department. The IRS is also required to notify the taxpayer in writing at the time it reverses certification. The IRS will send written notice by regular mail to the taxpayer's last known address.

MK

## Reversal Of Certification - Notice CP 508R

- The IRS will reverse a certification when:
  - The tax debt is fully satisfied or becomes legally unenforceable.
  - The tax debt is no longer seriously delinquent.
  - The certification is erroneous.
  - The IRS will make this reversal within 30 days and provide notification to the State Department as soon as practicable.

MK

## Reversal Of Certification - Notice CP 508R (cont.)

- A previously certified debt is no longer seriously delinquent when:
  - The taxpayer and the IRS enter into an installment agreement allowing the taxpayer to pay the debt over time.
  - The IRS accepts an offer in compromise to satisfy the debt.
  - The Justice Department enters into a settlement agreement to satisfy the debt.
  - Collection is suspended because the taxpayer request innocent spouse relief under IRC § 6015.
  - The taxpayer makes a timely request for a collection due process hearing in connection with a levy to collect the debt.

MK

## Reversal Of Certification - Notice CP 508R (cont.)

- The IRS will not reverse certification where a taxpayer requests a collection due process hearing or innocent spouse relief on a debt that is not the basis of the certification.
- ***The IRS will not reverse the certification because the taxpayer pays the debt below \$50,000.***

MK

## **What Can and Should a Taxpayer Do Now to Avoid Passport Certification?**

FA

## What Collection Alternatives/Proposals will Avoid Certification?

- § 6159 - Agreements for payment of tax liability in installments
- § 7122 - Compromises
- § 6330 - Notice and opportunity for hearing before levy [Collection due process]
- § 6015 - Relief from joint and several liability on joint return [Innocent Spouse]

FA

## Does Filing for **Bankruptcy** Stop or Delay Certification under Section 7345?

- IRM 5.19.1.5.19.4 (12-26-2017) – Discretionary Certification Exclusions include bankruptcy

FA

## Where and How Does a Taxpayer Challenge the Certification that He or She Has a Seriously Delinquent Tax Debt?

MK

### 7345(e)-Judicial review of certification

- (1) In general. After the Commissioner notifies an individual under subsection (d), the taxpayer may bring a **civil action against the United States in a district court of the United States** or the **Tax Court** to determine whether the certification was erroneous or whether the Commissioner has failed to reverse the certification.
- (2) Determination. If the court determines that such certification was erroneous, then the **court may order the Secretary to notify the Secretary of State that such certification was erroneous.**

MK

## Judicial Review Of Certification

- The State Department is held harmless in these matters and cannot be sued for any erroneous notification or failed decertifications under IRC § 7345.
- <https://www.irs.gov/businesses/small-businesses-self-employed/revocation-or-denial-of-passport-in-case-of-certain-unpaid-taxes>

MK

## Judicial Review Of Certification (cont.)

- IRC § 7345 does not provide the court authority to release a lien or levy or award money damages in a suit to determine whether a certification is erroneous.

MK

## Judicial Review Of Certification (cont.)

- The taxpayer is not required to file an administrative claim or otherwise contact the IRS to resolve the erroneous certification issue before filing suit in the U.S. Tax Court or a U.S. District Court.

MK

## **What Are the Procedures to Reverse a Certification at the IRS and at the State Department?**

FA

IRM 5.19.1.5.19.9 (12-26-2017)  
Reversal of Certification

- The IRS will systemically notify the State Department within 30 days if the previously certified tax debt is:
  - A. Fully satisfied,
  - B. Becomes legally unenforceable,
  - C. Ceases to be seriously delinquent tax debt,
- A previously certified debt ceases to be seriously delinquent tax debt when a statutory exclusion is met. See IRM 5.19.1.5.19.3, Statutory Certification Exclusions.

FA

IRM 5.19.1.5.19.9 (12-26-2017)  
Reversal of Certification (cont.)

- The IRS has the discretion to request a decertification for other reasons. The IRS will decertify a previously certified tax debt that ceases to be seriously delinquent tax debt when a discretionary exclusion is met. See IRM 5.19.1.5.19.4, *Discretionary Certification Exclusions*.

FA

## How Long Will it Take to Get a Certification Reversed?

FA

### 7345(c) Reversal of certification

- (1) In general  
In the case of an individual with respect to whom the Commissioner makes a certification under subsection (a), the Commissioner shall notify the Secretary (and the Secretary shall subsequently notify the Secretary of State) if such certification is found to be erroneous or if the debt with respect to such certification is **fully satisfied or ceases to be a seriously delinquent tax debt by reason of subsection (b)(2)**.

FA

### 7345(c) Reversal of certification (cont.)

- (2) Timing of notice
- **(A) Full satisfaction of debt**  
In the case of a debt that has been **fully satisfied or has become legally unenforceable**, such notification shall be made not later than the date required for issuing the certificate of release of lien with respect to such debt under section 6325(a).
- **(B) Innocent spouse relief**  
In the case of an individual who makes an election under subsection (b) or (c) of section 6015, or requests relief under subsection (f) of such section, such notification shall be made **not later than 30 days after any such election or request**.

FA

### 7345(c) Reversal of certification (cont.)

- **(C) Installment agreement or offer-in-compromise**  
In the case of an installment agreement under section 6159 or an offer-in-compromise under section 7122, such notification shall be made **not later than 30 days after such agreement is entered into or such offer is accepted by the Secretary**.
- **(D) Erroneous certification**  
**In the case of a certification found to be erroneous, such notification shall be made as soon as practicable after such finding.**

FA

## Hold of Application

- Before denying a passport, the **State Department** will **hold your application for 90** days to allow you to:
  - Resolve any erroneous certification issues
  - Make full payment of the tax debt
  - Enter into a satisfactory payment alternative with the IRS

FA

## IRM 5.19.1.5.19.9.1 (12-26-2017) Expedited Decertification

- 1. Request expedited decertification when all of the following conditions exist:
  - A. A certified taxpayer is eligible for decertification as described in IRM 5.19.1.5.19.9, Reversal of Certification.
  - B. The taxpayer states their foreign travel is scheduled within 45 days or less, or the taxpayer lives abroad and
  - C. The taxpayer has a pending application for a passport or renewal, and can provide their Passport Application number and Location of passport application (if applied outside the U.S.) (city, country).

FA

## IRM 5.19.1.5.19.9.1 (12-26-2017) Expedited Decertification (cont.)

### Note:

- Taxpayers residing outside of the United States may have an urgent need for a passport without having imminent travel plans. When a taxpayer residing outside of the United States meets conditions in IRM 5.19.1.5.19.3, Statutory Certification Exclusions, or IRM 5.19.1.5.19.4, Discretionary Certification Exclusions, and self-identifies as having an urgent need for decertification, request expedited decertification.

FA

Questions?

# Taxpayer Advocate Service

## *Hot Topics in Advocacy*



## **Roadmap**

- FAST Act Passport Revocations and Denials

## **FAST Act**

- 2015 Act – Fixing America’s Surface Transportation
- If a taxpayer has “seriously delinquent tax debt:”
  - Law requires denial of an individual’s passport application
  - Law allows State Dept. to revoke or limit a passport
- Exceptions
  - Emergency or humanitarian circumstances
  - IA or OIC
  - CDP Pending
  - Innocent Spouse Request Pending

## **FAST Act**

- Certification Process
- Reversal of Certification

## **FAST Act**

- Concerns:
  - Timing of notices to taxpayers
  - IRS not exercising discretion to exclude certain taxpayers
    - TAS Taxpayers
    - CDP Equivalent Hearing Taxpayers

## **Questions?**

References:

[www.irs.gov](http://www.irs.gov)

[TaxpayerAdvocate.irs.gov](http://TaxpayerAdvocate.irs.gov)

## Lunch - Atrium Tilles Center

## IRS Collection Update Part II

LIU Civil and Criminal Tax Controversy Forum  
August 16, 2018

Moderator: Frank Agostino, Esq., *Agostino & Associates*  
Panelists: Monica Koch, Esq., *IRS-Office of Chief Counsel*  
James Caligure, Esq., *IRS-Office of Chief Counsel*

## Big Picture - Objectives of the CDP case

To bring Taxpayer into **compliance** by filing returns and paying taxes.

To ameliorate harm from Taxpayer's past non-compliance and create the opportunity for a **fresh start**.

To arrive at a resolution that will promote Taxpayer's **future voluntary compliance**.

MK

## Issues That Can Be Raised at a CDP Hearing

IRC §§ 6330 allows taxpayers a meaningful opportunity to raise and the Appeals Officer to consider issues relating to the collection of the tax liability, including:

- **appropriateness** of the collection actions;
- **collection alternatives** (e.g., installment agreement, offer, substitution of other assets);
- **spousal defenses**;

MK

## Issues That Can Be Raised at a CDP Hearing (cont.)

- the existence or **amount of the underlying liability**, but only if the taxpayer did not receive a notice of deficiency or otherwise have an opportunity to dispute the tax

**Any other relevant issue relating to the unpaid tax, the lien, or the proposed levy.**

MK

Why should the Taxpayer request for face-to-face transcribed hearing pursuant to IRC § 7521?

“Having a transcript of the section 6330 hearing will allow us to perform better the review provided to taxpayer by Section 6330(d).

**Until now, in order to determine what issues taxpayers raised at the section 6330 hearing, the Court was faced with “he said-she said” situations – needless “credibility contests” between the taxpayer and the Appeals Officer.”**

Judge Vasquez, concurring opinion, *Keene v. CIR*, 121 T.C. 8 (2003)

JC

## Requesting the face-to-face transcribed CDP hearing pursuant to IRC § 7521? (cont.)

In *Keene v CIR*, 121 T.C. 8 (2003), the Tax Court held that a taxpayer may record a CDP hearing. Audio and stenographic recordings are allowed on Appeals cases scheduled for **in-person conferences** if a request to record is made pursuant to IRC 7521(a) is made **more than ten days prior to the hearing**.

**[Note - IRS will not allow the recording of phone conferences]**

LJC

## The Request for Verification Pursuant to IRC § 6330(c)(1)

Pursuant to IRC § 6330(c)(1) the Settlement Officer must obtain verification from the IRS that the requirements of any applicable administrative procedures have been met and must consider that verification, or lack thereof, in reaching a decision.

MK

## The Request for Verification Pursuant to IRC § 6330(c)(1) (cont.)

To ensure compliance with IRC § 6330(c)(1), the letter accompanying Form 12153 should request that:

(a) the Appeals Office obtain before the hearing **verification that the IRS followed** all laws and administrative procedures that appear in their Procedure and Administrative Deskbook [\[https://www.irs.gov/pub/irs-utl/PADeskbook.pdf\]](https://www.irs.gov/pub/irs-utl/PADeskbook.pdf) and

(b) the Appeals Office **abate all tax, penalty and interest** that was assessed in violation of applicable law and/or administrative procedures.

MK

Potential Verification Requests	Internal Revenue Code Section
The Record of Assessment	IRC § 6203 provides that: Upon request of the taxpayer, the Secretary shall furnish the taxpayer a copy of the record of the assessment.
If the assessment is for more than the tax shown on the return, the notice of deficiency	IRC § 6212
The Notice and Demand referred to in IRC §§ 6303(a) and 6601(e)	Collectively, IRC § s 6303(a), 6321, and 6331(a) provides that: Notice and demand must be provided to a taxpayer before the IRS can collect through the tax lien or by levy.
Statute of Limitations on Assessment  If the assessment at issue was made more than three years after the filing of the returns at issue, please verify that the statute of limitations prescribed by IRC § 6501 does not invalidate the assessment.	IRC § 6501
Statute of Limitation on Collection of the Assessment.  If the assessment at issue was made more than ten years ago, please verify that the statute of limitations prescribed by IRC § 6502 does not invalidate the assessment.	IRC § 6502
The documents demonstrating compliance with IRC §§ 7524, 6751(a) and (b)	IRC § 6751(b) provides that: No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.
Verification Required by IRC §§ 7524, 6404(f) 6404(g)	IRC § 6404(f) and (g) provides for the suspension of interest and certain penalties.
If the IRS intends to proceed against third parties, the approval required by Area Counsel.	IRM 5.12.7 <i>et seq.</i>

MK

## IRC § 6751(b)

IRC §6751 (b) Approval of assessment. (1) In general

**No penalty** under this title shall be assessed unless the initial determination of such assessment is **personally approved (in writing)** by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate

FA

## IRC § 6751(b)

In *Graev v. Commissioner*, 147 T.C. 460, 484 (slip. op. at 39) (Nov. 30, 2016), the Tax Court held that the taxpayers' argument in a deficiency case that the Commissioner failed to comply with sec. 6751(b)(1) was premature because the Commissioner had not yet assessed a sec. 6662(a) penalty. However, the Court stated:

**"We do not foreclose the possibility that a taxpayer who believes that a penalty has been assessed in violation of sec. 6751(b)(1) might raise this issue in a postassessment collection due process (CDP) proceeding."**

*Graev v. Commissioner*, 147 T.C. at 484, n. 22 (slip. op. at 39) (citing secs. 6320(c), 6330(c)(1) which require that the settlement officer in a CDP hearing obtain verification that the requirements of any applicable law or administrative procedure have been met).

FA

## The Request for De Novo Review of Tax, Interest and Penalty

A challenge to the underlying liability can include a challenge to **tax, interest and penalties** assessed for the relevant tax period, including: (a) tax assessed under the deficiency procedures, (b) tax reported on the taxpayer's tax return, interest and penalties assessed (i.e., IRC § § 6404, 7508, 7508A).

*Montgomery v. CIR*, 122 T.C. 1 (2004)

JC

## Challenges to the Liability Pursuant to IRC § 6330(c)(1)

IRC § 7805(a)(3) provides the "In discharging his duties, the Commissioner shall ensure that employees of the Internal Revenue Service are familiar with and act in accord with taxpayer rights as afforded by other provisions of this title, including — (c) the right to pay no more than the correct amount of tax. . ." Challenges to the liability can include:

- Amended Tax Return
- An offer in compromise based on doubt as to liability pursuant to IRC § 7122 or
- Request for Audit Reconsideration pursuant to IRS Publication 3598.

JC

## Limitations to Challenges to the Liability Pursuant to IRC § 6330(c)(2)(b)

A recurring theme in CDP cases is the "**one bite at the apple**" rule. A taxpayer may not challenge his liability pursuant to IRC § 6330(c)(2)(b) if he or she had a prior opportunity to dispute such tax liability, Prior Opportunities include:

- Receiving a Notice of Deficiency
- Refusing Service of Notice of Deficiency
- Having Prior CDP Hearing
- Receiving IRS Letter 1153, Proposed Assessment of Responsible Person
- Signing a Form 4549

JC

## Limitations to Challenges to the Liability Pursuant to IRC § 6330(c)(2)(b)

The "**one bite at the apple**" rule does not apply if the trier of fact concludes:

- The taxpayer did not **receive** a Notice of Deficiency.
- The taxpayer did not **receive** a Letter 1153.
- The Liability at Issue is not subject to deficiency procedures.

JC

## Pro Taxpayer Cases Discussing Challenges to the Liability Pursuant to IRC § 6330(c)(2)(b) (cont.)

***Mason v. Commissioner***, 132 T.C. 301 (2009): Court found that taxpayer could challenge the underlying penalty where Letter 1153 was returned to IRS undelivered and taxpayer did not deliberately refuse delivery.

***Lepore v. Commissioner***, T.C. Memo. 2013-135: Court found taxpayer's son received Letter 1153 at taxpayer's address but taxpayer did not know about it.

LJC

## Collection Alternatives

- Evaluating what collection alternative to request is a function of analyzing the taxpayer's financial condition to determine reasonable collection potential ("RCP").
- The starting point for analysis are the Collection Information Statements ("CIS") in the Form 433-series. The Form 433 series includes Form 433-A, Form 433-A (OIC) and Form 433-F.
- IRM 5.15, Financial Analysis Handbook, and IRM 5.8.5, Financial Analysis explain how the IRS analyzes the financial information provided by the taxpayer and computes the RCP.

MK

## Standards of Review

Section 6330(d)(1) does not prescribe the standard of review that the Court should apply in reviewing an IRS administrative determination in a CDP case.

**Where the validity of a taxpayer's underlying tax liability is properly at issue, the Tax Court reviews the IRS' determination de novo.**

*Goza v. Commissioner*, 114 T.C. 176,

MK

## Standards of Review

Where the taxpayer's underlying liability is not properly at issue, the Court review the IRS decision for abuse of discretion.

An abuse is discretion occurs if the Appeals Office exercises its discretion:

**“arbitrarily, capriciously, or without sound basis in fact or law.”**

*Woodral v. CIR*, 112 T.C. 19, 23 (1999).

JC

## Scope of Review

### Tax Court Rule 34(b)(4)

If an issue is not raised by the pleadings, it cannot be a part of the Court's redetermination.

**“Any issue not raised in the assignments of error shall be deemed to be conceded.”**

FA

## Scope of Review

### The Chenery Doctrine

The Chenery doctrine is an administrative-law principle that says a court, in reviewing a determination which an

**“administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency.”**

*SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947)

FA

## Scope of Review

*Giamelli v. Commissioner*, 129 T.C. 107, 115 (2007)

Pursuant to IRC § 6330(c)(3) the Appeals Office's determination shall take into consideration issues "raised" by the taxpayer.

**"Thus, if an issue is never raised at the hearing, it cannot be a part of the Appeals \* \* \*[Office's] determination."**

*Giamelli v. Commissioner*, 129 T.C. at 113.

The Court will review respondent's determination on the basis of an issue that petitioner did not raise in Appeals and that the Appeals Office never considered.

MK

## Scope of Review

Generally, when the case is remanded, **the Tax Court retains jurisdiction.**

The resulting hearing on remand provides the parties with an opportunity to **complete the initial hearing** while preserving the taxpayer's right to receive judicial review of the ultimate administrative determination.

FA

Questions?

## IRS EXAM PART I

LIU Civil and Criminal Tax Controversy Forum  
August 16, 2018

Moderator: Michael A. Wallace, EA, *Agostino & Associates*

Panelists: Keisha A. Cummins, *IRS-Office of Chief Counsel*

Noelle Geiger, Esq., *Grassi & Co.*

Monica Koch, Esq., *IRS-Office of Chief Counsel*

## Income Reconstruction



NG

## The cost of the tax gap

Approximately one-third of the annual tax gap is a result of under-reported income or overstated deductions on a Schedule C business.



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NG

## Income Reconstruction

- **Preparer Question:** I have a client who is self-employed but has no receipts for income or expenses. Should I refuse to prepare the return?

NG

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## Income Reconstruction

- **IRS Answer:** Not necessarily. You can take the opportunity to teach your clients about record-keeping requirements. If your client has any records and data on the amount earned and any expenses, you can explain how to reconstruct and/or help make a reasonable estimate of the income earned and expenses. If you choose to help your client reconstruct the records, be sure to document how you computed the income and expenses. Refusing to prepare the return is a decision only you can make.

NG

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## Prepare due diligence – interview your client

Client interview and targeted questions meant to assess how income can be recreated

Estimate time it will take and who will complete each action step.

Determine commitment of client to cooperate in the time it will take to reconstruct – Fees are an issue

Unrelated practice tip – memorialize terms in engagement letter and get retainers.



NG

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## Does it make sense?

- Being diligent in evaluating taxpayer's personal assets and expenses to assess whether lifestyle is consistent with income reconstruction



NG

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## Whether or not to engage or disengage client

- Taxpayer who is shopping for a CPA to prepare return their way
- Taxpayer is nonresponsive to CPA requests to provide information
- Taxpayer refuses to make commitment to become or stay in current compliance. Refusal to implement new best practices and modify lifestyle.

NG

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## Goal of Record Reconstruction

- Use available documentation to develop a **sound and reasonable estimate** of the taxpayer's business income and expenses to support the [tax return] prepared.



NG

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## Record Reconstruction

- Determine exactly what records have been lost
- Prioritize importance of lost items
- Consider the time and expense locating lost items
- Determine sources to obtain lost items (transcripts, FOIA, state and local agencies, financial institutions)

NG

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## Limits on Record Reconstruction – Section 274

- Section 274 prohibits claiming the following deductions unless substantiation requirements are maintained:
  - Meals and entertainment
  - Travel
  - Gift Expenses
  - Listed Property Expenses
- Estimates for these expenses are allowed only if the taxpayer lost records due to fire, flood or other catastrophe.

NG

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## Foundation for Record Reconstruction – Documents

- Income source documents
- Books and ledgers
- Invoices and receipts
- Cancelled checks
- Credit cards slips
- Real-estate closing statements
- Online Maps tools

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## Foundation for Record Reconstruction – Industry Standards



**sageworks**



NG

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## Foundation for Record Reconstruction- Testimony

- Oral Testimony
  - I.R.M. 4.10.7.3.2(01-01-2006)
- First Hand Knowledge
  - I.R.M. 4.10.7.3.3 (01-01-2006)
- Expert Testimony
  - I.R.M. 4.10.7.3.4 (01-01-2006)



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## Foundation for Record Reconstruction- IRS Reconstruction Methods

- Bank Deposits and Cash Expenditures Method
- Markup Method
- Net Worth Method
- Source and Application of Funds
- Unit and Volume Method

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# Reconstruction Example

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## Income reconstruction - jewelry designer/retailer

- No general ledger or trial balance.
- Obtain bank statements showed purchases, sales and wires to company to support basis.
- Contract with jewelry maker showed purchases and melting.
- Inventory lists and pictures, specifically identifiable
- Insurance claim – huge theft loss



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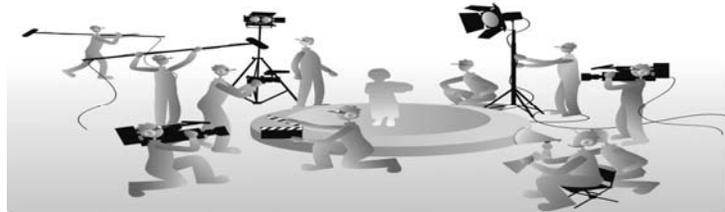
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## Income reconstruction – Production Company

Missing contracts, GL, bank statements not easy to decipher because taxpayer commingled subcontractor expenses with sales deposits

Get payroll information, W-2's and 1099's.

Calling subcontractors and suppliers to get invoices and payment information



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## *Bauer v. CIR*, T.C.Memo. 2012-156

- TP operated furniture moving business and Employed short-term labor paid in cash
  - IRS estimated contract labor as % of receipts, based on BizStats “freight trucking” category
  - Tax Court held for TP that BizMiner “household goods transport” category was more representative: allowed deduction for higher % of receipts

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# Expert Testimony



United States Tax Court	
<hr/> <p>Petitioner</p> <p>v.</p> <p>COMMISSIONER OF INTERNAL REVENUE, Respondent</p>	<p>Docket No.</p>
<p><b>PETITIONER'S EXPERT REPORT</b></p>	
<p><b>Identifying Information</b></p> <p>This report is submitted on behalf of Petitioner(s). For the reasons set forth above, I opine as follows:</p>	
<p><b>Qualifications of the Expert</b></p> <p>Tax Court Rule 143(g) requires that the Report include the witness's qualifications, including a list of all publications authored in the previous 10 years, and a list of all other cases in which, during the previous 4 years, the witness testified as an expert at trial or by deposition. My qualifications include:</p>	
<p>Education</p>	
<p>Training</p>	
<p>MK</p>	<p>Work Experience, including cases in which the witness testified as an expert witness</p>

## F.R.E. Rule 702

A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

- (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
- (b) the testimony is based on sufficient facts or data;
- (c) the testimony is the product of reliable principles and methods; and
- (d) the expert has reliably applied the principles and methods to the facts of the case.

MK

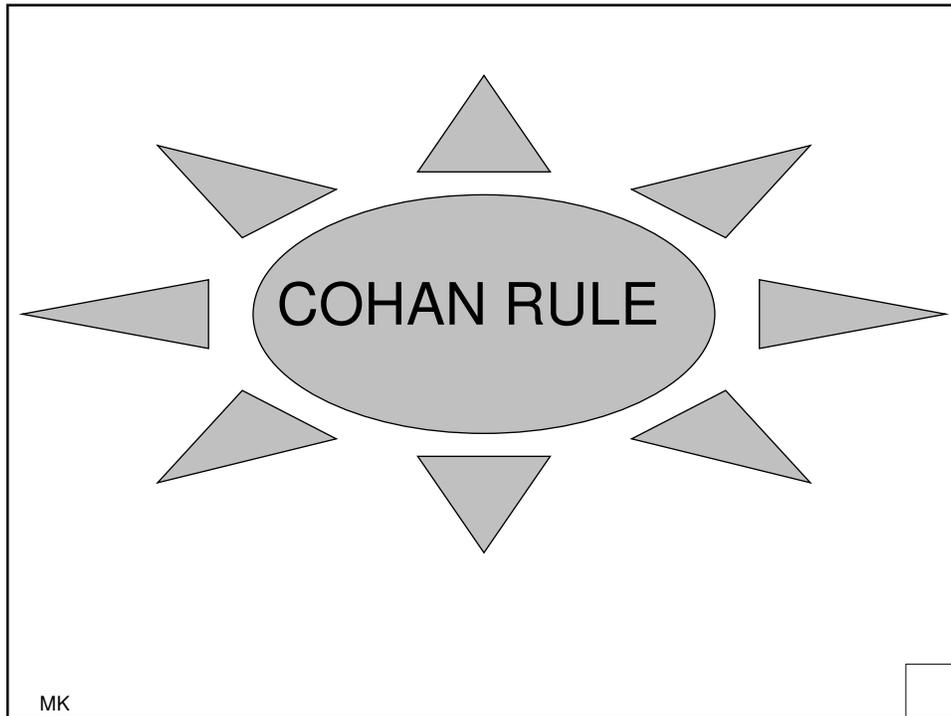
191

### *Feinberg v. CIR* T.C. Memo 211 (T.C. 2017)

- At trial, the taxpayer did not submit documentation to substantiate the cost of goods sold allowance or the ordinary and necessary business expenses. Instead, an expert report was submitted to substantiate a cost of goods sold allowance in excess of what the IRS allowed during the examination.
- The Tax Court ruled that the expert report was unreliable because it contained statements which failed to refer to underlying source information, failed to include underlying source information which the expert relied upon, and failed to include sufficient information and data to support the report's conclusions. As a result, the expert report was inadmissible

MK

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## Deductions in General

•“Deductions are a matter of legislative grace; taxpayers bear the burden of substantiating their claimed deductions by keeping and producing records sufficient to enable the Commissioner to determine the correct tax liability.”  
*INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 84 (1992)

TAX  
DEDUCTIBLE  
OR NOT ??

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MK

## Issues Raised in Litigated Cases

Issue	Type of Taxpayer	
	Individual	Business
Substantiation of Expenses under IRC § 162, Including Application of the Cohan Rule	12	49
Substantiation of Expenses under IRC § 274(d)	5	34
Schedule A Unreimbursed Employee Expenses	15	11
Hobby losses, nondeductible under the provisions of either IRC §§ 183 or 162	0	14
Home Office under IRC § 280A	3	8
Net Operating Losses under IRC § 172	0	8
Personal Expenditures Disallowed under IRC § 262	7	18
Capitalization and cost recovery under IRC §§ 263, 263A, and 167	1	10
Illegal activities under IRC §§ 280E, 162(c), 162(f), and 162(g)	1	2
Economic Substance Doctrine	0	4

MK Source: TAS 2017 Annual Report to Congress

## Authority for Estimates - Cohan Rule

- When the TP establishes that the TP paid or incurred deductible expenses but does not establish the amount of the deduction to which TP is entitled, TP may be entitled to estimate the amount allowable. Cohan v. Comm'r, 39 F.2d 540 (2d. Cir. 1930)

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MK

## Application of Cohan Rule

- “[T]o qualify for the estimation treatment under Cohan, the taxpayer must establish that he is entitled to some deduction.”
- “[A] court should allow the taxpayer some deductions if the taxpayer proves he is entitled to the deduction but cannot establish the full amount claimed”
- “bearing heavily ... upon the taxpayer whose inexactitude is of his own making”

MK

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## Application of Cohan Rule

- Burden of Proof:
  - Generally the taxpayer has the burden of proof
  - §IRC 7491(a) shifts burden of proof to IRS when the taxpayer:
    - Introduces credible evidence with respect to any factual issue relevant to ascertaining the taxpayer’s liability;
    - Complies with the requirements to substantiate deductions;
    - Maintains all records required under the Code; and
    - Cooperates with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews.

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## Cohan Rule Exceptions

- Heightened scrutiny for:
  - Expenses subject to IRC § 274(d)
  - Charitable contributions
  - Dependency
  - Real estate professional

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## Substantiation Overview

KC

## Substantiation in General

- I. R.C. § 6001
- **Requirement:** Taxpayers must keep permanent books of account or records, including inventories, sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.
- **Reality:** Taxpayers' records are often incomplete.

KC

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## Substantiation Schedule C

KC

**SCHEDULE C  
(Form 1040)**

Department  
Internal Rev

**SCHEDULE C-EZ  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

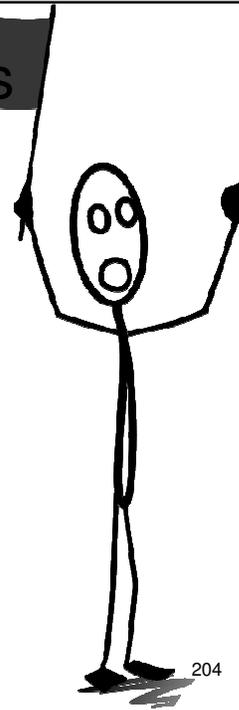
- Use Schedule C to report income or loss from a business you operated or a profession you practiced as a sole proprietor.
- Primary purpose for engaging in the activity is for income or profit and you are involved in the activity with continuity and regularity.
  - Sporadic activity or hobbies do not qualify as a business.

KC

203

## Schedule C – Red Flags

- Income in round numbers
- Schedule C cash businesses as the only income on the return claiming EITC
- Little or no expenses when expenses are expected
- Little or no records for income and expenses
- Schedule C without a Form 1099



KC

204

## IRC 183 – Activities not engaged in for profit

MK

## Taxpayers Subject to IRC 183

- Individuals
- S Corporations
- Partnerships
- Trusts and estates

MK

206

## Business or Hobby?

- A taxpayer may not deduct expenses incurred in connection with a hobby or other nonprofit activity to offset taxable income from other sources.

MK

207



## Business or Hobby, cont.

- Hobby –
- An “activity not engaged in for profit” as any activity other than one with respect to which deductions are allowable for the taxable year under Section 162

208

MK

## Facts and Circumstances Considered

- Deciding whether a taxpayer operates an activity with an actual and honest profit motive typically involves applying the nine non-exclusive factors contained in Treas. Reg. § 1.183-2(b).

MK

209

## Facts and Circumstances Considered, cont.

- Those factors are:
  - The manner in which the taxpayer carried on the activity
  - The expertise of the taxpayer in his or her advisers
  - The time and effort expended by the taxpayer in carrying on the activity
  - The expectation that the assets used in the activity may appreciate in value

MK

210

## Facts and Circumstances Considered, cont.

- The success of the taxpayer in carrying on other similar or dissimilar activities
- The taxpayer's history of income or loss with respect to the activity
- The amount of occasional profits, if any, which are earned
- The financial status of the taxpayer, and
- Elements of personal pleasure or recreation

MK

211

## Safe Harbor Under Section 183(d)

- Allows a presumption that the taxpayer is engaged in an activity for profit:
  - If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive years which ends with the taxable year exceeds the deductions attributable to such activity.
  - In the case of an activity which consists in major part of the breeding, training, showing or racing of horses, the preceding sentence shall be applied by substituting "2" for "3" and "7" for "5".

MK

212

## 183(d) Presumption Applies ...

- Only after an activity incurs a third profitable (or second) profitable year within a 5 year (or 7 year) period that begins with the first profitable year.
- Section 183(e) allows the taxpayer to elect to postpone the determination as to whether the Section 183(d) presumption applies.

MK

213

## *Kaiser v. CIR,* T.C. Summ. 2016-13

- Profit Intent: The Court determined a taxpayer did not operate her horse training activity for profit. The court found she did not have a business plan, did not keep books and records, and couldn't show how she intended to make a profit. Thus, she could not deduct her financial planning business against the losses from the horse activity.

MK

214

*Barker v. Comm'r*  
(T.C. Memo. 2018-67)

- The IRS examined Cecile's 2011 tax return and determined a deficiency in the amount of \$1,259,279 because they determined his business (SoBe Entertainment) to be a "hobby" that never made any money... The Court found a profit motive, and that SoBe wasn't merely a hobby, but did not find that sufficient back-up existed to substantiate the Net Operating Losses claimed and thus disallowed the deductions.

MK

215

Questions?

## Contact Info

- Keisha A. Cummins: [Keisha.A.Cummins@irs.counsel.treas.gov](mailto:Keisha.A.Cummins@irs.counsel.treas.gov)
- Noelle Geiger, Esq.  
[NGeiger@grassicpas.com](mailto:NGeiger@grassicpas.com)
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[mwallace@agostinolaw.com](mailto:mwallace@agostinolaw.com)
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[Monica.E.Koch@irs.counsel.treas.gov](mailto:Monica.E.Koch@irs.counsel.treas.gov)

## IRS Exam Part II

LIU Civil and Criminal Tax Controversy  
Forum

August 16, 2018

Moderator: Frank Agostino, Esq., *Agostino & Associates*

Panelists: Monica Koch, Esq., *IRS-Office of Chief Counsel*

James Caligure, Esq., *IRS-Office of Chief Counsel*

## International Penalties

### Consequences for Failing to File

Form	I.R. C. §	Civil Penalties
3520/3520A	§ 6677	Greater of \$10,000 OR : 35% of the gross value of any property transferred to a foreign trust 35% of the gross value of the distributions received from a foreign trust by a U.S. person and 5% of the gross value of all of a foreign trust's assets treated as owned by a U.S. person under the grantor trust rules (IRC sections 671-679)
3520A	§ 6677	Greater of \$10,000 or 5% of the gross value of the trust. \$10,000 per month continuation penalty
5471	§ 6038	\$10,000 per form; \$10,000 per month continuation penalty max \$50,000
5472	§ 6038A	\$25,000 per year \$25,000 continuation penalty per month
8938	§ 6038D	\$10,000 per form; \$10,000 per month continuation penalty

FA

## Assessable Penalties

- The IRS has determined that Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) does not apply in respect of the assessment or collection of any international reporting penalty except that the following international penalties are subject to deficiency procedures:
  - Form 3520 (IRC § 6039F(c)) – Taxability of Gift from Foreign Persons
  - Form 5471 (IRC § 6038(c)) – Penalty of Reducing Foreign Tax Credit Plus Continuation Penalty
  - Form 5472 (IRC § 6038A(e)) – Noncompliance Penalty for Failure to Authorize an Agent or Failure to Produce Records
  - Form 5472 (IRC § 6038C(d)) – Noncompliance Penalty for Foreign Related Party Failing to Authorize the Reporting Corporation to Act as its Limited Agent
  - Form 8938 (IRC § 6038D) – Failure to Disclose

## Assessment Process

- Once penalty is assessed and Form 8278 is processed, a CP notice is generated and sent to taxpayer:
  - CP 15 Notice of Penalty Charge; or
  - CP 215 Notice of Penalty Charge

## De Novo Review - Prior Opportunity to Challenge

- Consider *Flume v. Commissioner*, T.C. Memo. 2017-21;
  - Penalties for failure to file Form 5471 properly raised and subject to de novo review in Tax court.
- Contrast with *James v. Commissioner*, 850 F.3d 160 (4th Cir.)
  - In light of Section 6330(c)(2)(B)'s unqualified language, an administrative hearing is not categorically excluded from qualifying as "an opportunity to dispute" tax liability solely because it is administrative in nature. The statute unambiguously provides that a taxpayer may raise the issue of his liability in a CDP hearing if he has not yet had "an opportunity" to do so. ***By its own terms, then, Section 6330(c)(2)(B) does not specify "a judicial opportunity," but merely "an opportunity."*** The right to an administrative hearing may qualify as such "an opportunity." James's interpretation, by contrast, would add an adjective, "judicial," to the statute that Congress did not put there.

## Why is this Relevant?

- International penalties generally have post-assessment pre-payment appeal rights.

## Abatement strategy

- I.R.C. § 6751(b)
  - All penalties determined must be approved by a manager prior to being assessed.
    - Practitioners should request the 6751(b) memo
    - Practitioners should file a Freedom of Information Act (FOIA) to determine if the memo exists.

## Reasonable Cause

- IRM 20.1.1.3.2 (11-21-2017)
- All forms need to be filed before reasonable cause is considered.
- Facts and circumstances analysis.
- Focus is on taxpayer's reason for failing to file.
- Can be met by ignorance of law or by reliance on tax professional.
- Does not apply to continuation penalties.

*Form 5471, Information Return of U.S.  
Persons With Respect To Certain  
Foreign Corporations*

*Form 5471, Foreign Corps.*

Penalties (I.R.C. §§ 6038(b); 6038B(c))

- Statute of Limitations is tolled on entire tax return
- \$10,000 per foreign corporation plus a \$10,000 continuation penalty
- Foreign tax credit reduction- diminution of 10% with continuation diminution
- 6662(j)- underpayment due to undisclosed foreign financial asset-40%

*Form 5472, Information Return of a  
25% Foreign-Owned U.S. Corporation  
or a Foreign Corporation Engaged in a  
U.S. Trade or Business*

*Form 5472, Return of 25% Foreign  
Owned US Corps.*

- Penalties
  - Failure to file form 5472/Failure to file on time results in \$25,000 penalty per year (\$10,000 prior to 2017 tax year)
    - Continuation penalty assessed for each 30 days taxpayer failure to remedy failure to file within 90 days of being notified of failure
    - No cap on continuation penalty
  - Failure to maintain adequate books and records, \$25,000
- Statute of limitations to audit a Form 5472 is three years from the date of filing.

*Form 5472, Return of 25% Foreign  
Owned US Corps.*

- Re-characterization:
- I.R.C. § 6038A(e)(3) disallows the taxpayer's deductions for a failure to provide adequate books and records
- Fail to file or properly file form 5472 can subject the taxpayer to this loss

*Form 5472, Return of 25% Foreign  
Owned US Corps.*

- Other defenses to the penalty
  - Reasonable Estimate: if an amount reported on the Form 5472 is within 25% then it is considered a reasonable estimate (75% to 125% of actual amount).
  - Small Amounts: if the amount to be reported does not exceed \$50,000 then the reporting corporation should state so on the Form 5472 itself.

*Form 5472, Return of 25% Foreign  
Owned US Corps.*

- First Time Abatement
  - First Time Penalty Abatement I.R.M.  
20.1.9.3.5(3)(07-08-2015): taxpayer may be eligible for a first time penalty abatement, which is administrative relief, if a related abatement on a Form 1120 was filed with the Form 5472 if the taxpayer had no similar penalties for the three years prior.

*Form 3520, Annual Return To  
Report Transactions With Foreign  
Trusts and Receipt of Certain  
Foreign Gifts*

## Failure to File

- IRC § 6039F:
  - Tax consequences of the receipt of such gift shall be determined by the Secretary; and
  - 5% of the amount of the foreign gift for each month, not to exceed 25% (continuation penalty).

## Income Re-characterization

- IRC § 6039F(c)(1)(A):
  - “Tax consequences of the receipt of such gift shall be determined by the Secretary”;
- Aside from penalties:
  - Foreign gifts can be deemed gross income;
  - Distributions from foreign trusts can be included as gross income.

Form 8938, *Statement of Specified Foreign Financial Assets*

Form 8938 - *Statement of Specified Foreign Financial Assets*

**Part IV** Excepted Specified Foreign Financial Assets (see instructions)

If you reported specified foreign financial assets on one or more of the following forms, enter the number of such forms filed. You do not need to include these assets on Form 8938 for the tax year.

1. Number of Forms 3520 \_\_\_\_\_ 2. Number of Forms 3520-A \_\_\_\_\_ 3. Number of Forms 5471 \_\_\_\_\_  
4. Number of Forms 8621 \_\_\_\_\_ 5. Number of Forms 8865 \_\_\_\_\_

## Form 8938

- For a failure to timely file, a \$10,000 penalty may be imposed. Ninety days after notice of a failure to file from the IRS, the initial penalty increases by \$10,000 for each 30-day period, up to \$50,000 for each failure.
- The failure to comply with the reporting requirements or any underpayment related to such failure may result in criminal penalties.
- I.R.C. § 6038D(d); Treas. Reg. § 1.6038D-8(a),(c), (f)(2).

## Questions

BREAK

## Sales Reconstruction

LIU Civil and Criminal Tax Controversy Forum  
August 16, 2018

Moderator: Malinda Sederquist, Esq. CPA *Agostino & Associates*

Panelists: Noelle Geiger, Esq., *Grassi & Co.*

Christine Scala, CPA, *NYS Dept. of Taxation & Finance-Tax Auditor II*



## Record Keeping Requirements for Sales Tax Vendors

Registered sales tax vendors are required to keep adequate records

Records are not adequate unless they provide sufficient detail to independently determine the taxable status of each sale and the amount of tax

Tax Bulletin ST-770  
Publication 900 due and collected



## Record Requirements Vary

No one set of record-keeping rules applies to all vendors.

However, your records must be appropriate for your particular operation or business and any record-keeping systems or equipment you use.

## Sales Records

You must keep records of every sale, the amount of the sale, and the sales tax on the sale. Your must retain a true copy of each:

- sales slip, invoice, receipt, contract, statement, or other memorandum of sale;
- guest check, hotel guest check, receipt from admissions such as ticket stubs, receipt from dues; and
- cash register tape and any other original sales document.

## Taxable and Nontaxable Sales

- If you sell both taxable and nontaxable goods or services, you must identify which of the items you sell are subject to sales tax and which are not on the invoice or receipt. For example, a cash register tape must list each item sold with enough detail to determine whether that item is subject to sales tax. You must always separately state the amount of sales tax due on the invoice or receipt that you give your customer. For more information, see Tax Bulletin *Taxable Receipt* (TB-ST-860).



## Listing of Taxable and Exempt Foods and Beverages Sold by Food Stores - ST-525



UPC Code, Description, Department,  
Retail price, taxable or non-taxable.

Coordination with supermarkets IT  
systems to keep inventory updated and  
coded properly for sales tax purposes.

Reverse sales tax audit

[https://www.tax.ny.gov/pubs\\_and\\_bulls/tg\\_bulletins/st/listings\\_of\\_taxable\\_and\\_exempt\\_food.htm](https://www.tax.ny.gov/pubs_and_bulls/tg_bulletins/st/listings_of_taxable_and_exempt_food.htm)

## Delivery Records

- If you deliver the product or service to a place other than your place of business, you must maintain records that prove where delivery took place. A special rule applies to motor vehicles, trailers, and certain boats. For more information, see Publication 750, *A Guide to Sales Tax in New York State*.

Discussion Example – Expensive musical instrument  
manufacturer and retailer



## ERP systems to prove specifically identifiable inventory

- Musical instruments serial numbers
- Bill of Lading showing where and when instrument was delivered to
- Employee loaners
- Sales, resales, rentals, use
- Exempt organizations – festivals, schools
- R&D

## Purchase Records

Purchase records should show the taxable status of all purchases of property or services.

- purchases subject to state and/or local taxes,
- purchases for resale (e.g., inventory and raw materials), and
- purchases exempt from state and/or local taxes for reasons other than for resale.
- purchase records must substantiate all your expenses and your cost of goods sold. These records should also show that your business's purchases bear a reasonable relationship to your business's sales.
- you should also keep any other record or document that, given the nature of your business, would be necessary to prove that you have collected and paid the proper amount of sales or use tax due.

## Electronic Records

If you choose to keep records in electronic format, they must actually reproduce the original record.

Electronic records must be available and accessible to the Tax Department, even if the records are also maintained in paper form.

## Records Deemed Inadequate

If auditors properly request records and after evaluating them, conclude that your business records are not adequate, they may use an estimated audit method that is reasonably designed to calculate your state and local sales tax liability.

## Alternative Audit Methods

- Some situations that would justify using an alternative audit method
  - No records are available
  - Records are incomplete
  - Records are complete but there is a question regarding the reliability of existing records, for example:
    - Lack of proper internal control,
    - Questionable markup percentage reported
    - Questionable taxable ratio,
    - Questionable reported purchases
    - Questionable reporting of sales volume,
    - Questionable level of compensation (wages, income, receipts, etc.)

## Examples of Alternative Audit Methods

- Observation test
- Third party verification
- Taxable ratio
- Mark-up tests
- Prior audit findings
- Information from federal and state income tax returns
- Records from other government agencies or public records
- Indices from published guides (Dunn and Bradstreet rent factor, etc.)

Any of these methods may be used alone or in conjunction with other audit methods, depending on the audit situation.

## Observation tests

Type of businesses- somewhat consistent daily sales (ex. pizzeria, bagel place)

- How is an observation performed?
- Taxpayer shenanigans- phone off hook, specials, consistent hours
- Rep practice tips – should rep be physically present. Highlight legitimate outlier occurrences. Time to add value to analysis to secure accuracy
- Notice: If a taxpayer denies an observation, NYS may sit outside and count customers.



## Third Party Verification

Types of businesses- broad range (ex. auto body shops, liquor stores)

- Credit card data
- Insurance companies
- Customs reports
- Check cashers
- Pay pal accounts
- Banks
- Taxpayer reps should be pro-active and get third party info and reconcile and verify for the auditor.
- Example of rep who contacted bodega suppliers and conducted a shadow audit. Time constraints- getting IDR fulfilled and paying a rep, while running your business.

## Sales/use tax on imported goods

- **Does Customs and Border Protection (CBP) collect state sales tax on imported goods?**
- Customs and Border Protection (CBP) does not collect state sales tax on goods imported into the U.S.
- However, CBP will make entries and CBP declarations available to state tax representatives if requested. Some states occasionally review these documents and send letters to importers and travelers notifying them that they owe state taxes.
- [https://help.cbp.gov/app/answers/detail/a\\_id/295/~taxes-on-imported-goods](https://help.cbp.gov/app/answers/detail/a_id/295/~taxes-on-imported-goods)

# Taxable Ratio method

Types of businesses- businesses that have a combination of taxable and nontaxable sales

- Sales to exempt organizations (ex. Schools and churches)
- Contractors that do capital improvement work and repairs/maintenance projects (ex. plumbers, flooring, kitchen)
- Food & beverage (ex. bagel store, deli, pizza place)
- Out of State sales (internet)
- A business that is not 100% taxable. Gross sales are identifiable but what is the allocation to taxable vs. nontaxable. Mini observation. Square footage analysis what % is allocable to non-taxable.
- Clients who do non taxable sales tell your clients to request and keep exemption certificates. Opportunity to get exemption certificates during audit.

# Mark-up tests

- Liquor stores, bars, pizzerias
- Industries where purchases can be identified.
- NYS request purchase invoice
- NYS records selling prices
- Mark-up tables from NYS
- Adjustments for waste, spillage, personal consumption, buy-backs.



## Prior Audit Findings

- Re-audit to check for compliance
- Why would a company not report the proper taxable % after an audit?
- Taxable ratio will be used again and again
- Penalties

New York State Department of  
**Taxation and Finance**  
www.tax.ny.gov  
Transaction Audit Bureau  
Queens District Office  
80-02 Kew Gardens Rd., Kew Gardens, NY 11415-3618  
Phone: (718) 459-0385 Fax: (516) 430-8469

4/10/18

ID Number: [REDACTED]  
Audit Period: 03/01/2012 - 02/28/2015  
Tax Articles: 28 & 29  
Case ID: [REDACTED]

**We've completed the audit of your tax returns and records.**

During our audit, we reviewed the following audit areas:

- Expenses
- Capital

We have found that you owe additional tax, the result of errors you made in the following areas:

- Expenses - Additional expense purchases was found on audit
- Capital - Additional fixed asset purchases was found on audit

By correcting these errors in future filings you'll avoid having to pay additional tax, penalty, and interest.

Based on our review of the records that you provided, as of 11/07/17, you owe the following:

Additional Tax:	\$13,326.95
Penalties:	0.00
Interest:	\$6,159.93
Total amount due:	\$19,486.88

**Payment**

Our records indicate that we received check number(s) 14453 for full payment in the amount of \$19,486.88

**Tell us how we're doing**

Please visit our Web site and complete an anonymous survey about your audit experience. Your feedback will help us provide better service in the future.

- Go to: [www.tax.ny.gov/enforcement/audit/field\\_survey.htm](http://www.tax.ny.gov/enforcement/audit/field_survey.htm)
- Enter code: LAW

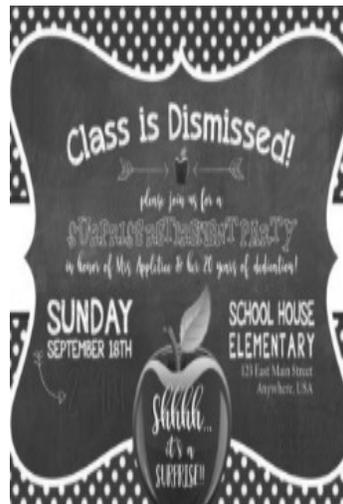
To learn more about your sales tax and other record keeping obligations:

- Visit our Web site at [www.tax.ny.gov](http://www.tax.ny.gov) and see:
  - o TD-87-770, *Recordkeeping Requirements for Sales Tax Vendors*;
  - o Publication 900, *Important Information for Business Owners*; and
  - o TSB-M-09(16)S, *Summary of 2009 Sales and Use Tax Budget Legislation*, that details new penalties related to record keeping.

AU-31 (3/11)

## Common taxpayer misconceptions about what is taxable

- There is nothing non-taxable in a strip club
- Caterers
- Events at churches, schools, hospitals. Who is hosting the event?



## Information from federal and state tax returns

- Federal gross receipts
- Reconcile sales from federal to state returns
- Rent to sales factor, if auditor can't get lease
- Review expenses computer expense or office expense

## Example of IDR requesting reconciliation

2. The worksheet titled: "Reconciliation of Gross Sales per Federal Tax Returns to Gross Sales per General Ledger".
  - Please reconcile sales per Federal Tax Returns to sales per General Ledger for years ended 8/31/11 & 8/31/12.

## Records from other government agencies or public records

Website provides roadmap to recreate sales



### Common sources

- DMV
- Websites
- Yelps
- Virtual map layouts to view size of establishment and nature of business
- App takes picture of receipt

## Indices from published guides

- IRS ratio
- Moody's
- Car wash indices
- Blue book
- Standard and Poors



## Reasonable Estimate vs. Accurate Estimate

The liability will not be canceled even if you can show that the state could have used a more accurate method, as long as the method used was reasonable.

If you wish to contest the method, you must prove by clear and convincing evidence that the method is unreasonable or that the resulting liability is wrong.

## Do you sign agreement for test period election?

- Signing agreement for test period election
- Point out anomalies
- Move to fixed assets to avoid extrapolation


New York State Department of Taxation and Finance  
www.tax.ny.gov  
Transaction Processing Bureau  
Metro NYC Regional Office  
Audit Operations, Room 4, 15 Beachfront Center, Brooklyn, NY 11201-3826  
Phone: (347) 300-7515 Fax: (516) 458-8567

July 2, 2018

50 Jericho Quadrangle  
Jericho, NY 11753

ID Number: [REDACTED]  
Audit Period: 03/01/2013 - 11/30/2015  
Tax Articles: 28/29  
Case ID: [REDACTED]

### Test Period Audit Method Election

sales and use

By signing this form, you're giving the Tax Department permission to conduct this audit by using the *Test Period Audit* method described below. You're **not** consenting to the audit results. You still have the right to challenge the audit results.

**Explanation of audit methods**

**Detailed Audit** – the actual examination and inspection of all books and records for the entire audit period. To use this method, your records must be complete and available for the entire audit period.

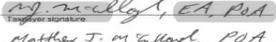
**Statistical Sampling Audit** – based on random sampling of transactions throughout the audit period. The sample size ensures that the audit will be statistically valid. To learn more, see Publication 132, *Computer-Assisted Audits*.

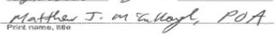
**Test Period Audit** – uses a limited period within the audit to determine the tax liability for the entire audit period. Generally, all applicable records within the selected test period are examined and the results, after appropriate adjustments, are projected over the remainder of the audit period.

**Terms and conditions**

1. **Your complete records must be available.** The department enters into this agreement on the assumption that your books and records, including computer files, are complete, reliable, and available for the entire audit period.
2. **You still have the right to protest.** Signing this agreement doesn't affect your right to protest the audit results.
3. **Power of Attorney.** An attorney or agent of the taxpayer can execute this agreement, if a *Power of Attorney* form is on file with the Tax Department.

The department representative Mr. Larry D. Mungal has advised me of the various audit methods. I agree the audit will be conducted using the **test period audit method** for: sales and recurring expense purchases.

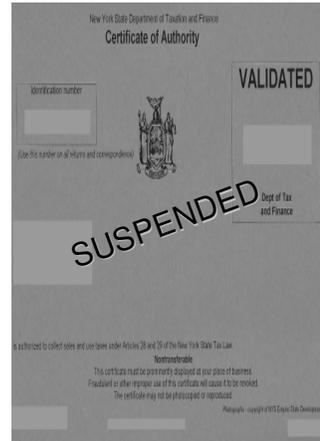

Signature


Matthew J. Mungal, POA  
Print name, title
 

NYS Tax Department representative  
Date: 7/2/18

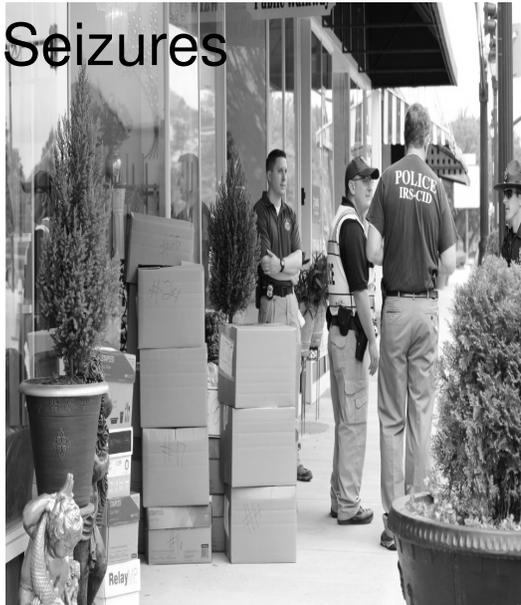
# Consequences of Inadequate Records

- Personal liability for sales tax liability
- Penalty intent letter from NYS outlines penalties for not having adequate records, not providing electronic records, not providing records in auditable condition.
- Suspension or revocation of your Certificate of Authority if you willfully fail to keep adequate records. Example cigarette certificate of authority revoked for 6 months.
- If your Certificate of Authority is suspended or revoked, you **must** discontinue making sales of taxable tangible personal property or services or tax exempt purchases, such as purchases for resale, which means you may be out of business.
- Practice tip: Communicate with the Tax Department. NYS will not just go away. Padlocks will come, Enforcement will prevail.
- Losing leverage in representing the taxpayer – at the mercy of the indirect methods. Costs of representation increases. Going to appeals becomes more of a challenge. Can't produce records at appeals, it is suspect. Where were the records three year ago. Audit lottery.



# War Stories Seizures

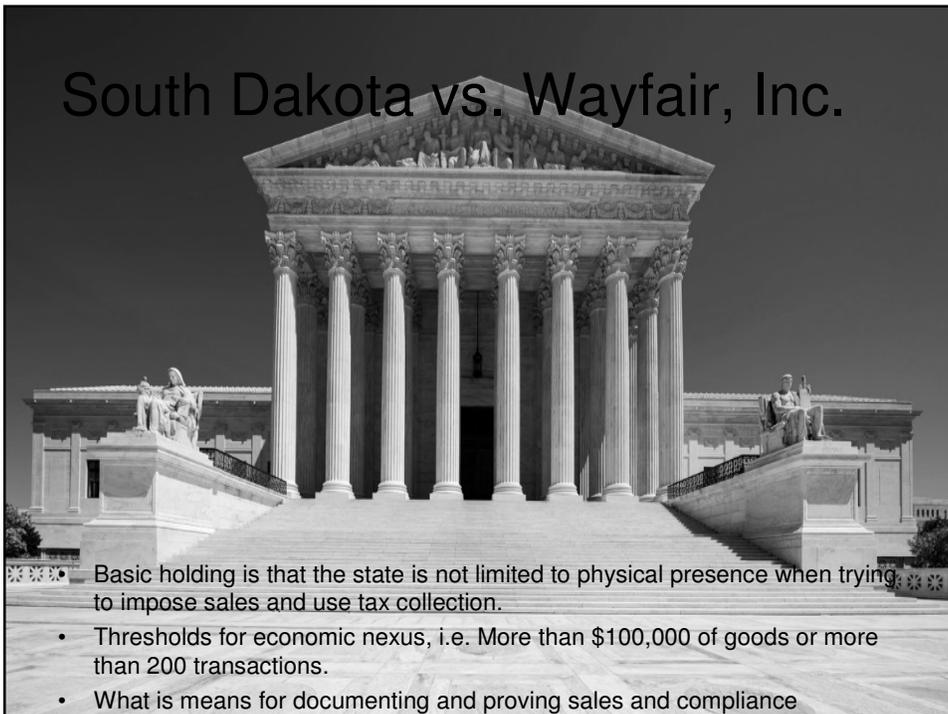
- Seizure vs. search warrant
- computers, drives and files
- Criminal vs. Civil
- Audits and collections



## Does it matter why your records were unavailable?

- Fire/flood/hurricane
- Change in cash register/computer system crashes
- Theft
- Out of business
- Sale of business, seller did not maintain records after sale of business. Bulk sales and escrow accounts. Hire counsel.
- Death, assess estate

## South Dakota vs. Wayfair, Inc.



# Technology

The future

Artificial Intelligence

Blockchain

Apps – technology to record sales

Future of Artificial Intelligence

- Blockchain & Deep Learning
  - Next-gen global computing network technology
  - Computation graphs
  - Self-operating state engines
  - Make probabilistic guesses about reality states of the world

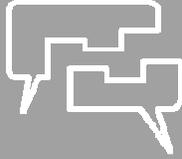
The graphic includes a vertical column of glowing nodes on the right, a horizontal row of transaction blocks labeled Tx.1, Tx.2, Tx.3 at the bottom left, and a neural network diagram at the bottom center.

Christine Scala, CPA  
Tax Auditor II  
NYS Department of Taxation and Finance

Noelle Geiger, Esq.  
Tax Principal Tax Controversy Services  
Grassi & Co.  
516-336-2447

Malinda Sederquist, Esq. CPA  
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201-488-5400





## Residency Update

August 16, 2018



Baker Tilly refers to Baker Tilly Virchow Krause, LLP, an independently owned and managed member of Baker Tilly International.



Candor. Insight. Results.

## Presenters



Candor. Insight. Results.



*Moderator*



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516-336-2447  
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*Panelist*



**Lisa Salvaggio**  
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*Panelist*



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## Agenda



Candor. Insight. Results.



- > NYS Residency Update
- > Hypotheticals

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## Part-year domicile cases



Candor. Insight. Results.



The taxpayer changed his domicile on July 4<sup>th</sup>, 2018 from New York to Florida.

His New York residence will be sold on December 31, 2018.

The taxpayer is a New York domiciliary from January 1, 2018 until July 4, 2018.

WHAT NYS TAX FORMS SHOULD THE CPA FILE?

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## Part-year domicile cases



Candor. Insight. Results.



### 2018 Calendar

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#### Federal Holidays 2018

<b>Jan 1</b> New Year's Day	<b>May 28</b> Memorial Day	<b>Oct 8</b> Columbus Day	<b>Nov 22</b> Thanksgiving Day
<b>Jan 15</b> Martin Luther King Day	<b>Jul 4</b> Independence Day	<b>Nov 11</b> Veterans Day	<b>Dec 25</b> Christmas Day
<b>Feb 19</b> Presidents' Day	<b>Sep 3</b> Labor Day	<b>Nov 12</b> Veterans Day (observed)	

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## OPTIONS FOR FILING?



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1. File IT-201 resident return for the entire year and pay NY tax on worldwide income because the taxpayer was a domiciliary and a statutory resident.
2. File an IT-203 Part-Year resident return and report worldwide income for period Jan 1 – July 4, 2018, and report only NY source income for period July 5 – December 31, 2018 because taxpayer is not a statutory resident for 2018.

## Sobotka case



Candor. Insight. Results.



- > *Sobotka*: When counting 183 days for statutory resident purposes, do not count the days for the portion of the year that the taxpayers were still domiciled in NYS (if at all)
- > *Sobotka* was an ALJ decision in 2015, not binding, NYS' approach has been to not apply *Sobotka*
- > <https://www.dta.ny.gov/pdf/ordersALJ/826286.ord.pdf>

## Law *Sobotka* was based on



Candor. Insight. Results.



NY Tax Law section 605(b)(1)(B): A resident individual means an individual...

Old language has been superseded (effective until April 12, 2018):

“who is not domiciled in this state but maintains a permanent place of abode in this state and spends in the aggregate more than one hundred eighty-three days of the taxable year in this state, unless such individual is in active service in the armed forces of the United States”

## Applying *Sobotka*



Candor. Insight. Results.



File IT-203 Part Year Resident return and pay NY tax on worldwide income from Jan 1- July 4, 2018 and pay NY tax on NY source income from July 5, 2018 – December 31, 2018.

According to *Sobotka*, taxpayer is not a statutory resident in 2018 because he did not spend more than 183 days in NY from July 5 – December 31, 2018

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## *Sobotka* Legislative Fix



Candor. Insight. Results.



New language in NY Tax Law section 605(b)(1)(B) (effective on or after April 17, 2018). Not retroactive.

Amendment to law. Part O Fiscal Year 2018-2019 Budget.

“who maintains a permanent place of abode in this state *and spends in the aggregate more than one hundred eighty-three days of the taxable year in this state*, whether or not domiciled in this state for any portion of the taxable year, unless such individual is in active service in the armed forces of the United States.”

[http://nyassembly.gov/leg/?default\\_fld=&leg\\_video=&bn=A09509&term=2017&Text=Y](http://nyassembly.gov/leg/?default_fld=&leg_video=&bn=A09509&term=2017&Text=Y)

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## Sobotka Legislative Fix



Candor. Insight. Results.



If the fact pattern was for 2019 tax year or a subsequent tax year, File IT-201 Resident return and pay NY tax on worldwide income for entire year.

Taxpayer would be a statutory resident in 2019 because we count the days for the entire calendar year whether or not he was domiciled in NY.

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## Sobotka Legislative Fix



Candor. Insight. Results.



- > Originally the amendment was drafted as retroactive and applicable to all tax years
- > Amendment passed to apply only to tax years beginning after April 17, 2018
- > TSB-M-18(4)I
  - “The definition of resident individual for New York State income tax purposes **has been clarified for tax years 2019 and after** to state that an individual who maintains a permanent place of abode in New York State and spends more than 183 days of the tax year in New York State, whether or not they are domiciled in this state, is a resident unless they were in active service in the military.”
- > What about prior to 2019? *Sobotka* good law? Recall that the legislature explicitly removed the retroactive component to the legislative change

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## NYS Residency Update – *Campaniello*



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- > Appellate Division sustained notice of deficiency pursuant to Article 78 proceeding
- > Long-time NY resident failed to change domicile from NY to FL prior to recognizing capital gain on sale of FL property
  - Emigrated from Italy to NY in late 1960s
  - Established successful retail furniture business in both NY and FL
  - Opened showroom in NYS in 1970s; opened first Miami showroom in 1981, and purchased condo in FL then
  - By 2007, acquired additional real estate holdings in NY, including two warehouses and co-op shares, used to operate a second retail furniture showroom
- > Taxpayer ultimately lost by failing to meet burden of proof of abandoning his NY ties
- > ***Campaniello v. N.Y. State Div. of Tax Appeals Trib.***, No. 524039, 2018 NY Slip Op. 03400 (3d Dep't, May 10, 2018).

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## NYS Residency issue initiated by a whistleblower



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- > False Claims Act Whistleblower case
  - Former employee alleges a Westchester doctor misrepresented to NYS that he lived in Florida while living and working full time in NY, resulting in underpaying NYS income and estate taxes
  - Whistleblower could be awarded over \$1 million
  - ***NYS ex rel. Light v. Melamed et al.*** (N.Y. Sup. Ct. 2018)

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## Double taxation unconstitutional?



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- > Dual resident credit case – Sam Edelman
  - Taxpayer lost.
  - Appellate Division upheld dismissal of a \$6.2 million protest
  - Famous shoe designer claimed NY's denial of a resident credit for tax paid to other states on intangible investment income violated the dormant commerce clause
  - Taxpayer domiciled in CT and a statutory resident of NY
  - Court: intangible investment income is not out-of-state income because it cannot be traced to any jurisdiction outside NYS and thus does not affect interstate commerce
  - **Edelman v. Department of Taxation and Finance** (N.Y. App. Div. 2018)

## Hypo 1 – The Serial Entrepreneur



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- >Taxpayer grew up in Queens, NY; never married, now 35 years old. Parents and two siblings live in NYC area
- >Taxpayer started a few tech companies in the NYC area and shares ownership with siblings and friends
- >Taxpayer no longer oversees day-to-day operations of those companies and has managers to handle. Now spends 3-5 hours a week consulting for the tech companies in and out of NY.
- >Taxpayer moved to Florida to start an entirely new endeavor in the food industry. Taxpayer rents an apartment in FL. Taxpayer owns a home in NY that is rented out to a unrelated third-party
- >Taxpayer spends 146 days in FL, 110 in NY, and 109 elsewhere traveling on business
- >Main issue: Did the taxpayer meet his burden of proving that he left NY and landed in FL which his necessary to effectuate a change of domicile?

### Hypo 2 – Relocate but keep NY job and work remotely



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- > Taxpayer built a consulting firm over several years in NYC and is the CEO
- > Taxpayer desires a warmer climate and moves to Austin, Texas
- > Taxpayer is married; kids are post-college and working in other states
- > Taxpayer sells his NY residence and buys a condo in Austin
- > After the move, the Taxpayer is in NY approximately 130 days a year compared to 200 days in Texas; Taxpayer claims approximately 100 working days in NY per year
- > Taxpayer stays in hotels when in NYS

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### Hypo 3 – Retire but keep the NYC pied à terre



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- > Taxpayer bought a home in Ft. Lauderdale, Florida in 2000, had financial services position with Citibank for 10 years
- > Offered and accepted position in NYC with Bank of America in 2010
- > Bought a one bedroom NYC apartment in 2010, kept FL home
- > Resigned from NYC position in 2015, been out of work since
- > Taxpayer retained FL home with intention of returning there upon retirement
- > Taxpayer revived dating life in FL upon return there
- > Taxpayer continues to spend time in NY for leisure

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#### Hypo 4 – Working remotely



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- > Taxpayer is domiciled in FL, no permanent place of abode in NY
- > Taxpayer is employed by a consulting company, a FL LLC. Taxpayer is sole member of LLC
- > Prior to employment, Taxpayer was president of a family-owned automotive dealership in Queens
- > Taxpayer's FL LLC provides consulting to a number of automotive dealerships in NY and NJ from its FL offices
- > FL LLC agreed to perform consulting services for the family-owned dealership (now owned by Taxpayer's sons) for a ten year term
  - Consulting agreement: consulting services "shall be provided via telephone or electronically" and not anticipated that the consulting services would require any FL LLC employee to travel to NY or any of its dealerships
- > Taxpayer visited NY during year, including dealerships with his sons, but allegedly the primary purpose of visits personal in nature

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#### The impact of consulting agreements in providing evidence to assist with sourcing income earned



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##### *Giuffre case*

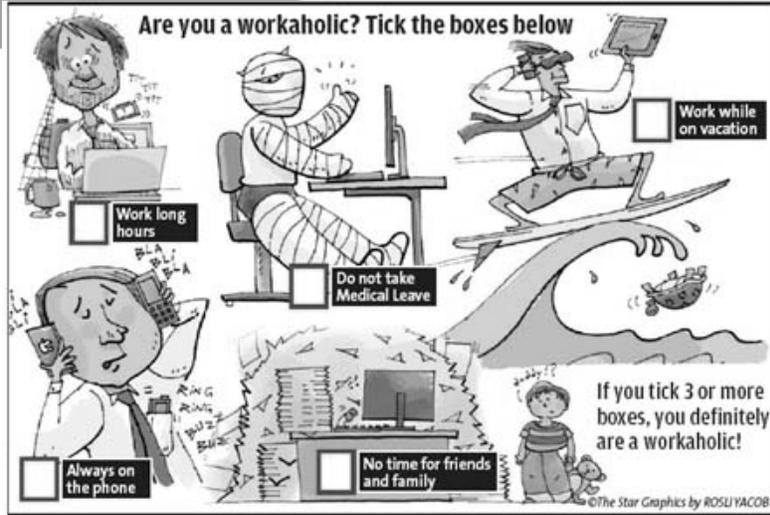
- > NYS proposed allocation of Taxpayer's 1.32M salary based on number of NY dealerships to total dealerships that the consulting company worked with
- > ALJ: Taxpayer did not carry on a trade or business in NYS
  - Employer did not maintain any office or place of business in NYS
  - Consulting agreement specifically states services provided by Taxpayer would be rendered via telephone or electronically
  - Distinguishable from convenience of employer analogy (because in this case the employer is not based in NY)
- > Because income not sourced to NY, then no allocation of wage income
- > **In re Giuffre**, DTA No. 826168 (Mar. 31, 2016)

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## Can you have 365 work days for allocation purposes?



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## Hypo 5 – Corporate executive workaholic



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- >Taxpayer is CEO of Fortune 500 company that is headquartered in Sioux Falls, SD
- >Taxpayer lives in Sioux Falls, SD
- >Company has a New York City office
- >Taxpayer works out of the NYC office approximately 20 days per year
- >Taxpayer's W-2 income is \$10M
- >Taxpayer IT-203-B: 5.48% NYS allocation (\$548k NY source)
  - 20 NY working days / 350 total working days
- >Taxpayer claims she essentially works every day
  - Does not generally work in the office on weekends
  - Works from home answering emails, analyzing reports, planning for the week
  - Issue: Meeting evidentiary burden to prove weekend working days

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“Any problem working remotely?”

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**Hypo 6 – Corporate executive workaholic with NYC primary office**

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- > Taxpayer lives in Greenwich, CT
- > Taxpayer’s primary office is in NYC
- > Taxpayer works from home on some Fridays and some weekends
- > No NY permanent place of abode

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## Nonresident Employees



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- **Working from Home – Convenience Rule**
  - Nonresident employee's office is in NY and works from home on Fridays and weekends: Are they NY Working Days?
  - Convenience rule: necessity of employer v. convenience of employee
  - Ask: Are the employee's duties those which, by their very nature, cannot be performed in NY?
- **Convenience examples**
  - Working from NJ home due to physical disability
  - FL resident who managed business ½ the year from NY office and ½ the year by phone from FL home
  - NY tenured professor who wrote scholarly publications from NJ home

## Connecticut Residents



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- **CT residents beware**
  - CT applies physical presence test for sourcing
  - CT does not employ any "convenience of employer" rule
  - CT resident who works 3 days a week in NYC and two days a week from home for convenience has to pay tax on wages for days worked from CT home to BOTH states
  - CT won't allow resident credit for days worked from home because CT sources the income as earned in CT
- **Most other states use physical presence rule**

## Nonresident Employees



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- Bona Fide Home Office Exception
  - If nonresident has bona fide home office, normal work day spent at home office considered as day worked outside NY
  - Meet one of two tests
- Test #1: Home office contains or is near specialized facilities not available at employer's place of business
- Test #2: Meet 4 Secondary factors and 3 Other factors
- TSB-M-06(5)I

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## Presenters



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Questions?

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**All Calendar Calls are Held at:**

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New York, NY 10278

- October 1, 2018
  - November 5, 2018
  - November 26, 2018
  - December 17, 2018
- Contact Jeffrey Dirmann, Esq. at (201) 488-5400, Ext 119 or [jdirmann@agostinolaw.com](mailto:jdirmann@agostinolaw.com) to volunteer.



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