Taxpayer Rights and Service Assessment: IRS and Data Relating to Taxpayer Rights and Service

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Taxpayer Rights and Service Assessment: IRS Performance Measures and Data Relating to Taxpayer Rights and Service

INTRODUCTION

The Taxpayer Rights and Service Assessment provides the IRS, Congress, and other stakeholders with a “report card” to measure how the agency is doing in protecting and furthering taxpayer rights and service while driving voluntary compliance. This report card can be integral to the IRS’s ongoing implementation of the Taxpayer Bill of Rights (TBOR) and may be used to indicate areas where shifting resources impact the IRS’s ability to maintain a robust adherence to TBOR in practice and provide a high level of customer service. Taxpayer rights and taxpayer customer service are discrete but closely linked considerations.

FIGURE 1.2.1[1]

The Taxpayer First Act (TFA), passed in 2019, required the IRS to submit a written comprehensive customer service strategy that “identified metrics and benchmarks for quantitatively measuring the progress of the Internal Revenue Service in implementing such strategy.”[2] This strategy includes the establishment of the IRS’s Taxpayer Experience Office (TXO), charged with, “focus[ing] on continuously improving the taxpayer experience across all interactions with the IRS.”[3] Employing the use of metrics is vital to gauging the success of any large public-facing system, and the Taxpayer Rights and Service Assessment can be an aid to the TXO in identifying customer service channels requiring adjustment by comparing fiscal year (FY) data as the customer service strategy is implemented.[4] Traditionally, IRS metrics have focused on “efficiency” – no-change rates, cycle time, etc. As the IRS evolves in its delivery of customer experience and it gains additional funding to realize its customer service goals, it will require the development of new taxpayer-centric metrics. We look forward to working further with the IRS on its TFA implementation, customer service strategy, and development of measures for gauging successful taxpayer service.

INTRODUCTION: The Most Serious Problems Encountered by Taxpayers

IRC § 7803(c)(2)(B)(ii)(III) requires the National Taxpayer Advocate to submit an annual report to Congress that contains a summary of the ten "Most Serious Problems" encountered by taxpayers.[1] While we use the method described below to identify the Most Serious Problems, the list remains inherently subjective in many respects.

A. METHODOLOGY OF THE MOST SERIOUS PROBLEM LIST

The National Taxpayer Advocate is in a unique position to identify the most serious problems facing taxpayers because we receive input from a wide variety of sources. Through our Case Advocacy operations, TAS helps hundreds of thousands of taxpayers to resolve their account problems with the IRS every year. We help many types of taxpayers including individuals, businesses, and exempt organizations, and we work with both unrepresented taxpayers and taxpayers represented by tax professionals. Some cases come to us directly, while others come through congressional referrals.

As part of our Systemic Advocacy operations, TAS leaders meet frequently with organizations that work in the tax administration field, and we maintain an online portal through which members of the public and IRS employees can call our attention to systemic problems that affect groups of taxpayers or all taxpayers.[2] We receive hundreds of submissions each year. We review them all, and we create "advocacy projects" to address priority problems. TAS employees also work on cross-functional teams with other parts of the IRS to address areas that impact taxpayer rights and taxpayer service.

The National Taxpayer Advocate considers the input from these sources and assesses the following factors in selecting the Most Serious Problems encountered by taxpayers:

- Impact on taxpayer rights;
- Number of taxpayers impacted;
- Financial impact on taxpayers;
- Visibility, sensitivity, and interest to stakeholders, Congress, and external indicators (*e.g.*, media);
- Barriers to tax law compliance, including cost, time, and burden;
- Taxpayer Advocate Management Information System (TAMIS) inventory data; and
- Emerging issues.

B. TAXPAYER ADVOCATE MANAGEMENT INFORMATION SYSTEM LIST

The identification of the Most Serious Problems reflects not only the mandates of Congress and the IRC but also TAS's integrated approach to advocacy – using individual cases to detect trends and identifying systemic problems in IRS policy and procedures or the IRC. TAS tracks individual taxpayer cases on its internal system, TAMIS.

C. THE MOST SERIOUS PROBLEMS ENCOUNTERED BY TAXPAYERS IN 2022

For the 2022 annual report, the ten Most Serious Problems are:

1. PROCESSING DELAYS: Paper Backlogs Caused Refund Delays for Millions of Taxpayers

The IRS still depends on outdated manual practices and a human assembly line for its paper processing operations, and paper is its Kryptonite. For the past 2.5 years, millions of taxpayers have experienced significant delays waiting for the IRS to process paper-filed tax returns and issue corresponding refunds. These unprecedented paper processing and refund delays are the product of the IRS falling behind during the pandemic, combined with its reliance on antiquated processing technology and manual data entry. Collectively, this resulted in backlogs that overwhelmed the IRS and even caused it to have to transform a campus cafeteria, conference rooms, and hallways into makeshift paper storage space. The IRS needs to modernize its antiquated paper processing procedures to clear the paper backlogs, streamline processing for the future, and improve related taxpayer services and the taxpayer experience.

2. COMPLEXITY OF THE TAX CODE: The Complexity of the Tax Code Burdens Taxpayers and the IRS Alike

The tax laws are overly complex, burden America's taxpayers, and negatively impact voluntary compliance. The system of preparing and filing taxes is too difficult because it is costly and time-consuming. This is especially problematic for taxpayers who access social programs through the IRS and for small business taxpayers. Some of this complexity exists because the IRC is antiquated and does not mirror modern life. The tax code can be simplified by making it easy to understand, which would make it easier for the IRS to administer, and easier for taxpayers to comply with their tax obligations. Simplifying the Code is the most important step Congress can take to reduce taxpayer compliance burdens. Simplification is essential to the integrity of the U.S. tax system and will enhance voluntary compliance.

3. IRS HIRING AND TRAINING: Weaknesses in the Human Capital Office's Hiring, Recruitment, and Training Programs Are Undermining the IRS's Efforts to Achieve Appropriate Staffing to Meet Taxpayer Needs

Over the past decade, the IRS's budget was reduced by more than 15 percent in inflation-adjusted terms, resulting in reduced staffing levels not seen since the 1970s. As staffing declined, so did taxpayer service levels. The Inflation Reduction Act of 2022 provided the IRS with much-needed funding and presented an excellent opportunity to improve taxpayer service. With this new funding, the IRS will need to recruit, hire, and train new employees on a historic scale as the IRS has never attempted to hire beyond its current capacities. It must do this while also keeping pace with the rate of attrition and accounting for the estimated 50,000 IRS employees expected to be lost through attrition within the next six years. To hire thousands of new employees over the next decade and replace employees who have retired or otherwise left, the IRS must increase its current hiring capacity to meet this demand and focus on the training of its employees. The IRS must also prioritize recruitment and counter recruitment challenges it faces in a competitive job market. The agency must work to revamp its training quality and overall efficiency. New IRS employees cannot provide an appropriate level of service on day one; they need significant resources and time to receive quality training, which can often mean both classroom-type and on-the-job training over an extended period. A workforce equipped with next-generation skills needs advanced training throughout their careers, which requires investment and dedicated budgetary resources. For years, the IRS has been developing and implementing a comprehensive training strategy as described in the IRS's Taxpayer First Act

Report to Congress. However, the IRS Human Capital Office (HCO) did not have dedicated budgetary resources needed to launch this vision. Without the appropriate reallocation of funding and a long-term investment in training strategy, HCO will continue to struggle. Although TAS is encouraged by the incremental progress recently in the areas of hiring, recruitment, and training, the IRS has much more work to do to increase HCO hiring capacity, improve recruitment strategies, and start implementation of its robust training program.

4. TELEPHONE AND IN-PERSON SERVICE: Taxpayers Continue to Experience Difficulties and Frustration Obtaining Telephone and Face-to-Face Assistance to Resolve Their Tax Issues and Questions

Though the IRS is increasing staffing and implementing technology designed to improve the customer experience, processing backlogs caused the demand for telephone and in-person service to remain high, while customer service levels continued to remain unacceptably low. The fiscal year 2022 post-pandemic filing season saw little improvement in telephone and Taxpayer Assistance Center services. Taxpayers and practitioners rely heavily on the ability to reach an IRS employee for account actions and answers to their inquiries. Lack of sufficient service jeopardizes compliance, frustrates taxpayers, and impacts the taxpayers' *right to quality service*.

5. ONLINE ACCESS FOR TAXPAYERS AND TAX PROFESSIONALS: Inadequate Digital Services Impede Efficient Case Resolution and Force Millions of Taxpayers to Call or Send Correspondence to the IRS

Providing tax information and services accessible through a robust online account and seamlessly integrated digital communication tools are essential for taxpayers, their representatives, and IRS employees. Taxpayers or their representatives wanting to interact online need and deserve quality service options and quick responses from the IRS. Today, most taxpayers and tax professionals can't depend on receiving either, causing dissatisfaction that can lead to distrust in tax administration. In recent years, the IRS developed standalone self-assistance web applications that allow taxpayers to perform a single task, such as resolving their inquiries via an automated voicebot or chatbot, sending and receiving secure digital messages, uploading documents, and viewing basic account information. While each application and tool has standalone value and facilitates a particular interaction, the IRS has not leveraged its utility by making them accessible from a central hub that provides a seamless taxpayer experience. As the IRS continues to introduce new self-assistance applications and improve existing ones, it should determine its priorities using a taxpayer-centric approach. The IRS must prioritize the experience of individual and business taxpayers as customers and provide an intuitive central hub with one-click access to all authenticated and unauthenticated self-assistance applications.

6. E-FILE AND FREE FILE: E-Filing Barriers and the Absence of a Free, Easy-to-Use Tax Software Option Cause Millions of Taxpayers to Continue to File Paper Tax Returns

The high number of e-filed returns shows that taxpayers are committed to e-filing, despite the obstacles they sometimes encounter. It is in the IRS's best interest to encourage this trend by making the e-file process more straightforward and user-friendly. By making all forms and schedules compatible with e-filing, as well as making taxpayers' information returns and payment histories downloadable from their online accounts, the IRS can facilitate quick and accurate e-filing for individuals. Opportunities for improvement also exist for business taxpayers, who are sometimes discouraged from e-filing information returns and employment tax returns on account of cumbersome technology. Enhancing this capacity while developing an IRS-run direct e-file option could take a creaky system still managing to produce good results and create a comprehensive e-file system that would benefit both taxpayers and the IRS. This transformation would improve the taxpayer experience, remove barriers to tax filing, improve the timeliness of refunds, and further voluntary compliance.

7. IRS TRANSPARENCY: Lack of Transparency About Processing Delays and Other Key Data Frustrates Taxpayers and May Undermine Voluntary Compliance

This Most Serious Problem addresses the importance of transparency and providing taxpayers with access to information. These bedrock principles of tax administration are especially critical since the IRS has recently received a significant increase in funding to be used for enforcement, customer service, and technology enhancements. It is also critical that the IRS provide taxpayers with complete, accurate, and timely information about the status of their refunds, and clear, concise, and reliable guidance on a variety of complex tax issues. A tax administration agency fully transparent and clear about how taxpayers can comply with their tax obligations and where their return is in the processing pipeline results in trust between the IRS and taxpayers, ultimately yielding optimal voluntary compliance.

8. RETURN PREPARER OVERSIGHT: Taxpayers Are Harmed by the Absence of Minimum Competency Standards for Return Preparers

Return preparers prepare over half of individual income tax returns and play a key role in tax administration. Many taxpayers are ill-equipped to assess a preparer's expertise in tax laws and tax return preparation. The absence of minimum competency standards for preparers of federal tax returns leaves taxpayers, particularly low-income taxpayers, vulnerable to return preparers' inadvertent errors that could cause them to overpay their tax – or to underpay their tax and face subsequent IRS enforcement action. Recent IRS data shows that taxpayers are harmed by non-credentialed return preparers. For example, about 92 percent of the total amount of 2020 Earned Income Tax Credit audit adjustments (in dollars) occurred on returns prepared by non-credentialed paid return preparers. Because taxpayers are financially responsible for inaccurately prepared returns, minimum competency standards for return preparers are an important taxpayer protection measure. Taxpayers should be able to rely on and trust qualified preparers.

9. APPEALS: Staffing Challenges and Institutional Culture Remain Barriers to Quality Taxpayer Service Within the IRS Independent Office of Appeals

Appeals plays a crucial role in administrative case resolution within the IRS. However, over the past decade, Appeals has faced challenges with funding and employee attrition that made providing top-notch taxpayer service difficult. The average Appeals case takes about a year to resolve, which means that taxpayers may be frustrated and discouraged with the process by the time it runs its course. With increased hiring and training and modernized systems for electronic case files, Appeals can improve cycle times, an important step toward quality taxpayer service. Appeals can also make important strides in reinforcing its role as an independent office within the IRS by adopting more taxpayer-friendly practices regarding conferences, by empowering Appeals Officers as final decision makers, and by providing taxpayers with access to Appeals Case Memoranda and post-settlement conferences, where applicable.

10. OVERSEAS TAXPAYERS: Taxpayers Outside of the United States Face Significant Barriers to Meeting their U.S. Tax Obligations

Many taxpayers face challenges understanding their tax obligations and accessing information and services from the IRS. However, taxpayers living overseas face additional challenges in virtually every aspect of their taxpayer experience. Whether they are U.S. citizens, resident aliens living abroad, or foreign persons with U.S. tax obligations, the laws that apply to these taxpayers are very complex.

These taxpayers are subject to highly complicated rules for determining whether they need to file a U.S. tax return and, if so, their correct U.S. tax liability. They have even more limited access to IRS customer service than domestic taxpayers, and they routinely face delays in receiving correspondence. They also face barriers in obtaining Taxpayer Identification Numbers, electronically filing returns, and accessing assistance from both the IRS and private industry. The National Taxpayer Advocate urges the IRS to take concrete steps to reduce the burden on these taxpayers and to better support them in their attempts to comply with U.S. law.

Endnotes

1 Prior to 2019, Congress tasked the National Taxpayer Advocate with identifying at least 20 of the most serious problems encountered by taxpayers. This change was the result of the passage of the Taxpayer First Act, Pub. L. No. 116-25, 133 Stat. 981 (2019).

2 The Systemic Advocacy Management System (SAMS) is a database of systemic issues and information reported online to TAS by IRS employees and members of the public. IRS, SAMS, https://www.irs.gov/advocate/systemic-advocacy-management-system-sams. TAS reviews and analyzes the submissions and determines a course of action, which may include information-gathering projects, immediate interventions, and advocacy projects. Internal Revenue Manual 1.4.13.4.9.2, Systemic Advocacy Management System (SAMS) (July 16, 2021).

The Inflation Reduction Act of 2022 Has Given the IRS a Rare Opportunity to Transform and Dramatically Improve Its Customer Service – But Funding Alone Does Not Guarantee Success

In recent reports, this assessment has highlighted IRS challenges as its inflation-adjusted budget appropriation and staffing levels have declined in the face of rising workloads. TAS has maintained that without sustained, consistent, and dedicated funding, the IRS would remain challenged to develop and maintain the workforce and administrative tools necessary to deliver a high quality of customer service that all taxpayers are entitled to and should reasonably expect from their federal tax administrator.

In FY 2022, Congress passed the Inflation Reduction Act of 2022, which appropriates nearly $80 billion in additional IRS funding, including almost $3.2 billion allotted for taxpayer services, $45.6 billion for enforcement, $25.3 billion for operations support, and nearly $4.8 billion for business systems modernization.[5] This legislation provides the IRS a critical opportunity to significantly improve its delivery of taxpayer services, but increased funding alone will not guarantee improvement. On August 17, 2022, Secretary of the Treasury Janet Yellen formally requested the IRS provide a strategic plan on how the agency intends to apply this funding.[6] The plan should clearly communicate its vision and strategy with defined metrics and benchmarks to determine when resource allocations are or are not successfully improving the taxpayer experience. The choices made regarding the use of this historic funding and the level of transparency exhibited while communicating the intent behind these decisions should significantly impact the quality of IRS customer service as well as taxpayers' perception of the organization as a service-oriented provider.[7] It should be noted while reviewing this assessment that as the Inflation Reduction Act was enacted on August 16, 2022, it will not effect a change when looking at FY 2022 performance metrics. TAS will continue to pay keen attention, however, to determine how the IRS's use of this additional funding will improve taxpayer service moving forward.

FIGURE 1.2.2[8]

IRS Pre-Inflation Reduction Act of 2022 Snapshot

IRS Full-Time Equivalents, Return Volume, and Inflation-Adjusted Budget, FYs 2010-2022

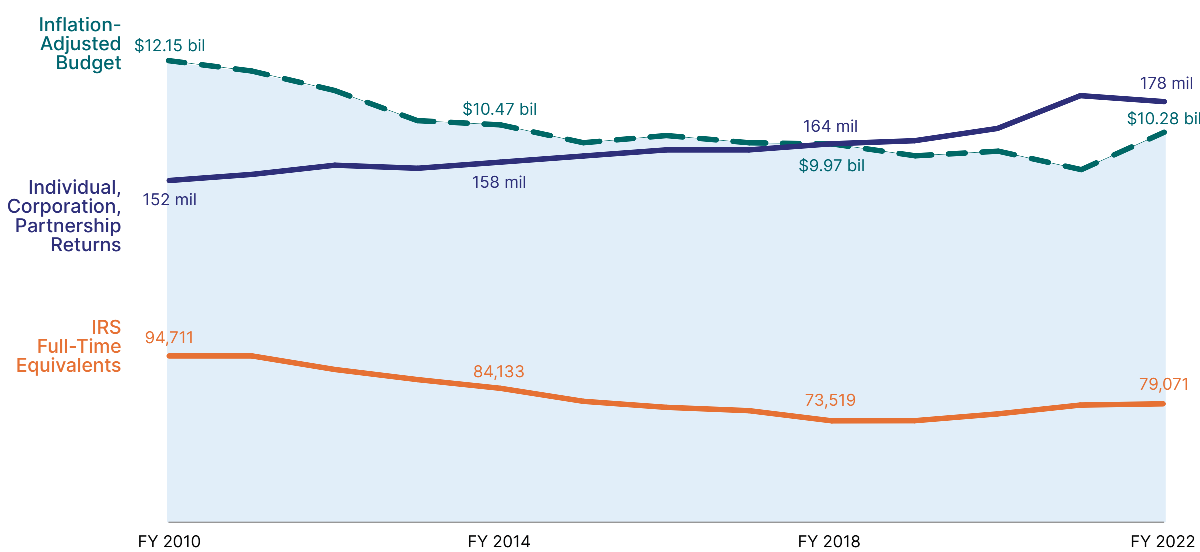
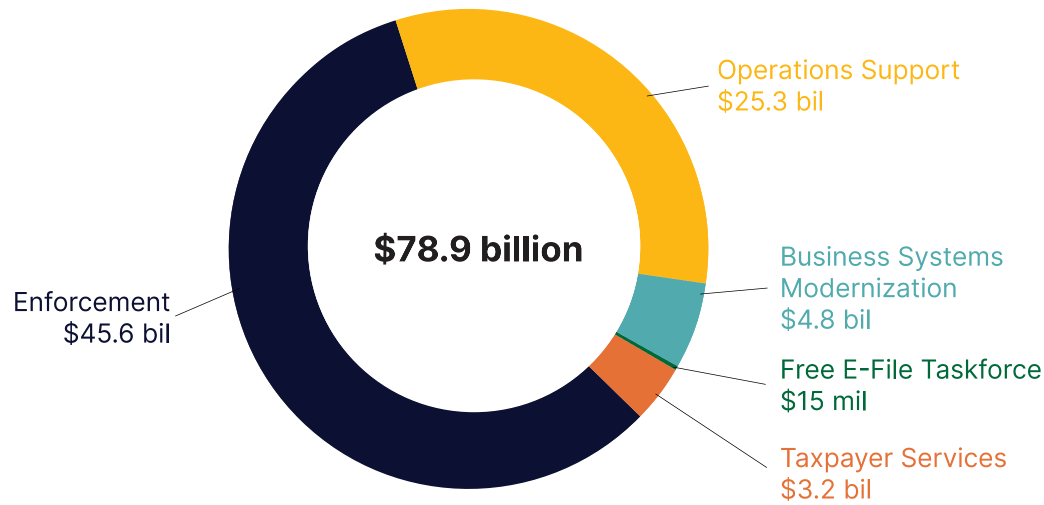


FIGURE 1.2.3[9]

Inflation Reduction Act of 2022



TAXPAYER SERVICE: TAX RETURN PROCESSING[10]

Processing Center Closures, the Impact of COVID-19, Rising Return Inventories, and Diminishing Resources Have Negatively Influenced the Quality of Customer Service

Tax return processing is a fundamental IRS function, and return filing metrics are an important measure of IRS workload. Rising return inventories coupled with diminishing resources influence the quality of customer service taxpayers receive, and disruptions to this essential function negatively impact taxpayer rights.[11] Large paper processing backlogs experienced due to COVID-19 highlight how dramatically taxpayers are impacted when this essential process falters.[12] The number of individual, business, and other returns filed each year is on the rise, growing from 255,249,983 returns filed in FY 2019 to 271,612,000 projected returns filed for FY 2022.[13] While the majority of taxpayers opt to file electronically, millions of tax returns are still filed on paper as a percentage of our population lacks the ability or desire to file electronically, such as those without internet access; low-income or elderly taxpayers; or taxpayers who are required to file using forms that are not currently available in an electronically submittable format. The IRS must devote staffing and resources to processing these paper submissions and continue to invest in the maintenance and modernization of its systems to successfully manage paper *and* electronically filed returns. As noted by the National Taxpayer Advocate in her 2022 Taxpayer Advocate Directive (TAD) to the IRS, this effort should include an expanded use of scanning technology to efficiently speed the processing of paper-filed tax returns.[14]

FIGURE 1.2.4, Income Tax Returns Filed

Measure/Indicator	FY 2019	FY 2020	FY 2021	FY 2022
Number of Returns Filed (Projected, All Types)[15]	255,249,983	242,093,670	269,032,799	271,612,000
Total Individual Income Tax Returns[16]	154,094,555	157,195,302	167,915,264	166,076,400
Total Individual Income Tax Returns Filed on Paper[17]	16,578,426	8,749,558	16,463,292	12,918,800
Total Individual Income Tax Returns Filed Electronically[18]	137,516,129	148,445,744	151,451,972	153,157,600
Free File Consortium (Tax Year)[19]	2,528,639	4,018,163	4,997,000	2,449,458

Measure/Indicator	FY 2019	FY 2020	FY 2021	FY 2022
Fillable Forms (Tax Year)[20]	283,244	519,133	795,000	645,049
Total Corporation Income Tax Returns[21]	7,288,019	6,841,771	7,464,790	7,523,400
Total Corporation Income Tax Returns Filed on Paper[22]	1,325,429	697,421	1,062,200	963,600
Total Corporation Income Tax Returns Filed Electronically[23]	5,962,590	6,144,350	6,402,590	6,559,800

Observation: The total amount of individual and corporate income tax returns filed electronically remains high. Electronically filed returns now account for over 92 percent of individual filings and approximately 87 percent of corporate filings in FY 2022 (please note FY 2022 return counts are projected numbers).

TAXPAYER SERVICE: EXAMINATION AND COLLECTION[24]

Without Adequate Staffing, the IRS Has Had to Make Tough Decisions on Where to Focus Compliance Resources

IRS examination and collection action can lead to taxpayer anxiety, which may be exacerbated if the process is perceived as prolonged or inequitable. Declining IRS staffing levels and high case inventory volumes have posed challenges to maintaining acceptable levels of taxpayer customer service. The strategic allocation of limited workforce resources is challenging yet vital to ensuring equitable treatment across all taxpayer populations, while attention to closed case resolutions can indicate whether the IRS is applying resources appropriately and/or promoting a sense of parity. A higher rate of no-response audit[25] closures in the lower-income taxpayer category, for example, warrants consideration for adjustments in approach. Rising no-change audit[26] closures might suggest resources would be better targeted toward areas of greater non-compliance. The Inflation Reduction Act has allotted $45.6 billion in additional IRS enforcement funding through the end of FY 2031, giving the IRS's collection function a tremendous boost in its ability to hire.[27] Additional hiring addresses a critical IRS need, but hiring alone will not guarantee an improved taxpayer experience. New IRS employees must be adequately trained to perform their duties, and that training must include guidance on recognizing, understanding, and integrating a respect for taxpayer rights into the essential work they do.[28] The quality of customer service provided must always respect the taxpayers' *rights to be informed, to quality service, to pay no more than the correct amount of tax,* and *to a fair and just tax system.*[29]

FIGURE 1.2.5, Type of Audit, Outcomes, and Time to Complete by Income, FYs 2019-2022

Measure/Indicator	FY 2019	FY 2020	FY 2021	FY 2022
Examination				
Total Number of Open Audits Pending in Exam[30]	525,525	614,359	527,353	425,704
Total Number of Closed Examinations – **Individual Tax Returns**[31]	680,463	452,510	658,998	625,947
Total Positive Income (Under $50,000)				
No-Change Rate	10.1%	11.4%	8.6%	12.8%
Agreed Rate[32]	23.3%	20.6%	19.8%	17.1%
Taxpayer Failed to Respond Rate[33]	39.8%	44.7%	46.4%	44.2%
Average Days to Audit Completion	278.7	263.2	339.5	269.6
Average Total Exam Time (Hours) Correspondence Audits	1.4	1.4	1.4	1.4
Average Total Exam Time (Hours) Field Exams	20.4	25.1	28.8	28.8

Measure/Indicator	FY 2019	FY 2020	FY 2021	FY 2022
Percent of Correspondence Audit[34]	88.1%	90.0%	92.4%	91.3%
Total Positive Income (Greater than $50,000 and under $10,000,000)				
No-Change Rate	12.4%	16.0%	11.6%	13.1%
Agreed Rate	42.8%	44.6%	39.6%	40.3%
Taxpayer Failed to Respond Rate	20.0%	17.5%	22.7%	21.3%
Average Days to Audit Completion	288.2	301.2	385	317.6
Average Total Exam Time (Hours) Correspondence Audits	2.1	2.2	2.4	2.3
Average Total Exam Time (Hours) Field Exams	28.7	28.5	37.1	38.2
Percent of Correspondence Audit[35]	67.7%	62.0%	71.4%	72.2%
Total Positive Income (Greater than $10,000,000)				
No-Change Rate	21.3%	19.7%	30.3%	31.1%
Agreed Rate	50.5%	52.2%	52.1%	51.5%
Taxpayer Failed to Respond Rate	1.8%	0.8%	0.2%	0.2%
Average Days to Audit Completion	703.8	994.7	682.9	982.0
Average Total Exam Time (Hours) Correspondence Audits	11.2	9.1	8.9	7.7
Average Total Exam Time (Hours) Field Exams	117.1	94.3	91.4	110.6
Percent of Correspondence Audit[36]	37.0%	43.3%	24.3%	32.2%

Observation: Taxpayers with incomes below $50,000 had about 90 percent of their audits conducted by correspondence, nearly 40 percent or more failed to respond to the IRS, and less than 25 percent agreed to the proposed adjustments. As income levels increase, the relative number of correspondence audits and failure-to-respond rates decrease, whereas the agreed rates rise.

FIGURE 1.2.6, Offers in Compromise, Installment Agreements, and the Queue, FYs 2019-2022

Measure/Indicator	FY 2019	FY 2020	FY 2021	FY 2022
Collection				
Offer in Compromise: Number of Offers Submitted[37]	54,225	44,809	49,285	36,022
Offer in Compromise: Percentage of Offers Accepted[38]	35.3%	34.3%	30.9%	28.7%
Installment Agreements (IAs): Number of Individual & Business IAs[39]	2,821,134	1,825,378	2,361,646	2,383,849
Number of IAs With Bots[40]	0	0	0	8,505
Rejected Taxpayer Requests for IAs[41]	32,281	15,483	14,164	8,800
Percentage of Cases Pending Assignment (in the Queue) (Taxpayers)[42]	24.1%	28.1%	20.9%	17.5%
Percentage of Cases Pending Assignment (in the Queue) (Modules)[43]	33.6%	39.3%	28.5%	24.0%
Age of Individual Delinquencies Pending Assignment (in the Queue)[44]	4.8 years	4.6 years	4.3 years	4.9 years

Observation: Offers in compromise decreased by nearly 27 percent from FY 2021 to FY 2022 while IA submissions increased by less than one percent during this same period. Fewer taxpayers remained in the queue, but the average age of individual unassigned delinquencies increased by about one-half year.

TAXPAYER SERVICE: TAXPAYER-FACING COMMUNICATION CHANNELS[45]

Taxpayers Attempt to Reach the IRS Via Various Channels, But the IRS Faces Challenges in Timely Responding

Taxpayers are increasingly reaching out to the IRS through a variety of communication channels, particularly since the onset of COVID-19, but the IRS is challenged to efficiently and timely address taxpayer contacts when budget and workforce resources are down[46] or have been temporarily redirected to address the processing of paper return backlogs.[47] Individual correspondence processing cycle times, for instance, have risen considerably since FY 2019, while percentages of calls answered by IRS employees have dropped from 28.7 percent in FY 2019 to only 12.5 percent in FY 2022.[48] Increases in virtual service contacts are also important, but taxpayers' continued preference and need for face-to-face assistance must always be considered and supported. It's worth noting that while the IRS has maintained at least 358 Taxpayer Assistance Centers since FY 2018, COVID-19 protocols and limited staffing have meant that not all TACs have remained open or staffed throughout each year.[49]

Additional funding provided under the Inflation Reduction Act of 2022 will supplement and enhance IRS efforts to improve its customer service across all service channels, and the IRS announced in October that it had already successfully hired 4,000 new customer service representatives (CSRs) to help answer phones and provide other services for the next filing season.[50] A portion of these new hires will be filling positions opened though CSR attrition and turnover, so efforts to maintain a bolstered customer service workforce remain an ongoing challenge. The IRS will need to be strategic and monitor customer service measures to be sure its application of resources is generating the improvements in taxpayer service it seeks and that it maintains a balance across all service areas. Taxpayers have the *rights to quality service, to be informed, to pay no more than the correct amount of tax*, and *to a fair and just tax system*. These rights are essential to the standard of service a taxpayer receives when working with the IRS, no matter the communication channel.

FIGURE 1.2.7, In-Person Service, Correspondence, Telephone, and Online Service, FYs 2019-2022

Measure/Indicator	FY 2019	FY 2020	FY 2021	FY 2022
In-Person Service				
Number of Taxpayer Assistance ("Walk-In") Centers (TACs)[51]	358	358	358	360
Number of Face-to-Face TAC Contacts[52]	2.3 million	1.0 million	940,000	1.3 million
Number of Calls to the TAC Appointment Line That Did Not Result in a Scheduled Appointment[53]	1.4 million	694,000	922,000	501,000
Correspondence[54]				
Individual Correspondence[55]	4,134,753	2,765,003	6,306,488	6,950,094
Average Cycle Time to Work Individual Correspondence[56] (Master File (IMF))	74 days	96 days	201 days	207 days
Inventory Overage[57]	41.8%	41.6%	59.6%	44.6%
Business Correspondence[58]	2,717,819	2,038,291	4,197,132	4,599,806
Average Cycle Time to Work Business Correspondence[59] (Master File (BMF))	101 days	149 days	145 days	163 days
Inventory Overage[60]	57.8 %	71.9%	51.5%	60.4%

Measure/Indicator	FY 2019	FY 2020	FY 2021	FY 2022
Telephone Service				
Total Calls to IRS[61]	99,373,456	100,514,299	281,708,009	173,265,572
Number of Calls Answered by IRS Employees[62]	28,558,862	24,192,386	32,039,550	21,740,474
Percentage of Calls Answered by IRS Employees[63]	28.7%	24.1%	11.4%	12.5%
IRS Level of Service (LOS)[64]	56.2%	51.2%	21.3%	21.3%
IRS Average Speed of Answer[65]	16.2 minutes	18.3 minutes	22.8 minutes	28.6 minutes
Practitioner Priority: Percentage of Calls Answered (LOS)[66]	78.3%	56.3%	28.0%	16.9%
Practitioner Priority: Average Speed of Answer[67]	8.8 minutes	12.7 minutes	16.1 minutes	25.4 minutes
Online Service				
Number of Visits to IRS.gov[68]	650,989,560	1,603,938,876	1,999,988,189	1,087,210,500
Number of Page Views[69]	3,350,072,964	9,225,312,072	11,452,583,281	5,310,673,611
Online Installment Agreements[70]	786,505	719,752	1,051,708	1,184,711
Where's My Refund? Inquiries[71]	368,848,775	505,611,474	632,361,686	447,729,355

Observation: In-person visitations remain limited due to closed or virtual TACs as FYs 2020, 2021, and 2022 numbers all remain significantly less than FY 2019 levels; FYs 2021 and 2022 correspondence volumes remained significantly higher than prior years, contributing to longer processing delays; the percentage of FY 2022 calls answered by an IRS employee remained below 50 percent of FY 2019 pre-pandemic levels; and taxpayers continued to use online tools and the IRS website in dramatically greater numbers than they did prior to COVID-19.

TAXPAYER SERVICE: INFORMATION TECHNOLOGY

Taxpayers have continued to experience increased frustration and difficulty resolving their IRS issues, receiving timely notices, accessing detailed information on their Online Account or IRS tools, or reaching an IRS employee,[72] and modernization efforts are challenged when a large portion of available funding is required to maintain current operations and legacy systems. The Inflation Reduction Act budgets the IRS an additional $4.8 billion in funding for business modernization, which is key for the IRS to successfully update its systems.[73] TAS looks forward to seeing the IRS use this opportunity to advance its modernization initiatives and establish more effective systems to serve taxpayers quickly and comprehensively. The modernization of aging IRS information systems and the requisite application of staffing to maintain that effort is integral to improving IRS customer service and respecting taxpayers' *right to quality service*.

Endnotes

1 See TBOR, www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in TBOR are also codified in the IRC. *See* IRC § 7803(a)(3).

2 Taxpayer First Act, Pub. L. No. 116-25, § 1101(a)(5), 133 Stat. 985-986 (2019).

3 IRS, Taxpayer First Act Report to Congress 99 (Jan. 2021).

4 These measures are presented as a sample of indicators and are not intended to be read as a comprehensive listing of performance benchmarks.

5 An Act to Provide for Reconciliation Pursuant to Title II of S. Con. Res. 14, Pub. L. No. 117-169, 136 Stat. 1831-32 (2022) [hereinafter referred to as the "Inflation Reduction Act"].

6 Memorandum from Janet L. Yellen, Sec'y of the Treasury, to Charles P. Rettig, Comm'r. Internal Revenue (Aug. 17, 2022), (on file with TAS).

7 For a further discussion of IRS transparency, *see* Most Serious Problem: *IRS Transparency: Lack of Transparency About Processing Delays and Other Key Data Frustrates Taxpayers and May Undermine Voluntary Compliance*, *infra*.

8 IRS responses to TAS fact checks (Dec. 14, 2020; Dec. 23, 2020; Dec. 8, 2022). IRS email response to TAS (Oct. 20, 2022). IRS Full-Time Equivalents (FTE) line: This figure represents the average number of FTE positions actually used to conduct IRS operations, which excludes FTEs attributable to overtime, terminal leave, and those funded by reimbursable agreements from other federal agencies and private companies for services performed for these external parties. It also excludes positions funded by private debt collection funds. Individual, Corporate, Partnership Returns line: IRS, Pub. 6292, Table 1, Fiscal Year Return Projections for the United States: 2011-2018, Fall 2011 Update 6 (Rev. 8-2011), and subsequent annual Fall Pub. 6292 updates through IRS, Pub. 6292, Table 1, Fiscal Year Return Projections of the Number of Returns To Be Filed with IRS, 2022-2029, at 4 (Rev. 9-2022). The return volume reported for FY 2022 is a projected number. Inflation-Adjusted Budget line: The budget figures include rescissions and funds provided in the administrative provisions of appropriations bills but exclude supplemental funds passed outside of the normal appropriations bills. The inflation adjustment is computed using the Gross Domestic Product Price Index from the President's Budget FY 2022, Historical Tables, Table 10.1.

9 An Act to Provide for Reconciliation Pursuant to Title II of S. Con. Res. 14, Pub. L. No. 117-169, 136 Stat. 1831-32 (2022).

10 When considering FY 2020 data, note that core IRS services were suspended or reduced for a portion of FY 2020 due to COVID-19.

11 For example, the IRS encountered a system outage on April 17, 2018 (the 2017 tax return filing deadline), and had to provide taxpayers an additional day to file and pay their taxes. *See* IRS, IR-2018-100, IRS Provides Additional Day to File and Pay for Taxpayers Through Wednesday, April 18; IRS Processing Systems Back Online (Apr. 17, 2018); Jeff Stein, Damian Paletta & Mike DeBonis, *IRS to Delay Tax Deadline By One Day After Technology Collapse*, Wash. Post (Apr. 17, 2018), https://www.washingtonpost.com/business/economy/irs-electronic-filing-system-breaks-down-hours-before-tax-deadline/2018/04/17/4c05ecae-4255-11e8-ad8f-27a8c409298b_story.html.

12 For a discussion of IRS processing issues, *see* Most Serious Problem: *Processing Delays: Paper Backlogs Caused Refund Delays for Millions of Taxpayers*, *infra*. *See also* National Taxpayer Advocate 2021 Annual Report to Congress 37 (Most Serious Problem: *Processing and Refund Delays: Excessive Processing and Refund Delays Harm Taxpayers*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2022/01/ARC21_MSP_01_Processing-Delays.pdf); National Taxpayer Advocate 2021 Annual Report to Congress 95 (Most Serious Problem: *Filing Season Delays: Millions of Taxpayers Experienced Difficulties and Challenges in the 2021 Filing Season*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2022/01/ARC21_MSP_05_FilingDelays.pdf).

13 The sudden rise in FY 2021 filed individual returns can in part be attributed to returns filed by taxpayers who traditionally are not required to file a return but who filed solely to receive the Recovery Rebate Credit in advance. IRS, Pub. 6292, Fiscal Year Return Projections for the United States: 2022-2029, at 4 (Rev. 9-2022).

14 In March 2022 the National Taxpayer Advocate issued a TAD directing the IRS "to implement 2-D barcoding or other scanning technology to automate the transcription of paper tax returns." Despite a non-committal IRS response, Secretary of the Treasury Janet Yellen subsequently pledged that "[i]n this coming filing season, the IRS will automate the scanning of millions of individual paper returns into a native digital copy." *See* Department of the Treasury, *Remarks by Secretary of the Treasury Janet L. Yellen at the IRS facility in New Carrollton, Maryland* (Sept. 15, 2022), https://home.treasury.gov/news/press-releases/jy0952.

15 IRS, Pub. 6292, Fiscal Year Return Projections for the United States: 2020-2027, at 4 (Rev. 9-2020); IRS, Pub. 6292, Fiscal Year Return Projections for the United States: 2021-2028, at 4 (Rev. 9-2021); IRS, Pub. 6292, Fiscal Year Return Projections for the United States: 2022-2029, at 4 (Rev. 9-2022). The FY 2020 figure has been updated from what was reported in the 2021 Annual Report to Congress. The FY 2021 figure has been updated from what was reported in the 2021 Annual Report to Congress to report actual return counts. The FY 2022 figures are projected numbers. The number of returns and related metrics are proxies for IRS workload and provide context for the environment in which taxpayers seek quality service and other rights from TBOR.

16 *Id*. The FY 2021 figure has been updated from what we reported in the 2021 Annual Report to Congress to report actual return counts. The FY 2022 figures are projected numbers.

17 *Id*.

18 *Id*.

19 FY 2019 and 2021 numbers updated from IRS response to TAS fact check (Dec. 17, 2021) including returns filed solely to claim the Advance Child Tax Credit (AdvCTC). FY 2020 and FY 2022 numbers are from IRS, Compliance Data Warehouse (CDW), Electronic Tax Administration Research and Analysis System Modernized e-File for Individuals and exclude about 8.5 million returns filed for the purpose of claiming Economic Impact Payments in FY 2020. The FY 2019 figures represent TY 2018 tax returns. The FY 2020 figures represent TY 2019 tax returns. The FY 2021 figures represent TY 2020 tax returns. The FY 2022 figures represent TY 2021 tax returns.

20 FY 2021 numbers updated from IRS response to TAS fact check (Dec. 17, 2021), including some returns filed solely to claim the AdvCTC. FY 2020 and FY 2022 numbers are from IRS, CDW, Electronic Tax Administration Research and Analysis System Modernized e-File for Individuals and exclude returns filed for the purpose of claiming Economic Impact Payments. The FY 2020 figures represent TY 2019 tax returns. The FY 2021 figures represent TY 2020 tax returns. The FY 2022 figures represent TY 2021 tax returns.

21 IRS, Pub. 6292, Fiscal Year Return Projections for the United States: 2020-2027, at 4 (Rev. 9-2020); IRS, Pub. 6292, Fiscal Year Return Projections for the United States: 2020-2027, at 4 (Rev. 9-2021); IRS, Pub. 6292, Fiscal Year Return Projections for the United States: 2022-2029, at 4 (Rev. 9-2022). The FY 2021 figure has been updated from what was reported in the 2021 Annual Report to Congress to report actual return counts. The FY 2022 figures are projected numbers.

22 *Id*. The FY 2021 figure has been updated from what was reported in the 2021 Annual Report to Congress to report actual return counts. The FY 2022 figures are projected numbers.

23 *Id*.

24 When considering FY 2020 data, note that core IRS services were suspended or reduced for a portion of FY 2020 due to COVID-19.

25 A no-response audit occurs when a taxpayer under exam does not respond to IRS communication attempts, and the proposed tax adjustments are subsequently input as if the taxpayer had agreed to the exam determination. This metric includes cases where the audit notice was deemed undeliverable (*e.g.*, a taxpayer may have moved without giving an updated address, and the notice was returned), and there was no response from the taxpayer.

26 A no-change audit occurs when a taxpayer substantiates all items being reviewed by the audit, resulting in no change to the reported tax.

27 An Act to Provide for Reconciliation Pursuant to Title II of S. Con. Res. 14, Pub. L. No. 117-169, 136 Stat. 1832 (2022).

28 The National Taxpayer Advocate recently partnered with the IRS in developing a mandatory IRS-wide TBOR training course and will continue to advance training opportunities that promote taxpayer rights awareness.

29 *See* IRC § 7803(a)(3); *see also* www.taxpayeradvocate.irs.gov/taxpayer-rights.

30 IRS response to TAS fact checks (Dec. 17, 2021; Dec. 9, 2022).

31 IRS response to TAS fact checks (Dec. 14, 2020; Dec. 17, 2021; Dec. 9, 2022). These numbers reflect examination cases closed by the IRS and do not account for subsequent appeal or litigation.

32 An audit is closed as agreed when the IRS proposes changes and the taxpayer understands and agrees with the changes.

33 The non-response rate includes taxpayers with undelivered IRS audit notices or statutory notices of deficiencies and taxpayers who did not respond to the IRS audit notices.

34 Represents percentage of correspondence audits for taxpayers with total positive income under $50,000.

35 Represents percentage of correspondence audits for taxpayers with total positive income greater than $50,000 and under $10,000,000.

36 Represents percentage of correspondence audits for taxpayers with total positive income greater than $10,000,000.

37 IRS, Small Business/Self-Employed (SB/SE), Collection Activity Report (CAR) No. 5000-108, Monthly Report of Offer in Compromise Activity, cumulative through September, FY 2019 (Sept. 30, 2019); FY 2020 (Sept. 28, 2020); FY 2021 (Oct. 4, 2021); FY 2022 (Oct. 3, 2022).

38 *Id*.

39 IRS, SB/SE, CAR No. 5000-6, Installment Agreement Cumulative Report, FY 2019 (Sept. 29, 2019); FY 2020 (Sept. 27, 2020); FY 2021 (Oct. 4, 2021); FY 2022 (Oct. 2, 2022). Number includes short-term payment agreements and continuous wage levies.

40 Weekly ACI and Voice Bot Reports for Week Ending 9/30/2022 (Cumulative). This service was not offered until July 2022.

41 IRS, CDW, FY 2019 (Oct. 2021); FY 2020 (Oct. 2021); FY 2021 (Oct. 2021); FY 2022 (Oct. 2022). The IRS accepts about 99 percent of requests for IAs that meet the processable criteria.

42 IRS, SB/SE, CAR No. 5000-2, Taxpayer Delinquent Account Cumulative Report, FY 2019 (Sept. 29, 2019); FY 2020 (Sept. 27, 2020); FY 2021 (Oct. 4, 2021); FY 2022 (Oct. 2, 2022). When taxpayers incur delinquent tax liabilities, the IRS sends them a series of notices during an approximately six-month period in which the taxpayers are in "notice status." If the taxpayer does not resolve his or her liability during the notice status, the account enters into taxpayer delinquent account status. The IRS then determines whether the case will be referred to the Automated Collection System (ACS), assigned directly for in-person contact by a revenue officer, assigned to the collection queue to await assignment to a revenue officer, or shelved. ACS may also assign cases to the collection queue. The IRS shelves cases prior to assigning the case to a private collection agency.

43 *Id*. Modules are the number of accounts attributable to a taxpayer. For example, an individual taxpayer may owe unpaid taxes on the 2017 and 2018 Forms 1040 – this would be one taxpayer with two modules.

44 Query by TAS Research of tax delinquent accounts with queue status in IRS, CDW, Accounts Receivable Dollar Inventory, Individual Master File (IMF), Modules. Age of balance due cases in the collection queue as of cycle 37 of FY 2019, cycle 38 of FY 2020, cycle 37 of FY 2021, and cycle 37 of FY 2022. The age of Taxpayer Delinquency Investigations is not considered.

45 When considering FY 2020 data, note that core IRS services were suspended or reduced for a portion of FY 2020 due to COVID-19.

46 *See* Most Serious Problem: *Inadequate Digital Services Impede Efficient Case Resolution and Force Millions of Taxpayers to Call or Send Correspondence to the IRS*, *infra*; Most Serious Problem: *Telephone and In-Person Service: Taxpayers Continue to Experience Difficulties and Frustration Obtaining Telephone and Face-to-Face Assistance to Resolve Their Tax Issues and Questions*, *infra*; Most Serious Problem: *IRS Hiring and Training: Weaknesses in the Human Capital Office's Hiring, Recruitment, and Training Programs Are Undermining the IRS's Efforts to Achieve Appropriate Staffing to Meet Taxpayer Needs*, *infra*.

47 *See* Oversight Subcomm. Hearing With IRS Commissioner Rettig on the 2022 Filing Season 5, 117th Congress (written testimony of Charles P. Rettig, Commissioner, Internal Revenue), "We are temporarily moving approximately 900 employees with previous relevant experience back into key areas from other organizations. In addition to this accounts management surge team, we are working to assemble a similar surge team for our submission processing area with 700 employees," https://www.irs.gov/newsroom/written-testimony-of-charles-p-rettig-commissioner-internal-revenue-service-before-the-house-ways-and-means-committee-subcommittee-on-oversight-on-the-filing-season-and-irs-operations (Mar. 17, 2022).

48 One aspect of this drop in service may be attributable to the sharp rise in volume of calls made to the IRS in FYs 2021 and 2022.

49 Secretary of the Treasury Janet Yellen has pledged that "[b]y next year, every single [Taxpayer Assistance] center will be fully staffed." *See* Department of the Treasury, *Remarks by Secretary of the Treasury Janet L. Yellen at the IRS facility in New Carrollton, Maryland* (Sept. 15, 2022), https://home.treasury.gov/news/press-releases/jy0952.

50 IR-2022-191, IRS quickly moves forward with taxpayer service improvements; 4,000 hired to provide more help to people during 2023 tax season on phones (Oct. 27, 2022), https://www.irs.gov/newsroom/irs-quickly-moves-forward-with-taxpayer-service-improvements-4000-hired-to-provide-more-help-to-people-during-2023-tax-season-on-phones.

51 FY 2019 figure from IRS response to TAS fact check (Nov. 15, 2019); FY 2020 figure from IRS response to TAS information request (Sept. 30, 2020). FY 2021 figure from IRS response to TAS information request (Sept. 2021). Due to COVID-19, a total of 49 TACs were unstaffed at some point during FY 2021. FY 2022 figure from IRS response to TAS fact check (Dec. 12, 2022). As of October 31, 2022, 326 of the 360 TACs were open, and 34 were closed or unstaffed. IRS, Status of Unopened Mail and Backlog Inventory Report (Nov. 4, 2022).

52 Wage and Investment Division, Business Performance Review, 4th Quarter, FY 2021 (Nov. 2021); FY 2021 and FY 2022 figures from IRS response to TAS fact check (Dec. 12, 2022).

53 IRS response to TAS information request (Oct. 2022); IRS response to TAS fact check (Dec. 12, 2022). Please note these numbers include both calls resolved by the CSR (thus negating the need for a TAC appointment) and calls where the taxpayer could not schedule an appointment at the available times.

54 Correspondence represents Accounts Management inquiries and responses received from taxpayers who do not belong specifically to another area.

55 IRS, Joint Operations Center (JOC), Adjustments Inventory Reports: July-September FY Comparison (FY 2020, FY 2021, FY 2022). The FY 2021 figure have been updated from what was reported in the 2021 Annual Report to Congress. These are IMF cumulative fiscal year receipts for Correspondence, Amended, Carryback, Injured Spouse and Individual Taxpayer Identification Number (ITIN). This metric measures taxpayer correspondence requesting account adjustment.

56 IRS, Research Analysis and Data (RAD), Accounts Management Reports: Collection Imaging System (CIS) Closed Case Cycle Time (FY 2020, FY 2021, and FY 2022). The FY 2021 figure has been updated from what was reported in the 2021 Annual Report to Congress.

57 IRS, Weekly Enterprise Adjustments Inventory Report, FYs 2019-2022 (weeks ending Sept. 28, 2019; Sept. 26, 2020; Sept. 25, 2021; Sept. 24, 2022). Certain IRS inventories must be worked within a specific timeframe to be considered timely. If not closed in that timeframe, the inventory item will be classified as "overaged."

58 IRS, JOC, Adjustments Inventory Reports: July-September Fiscal Year Comparison (FY 2020, FY 2021, FY 2022). This metric measures taxpayer correspondence requesting account adjustment. The FY 2021 figures have been updated from what was reported in the 2021 Annual Report to Congress.

59 IRS, RAD, Accounts Management Reports: CIS Closed Case Cycle Time (FY 2020, FY 2021, and FY 2022). The FY 2021 figure has been updated from what was reported in the 2021 Annual Report to Congress.

60 IRS, Weekly Enterprise Adjustments Inventory Report, FYs 2019-2022 (weeks ending Sept. 28, 2019; Sept. 26, 2020; Sept. 25, 2021; Sept. 24, 2022).

61 IRS, JOC, Snapshot Reports: Enterprise Snapshot (weeks ending Sept. 30, 2020; Sept. 30, 2021; Sept, 30, 2022; reports generated Oct. 18, 2022, and Nov. 27, 2022).

62 *Id.*

63 *Id.*

64 *Id.* The IRS generally defines its LOS measure as Numerator = Assistor Calls Answered + Info Messages and Denominator = Assistor Calls Answered + Info Messages + Emergency Closed + Secondary Abandons + (Add either Calculated Busy Signals OR Network Incompletes) + (Add either Calculated Network Disconnects OR Total Disconnects).

65 *Id.*

66 IRS, JOC, Snapshot Reports: Product Line Detail (weeks ending Sept. 30, 2020; Sept. 20, 2021; Sept. 30, 2022; reports generated Oct. 18, 2022, and Nov. 27, 2022).

67 *Id.*

68 IRS.gov Site Traffic Calculator (FYs 2019-2022).

69 *Id.*

70 IRS, SB/SE, CAR No. 5000-6, Installment Agreement Cumulative Report, FY 2020 (Sept. 27, 2020); FY 2021 (Oct. 4, 2021); FY 2022 (Oct. 2, 2022). Number includes short-term payment plans.

71 IRS response to TAS fact check for FY 2019 (Dec. 17, 2021); IRS Databook for FY 2020 and 2021; IRS response to TAS fact check for FY 2022 (Dec. 14, 2022). This metric measures the number of successful Where's My Refund? queries (as opposed to the total number of Where's My Refund? query attempts).

72 For a discussion of IRS information technology modernization, see National Taxpayer Advocate 2020 Annual Report to Congress 84 (Most Serious Problem: *Information Technology Modernization: Antiquated Technology Jeopardizes Current and Future Tax Administration, Impairing Both Taxpayer Service and Enforcement Efforts*), https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20_MSP_06_ITmod.pdf. *See also* Most Serious Problem: *Inadequate Digital Services Impede Efficient Case Resolution and Force Millions of Taxpayers to Call or Send Correspondence to the IRS, infra*.

73 An Act to Provide for Reconciliation Pursuant to Title II of S. Con. Res. 14, Pub. L. No. 117-169, 136 Stat. 1832 (2022).

NTA BLOG
NATIONAL TAXPAYER ADVOCATE

NTA Blog: IRS Strategic Operating Plan Has Potential to Transform Tax Administration

April 6, 2023

Today, the IRS released a Strategic Operating Plan (SOP) outlining how it intends to use the nearly $80 billion in additional funding received as part of the Inflation Reduction Act of 2022 (IRA) to improve the taxpayer experience, modernize its information technology (IT) systems, and strengthen tax compliance programs in a fair and equitable manner.
This is a game changer to transform how the U.S. government administers the tax laws in a more helpful and efficient manner while focusing on providing the service taxpayers deserve.
However, of the nearly $80 billion in supplemental IRA funding, only $3.2 billion was allocated for Taxpayer Services and $4.8 billion was allocated for the IRS Business Systems Modernization (BSM) projects. Combined, that's just ten percent of the total. By contrast, 90 percent was allocated for Enforcement ($45.6 billion) and Operations Support ($25.3 billion). The additional long-term funding provided by the IRA, while appreciated and welcomed, is disproportionately allocated for enforcement activities, and I believe Congress should reallocate IRS funding to achieve a better balance with taxpayer service needs and IT modernization.

As discussed in the Estimated Allocation of Funds section of the SOP, the additional resources the IRS has deployed to meet current taxpayer service needs will deplete the entire $3.2 billion IRA allocation for Taxpayer Services in less than four years if additional annual appropriations or supplemental funding is not provided. The SOP also expresses concern about the adequacy of BSM funding to modernize the agency's antiquated IT systems.
In my opinion, the most efficient way to improve compliance is by encouraging and helping taxpayers to do the right thing on the front end. That is much cheaper and more effective than trying to audit our way out of the tax gap one taxpayer at a time on the back end. The success of IT is instrumental in accomplishing the SOP's objectives of improving compliance. Allocating more funds to service and IT is key to taxpayers and tax administration.

Even before the COVID-19 pandemic began, taxpayer service was unacceptably poor. Since the onset of the pandemic taxpayer service has fallen through the floor and the IRS has not been able to provide the service taxpayers deserve. Taxpayers and practitioners have struggled to get basic service and help understanding the tax laws and IRS procedures. This is not sustainable. As more Americans interact with the IRS each year than with any other federal agency the government has a moral and practical obligation to make those interactions as productive, fair, and painless as possible.

The vision of the SOP contemplates a significantly different experience for individuals, businesses, practitioners, and industry by providing the ability to obtain the information and help they need, when they need it, and in a variety of ways.

Although I share the long-term vision of the SOP, I want to caution that the IRS should not lose sight of its core mission and its immediate challenge of reducing the large backlog of amended tax returns and taxpayer correspondence. The IRS's customer service representatives (CSRs) alternate between answering taxpayer telephone calls and processing paper. As the IRS has

been assigning more CSRs to answer the phones this year, the paper backlog has been growing. **Although the SOP offers the promise of many positive changes in the coming years, I urge the IRS to put appropriate focus on getting its inventories under control now and not lose sight of its core mission.**
Throughout the year, my office participates on inter-agency teams and makes many recommendations to fix taxpayer problems within the IRS. I also make recommendations in my annual reports to Congress. Often, the IRS responds to our recommendations by saying, in effect, "Good idea in theory, but we barely have enough funds to keep our 1960s COBOL-based technology systems operating. We just don't have the resources to do what you're suggesting."

See my annual reports to Congress for a discussion of serious problems impacting taxpayers and practitioners over the past three years and recommendations to improve service. **With the long-term funding the IRS has received and prudent management, change is possible. There is light at the end of the tunnel.**
Several of TAS's senior leaders played leadership roles in developing the plan and beginning the process of transforming the agency. Many sections of the plan released today reflect recommendations that TAS has been making for years, as well as recommendations included in the Taxpayer First Act report to Congress, the Taxpayer Experience Office's roadmap, and outside stakeholder recommendations.

The plan is organized around 5 objectives:

1. Dramatically improve services to help taxpayers meet their obligations and receive the tax incentives for which they are eligible.
2. Quickly resolve taxpayer issues when they arise.
3. Focus expanded enforcement on taxpayers with complex tax filings and high-dollar noncompliance to address the tax gap.
4. Deliver cutting-edge technology, data, and analytics to operate more effectively.
5. Attract, retain, and empower a highly skilled, diverse workforce and develop a culture that is better equipped to deliver results for taxpayers.

Below is a select list of service recommendations and IT projects, as they appear in the SOP, that reflect prior TAS recommendations and have the potential to dramatically improve services for individuals, businesses, practitioners, and industry:

- **Improve the availability and accessibility of customer service:** Taxpayers will be able to receive on-demand customer service or schedule service ahead of time.
- **Provide comprehensive secure online account services for individual taxpayers:** The IRS will add features to Individual Online Accounts, including the ability to schedule payments, save payment information, create and change payment plans, access user-friendly tax records, view the status of returns, refunds and audits, opt into certain notifications, use secure messaging, and more. Businesses and tax professionals will be offered similar online account services.
- **Evaluate which taxpayers are most burdened during filing and remove barriers to electronic filing:** Evaluate which taxpayers face barriers during filing, such as those who may be eligible for credits and deductions; those who need information quickly from the IRS, such as residency certificates; or those who are required to paper-file in certain circumstances. Prioritize creating and improving digital pathways for these taxpayers.

- **Expand digital services and digitalization:** Taxpayers will be able to file all documents securely and exchange correspondence electronically.
- **Implement a standard case management platform:** Consolidate disparate case management systems onto one standard platform. This upgrade will make managing the foundational technology more efficient and help employees to help taxpayers resolve issues.
- **Make transcripts and account data easier to read and understand:** Use plain language for IRS transcripts for all taxpayers and make them available in additional languages.
- **Help taxpayers understand and claim appropriate credits and deductions:** Develop better tools to help taxpayers identify and claim tax benefits for which they are eligible.
- **Build status-tracking tools for taxpayers:** Taxpayers will be able to use new status-tracking tools to see real-time status updates, next steps, and estimated time to process documents and resolve issues.
- **Provide earlier legal certainty:** Expand capacity in the Office of Chief Counsel and with the Department of the Treasury Office of Tax Policy to address more taxpayer questions proactively using both formal and informal legal guidance and rulings.
- **Streamline multichannel customer assistance:** Taxpayers will be able to get the help they need quickly, securely and accessibly, resolve more issues in a single contact, and experience minimal delays during interactions with the IRS.
- **Expand service offerings across multiple service channels to meet the needs of taxpayers and tax professionals:** Use improved data and analytics to project demand, staffing, estimated wait and processing times, and service locations. Adjust policies, services offered, and locations to provide in-person, telephone, and digital services for all taxpayers and tax professionals, including those in rural and underserved areas. This includes expanding the services available through current customer service channels such as the Taxpayer Assistance Centers (TACs) and phones.
- **Provide the public with accurate wait time estimates:** Include estimated wait times in customer service channels and processing times for high-volume returns and other forms.
- **Staff customer service functions to meet projected demand:** Use enhanced data and analytics to project demand for customer services and better allocate well-equipped employees to meet demand.
- **Improve appointment scheduling and on-demand capabilities:** Offer appointment scheduling and on-demand services across service channels.
- **Develop policies and tools that support first-contact problem resolution:** Develop policies and tools that support the immediate involvement of the right people to resolve taxpayer issues quickly, even when first-contact employees do not have the information or authority to resolve the issues.
- **Enhance IRS.gov systems and content to support new digital tools, products, and services for taxpayers:** Upgrade systems and improve content development to make sure IRS.gov supports the new capabilities and is accessible to taxpayers and stakeholders, including underserved and Limited English Proficiency (LEP) populations.
- **Develop taxpayer-centric notices:** The IRS will send taxpayers notices they can understand, delivered in ways they prefer, with clear explanations of issues and steps to resolution.
- **Use improved data and analytics to tailor timely collections contacts:** The IRS will provide early, tailored contacts to all taxpayers with past-due balances and will only escalate to more intensive treatments when appropriate.

Although my primary goals as the National Taxpayer Advocate are to protect taxpayer rights and improve taxpayer service, we need to acknowledge that enforcement is also central to the IRS's tax collection mission. It is necessary both to collect the taxes essential to fund the government and to ensure equity, so that all taxpayers are paying their fair share. The SOP contains initiatives to improve tax compliance, particularly among high-income individual taxpayers, large businesses, and pass-through entities. As enforcement plans continue to develop, the IRS needs to improve and reimagine its examination process for correspondence audits, particularly for low-income taxpayers, to reduce burdens and eliminate unnecessary challenges in a more proactive and responsive manner.

The summary above reflects a small number of the planned initiatives. The report runs almost 150 pages and contains a lot of information. By design, the report is high level, with specifics left to be fleshed out. Some initiatives are contingent on attracting, hiring, training, and retaining a diverse workforce of the future to accomplish the vision of the SOP.

Conclusion

As always, the devil is in the details, and the proof is in the pudding. Developing a plan and successfully implementing it are two different things. But, for the first time in my 40 years as a tax professional, the tax administration stars seem to be aligning. Congress has provided the IRS with significant long-term funding to improve taxpayer service, modernize IT systems and enhance enforcement, the IRS has developed an ambitious, albeit general plan to transform tax administration, and a new Commissioner with significant management experience has just taken office with a mandate to implement the plan and transform the taxpayer experience.

With continued support and oversight by Congress, the Government Accountability Office, the Treasury Inspector General for Tax Administration, and my office, I am hopeful and optimistic that five years from now, tax administration will be transformed and taxpayers, for the first time in memory, will receive the service they deserve. And that any additional resources the IRS expends for enforcement will be applied in a fair and equitable manner benefiting all taxpayers.

Data Security: Scams, Security Plan, Identity Theft

By LaTanya Bacon

Communication & Liaison
STAKEHOLDER LIAISON

2023 Tax Alliance Conference
June 7, 2023


Scams, Security Plan, Identity Theft

LaTanya Bacon, Stakeholder Liaison
Cleveland Ohio

1

Security Summit

The IRS, state tax agencies, and the tax community are working in partnership to combat identity theft refund fraud to protect the nation's taxpayers.

2

Common Scams

- Email, Phishing and Malware Schemes
- Fake Charities
- Threatening Impersonator Phone Calls
- Refund Theft
- Scams targeting non-English speakers
- Unscrupulous Return Preparers

3

Spotting Phishing Emails

- The email asks you to confirm personal information
- The web and email addresses do not look genuine
- It's poorly written
- There's a suspicious attachment
- The message is designed to make you panic

4

Spear-phishing Aimed at Tax Pros

Home / News / News Releases / Dirty Dozen: IRS urges tax pros and other businesses to beware of spearphishing; offers tips to avoid dangerous common scams

Dirty Dozen: IRS urges tax pros and other businesses to beware of spearphishing; offers tips to avoid dangerous common scams

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Multimedia Center

IR-2023-62, March 29, 2023

WASHINGTON —The Internal Revenue Service today warned tax professionals and businesses that they remain a top target for identity thieves and face threats from common scams on this year's Dirty Dozen list.

As part of the annual Dirty Dozen tax scams effort, the IRS and the Security Summit partners urged tax professionals and businesses to be on the lookout for a variety of suspicious email requests. Through these spearphishing emails, scammers try to steal client data, tax software preparation credentials and tax preparer identities with the goal of getting fraudulent tax refunds. These requests can range from an email that looks like it's from a potential new client to a request targeting payroll and human resource departments asking for sensitive Form W-2 information.

5

Account On Hold Landing Page

6

SMS/Smishing

Original SMS/text message

Phishing Website

7

Educate yourself on phishing scams

- **Many data thefts start with a phishing email**
  - Click on a link to a fake website
  - Open an attachment with embedded malware
- **Spear phishing email to pose as a trusted source**
  - Account Takeover
  - Ransomware

8

Reporting phishing attempts

- Unsolicited emails or social media attempts to gather information that appear to be from either the IRS or an organization closely linked to the IRS, should forward the message to **phishing@irs.gov.**

9

Signs of a Data Breach

Know the Signs of Tax-Related Identity Theft

- E-Filed return rejects due to duplicate Social Security Number.
- Letter from the IRS inquiring about a suspicious tax return that you did not file.

10

Signs of a Data Breach

Know the Signs of Tax-Related Identity Theft (cont.)

- You get an IRS notice that you owe additional tax or refund offset, or that you have had collection actions taken against you for a year you did not file a tax return
- You receive a Form W-2 or Form 1099 from an employer for whom you didn't work or benefits from a government agency, or IRS records indicate you received wages or other income from an employer you didn't work for

11

Responding to a Data Breach

Report and Respond

Report Data Loss to IRS/States

Tax practitioners should report data losses or thefts immediately to the IRS so that appropriate precautions can be made to protect clients from fraudulent returns being filed in their names. Here's how to report data thefts to the IRS:

- Contact the IRS and law enforcement:
  - Internal Revenue Service, report client data theft to your local stakeholder liaison.
  - Federal Bureau of Investigation, your local office (if directed by IRS).
  - Local police – To file a police report on the data breach.
- Contact states in which you prepare state returns:
  - Email the Federation of Tax Administrators at StateAlert@taxadmin.org to get information on how to report victim information to the states.
  - State Attorneys General for each state in which you prepare returns. Most states require that the attorney general be notified of data breaches.

Practitioner Data Loss

Point of Contact – Stakeholder Liaison

IRS.gov – Key word search: Stakeholder Liaison

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Preventing Online Identity Theft

- Don't respond to suspicious IRS emails, Texts and Faxes
- Secure your computers (i.e., firewalls, anti-virus/anti-phishing/anti-spam, etc.)
- Use strong passwords
  Back up critical personal information
- Limit the personal information you provide on social media
- Visit OnGuardOnline.gov - IRS.gov/IDTheft – StaySafeOnline.org

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Remember, the IRS will never…

- Contact you by email, text or social media to ask for personal or financial data.
- Call to demand immediate payment using a prepaid debit card, gift card or wire transfer.
- Threaten to bring in police, immigration or other agencies to have you arrested.
- Ask for credit/debit card or other financial account information over the phone.
- Request login credentials, Social Security Numbers or other sensitive information.

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2023 IRS Dirty Dozen


IRS
File Pay Refunds Credits & Deductions Forms & Instructions
IRS opens 2023 Dirty Dozen with warning about Employee Retention Credit claims; increased scrutiny follows aggressive promoters making offers too good to be true

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DATA SECURITY PLAN

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Create a Data Security Plan

- **Required under federal law**
  - The Gramm-Leach-Bliley (GLB) Act
  - Federal Trade Commission (FTC) Safeguards Rule

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Publication 5708 - WISP

Creating a **W**ritten **I**nformation **S**ecurity **P**lan for your Tax & Accounting Practice

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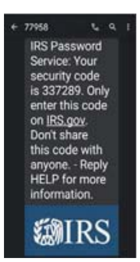

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Multi-factor Authentication (MFA)

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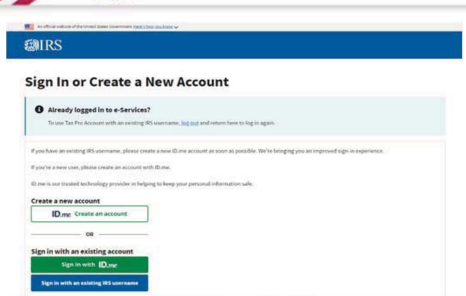
Multi-Factor Authentication



27

The Identity Protection PIN (IP PIN)

Proactively protect your federal tax account from identity theft.

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What is the IP PIN?

- An Identity Protection PIN (IP PIN), is a six-digit number that prevents someone else from filing a tax return using your Social Security number or Individual Taxpayer Identification Number
- Even though you may not have a filing requirement, an **IP PIN still protects your account from fraudulent filings**
- An electronically filed return filed without your IP PIN, or an incorrect IP PIN, will reject, including your return and any fraudulent returns using your Social Security Number.
- Any paper returns filed without your correct IP PIN will undergo additional scrutiny and any fraudulent returns will be removed from your account. If the return verifies to be yours, we will continue to process it.

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IRS IP PIN Opt-in Program

- As of January 2021, all taxpayers who can verify their identities may obtain an IP PIN to protect their tax returns
- One-time registration process
- Use online tool each January to obtain your IP PIN
- Review the process at www.IRS.gov/IPPIN

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Important Reminders

- IP PIN protects your federal tax account from Identity Theft
- An IP PIN is valid for one calendar year, each year a new IP PIN is generated for your account
- An IP PIN must be used when filing any federal tax returns during the year including prior year returns
- **Never share your IP PIN with anyone** other than your tax preparer at the time of filing
- If unable to enroll online there are alternatives
  - Form 15227, Application for an IP PIN
  - In-Person Meeting at a local Taxpayer Assistance Office, (TAC)
- IP PIN participants must keep their address current including dependents
  - By filing Form 8822, Change of Address

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IRS Resources

- www.irs.gov/identity-theft-central
- **Publication 5477,** All Taxpayers now Eligible for Identity Protection Pins
- **Publication 5417,** Basic Security Plan Considerations for Tax Professionals
- **Publication 4557**, Safeguarding Taxpayer Data
- **Publication 5293**, Data Security Resource Guide for Tax Professionals
- **Publication 5708**, Creating a Written Information Security Plan for your Tax & Accounting Practice

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Communications & Liaison
STAKEHOLDER LIAISON

Thank You!

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Comprehensive IRS Voluntary Disclosure Program and Others: Key Aspects and Developments

By Hale E. Sheppard, Esq.

Comprehensive IRS Voluntary Disclosure Program and Others: Key Aspects and Developments

Tax Alliance Conference 2023

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ABOUT THE SPEAKER

Hale E. Sheppard is a Shareholder in the Tax Controversy Section of Chamberlain Hrdlicka in Atlanta. Hale defends individuals and businesses during tax audits, tax appeals, and tax litigation.

Cases and Rulings. Hale has participated in over 150 tax cases before the Tax Court, Courts of Appeal, District Courts, and various State Tax Tribunals. In addition to resolving issues through tax litigation, Hale has obtained dozens of favorable Private Letter Rulings for clients from the IRS National Office on procedural, tax, and international issues.

Education. Hale holds five college degrees. At the University of Kansas, he earned a B.S., with distinction, M.A., with honors, and J.D. He later received an LL.M. degree in international law, with highest distinction, from the Universidad de Chile in South America. Finally, he obtained an LL.M. degree in tax from the University of Florida, where he was a graduate tax scholar.

Awards and Recognitions. During his studies, Hale received several awards for academic excellence, including the prestigious Harry S. Truman Foundation Scholarship, Janice Dawson Quinn Tax Scholarship, Tinker Foundation Scholarship, and Senator James B. Pearson International Fellowship. Hale also served as a graduate editor of the Florida Tax Review and member of the Kansas Journal of Law & Public Policy. Chambers USA, Legal 500, Super Lawyers, Best Lawyers in America, and other groups have recognized Hale as a leader in tax litigation for many years. He has also been inducted into the American College of Tax Counsel.

Publications. Hale ranks among the most active tax writers in the country. He has published over 225 major articles in top tax journals, including Journal of Taxation, International Tax Journal, The Tax Adviser, Journal of International Taxation, Journal of Tax Practice and Procedure, Taxes Magazine, Journal of Corporate Taxation, Practical Tax Lawyer, Journal of Passthrough Entities, Tax Management International Journal, Journal of Multistate Tax & Incentives, Tax Notes International, Taxation of Exempts, Practical Tax Strategies, Corporate Business Taxation, Trust and Estates Journal, Journal of Taxation of Financial Products, Real Estate Taxation, and others. He has also published major articles in more than 20 university law reviews, both in the United States and abroad.

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SOURCES FOR THIS OUTLINE – AVAILABLE UPON REQUEST

This outline derives from the following articles, all written by Hale. If you would like a copy of any of the articles, please send Hale an e-mail at *hale.sheppard@chamberlainlaw.com* or call him at 404-658-5441. He would be glad to send you the articles free of charge.

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A. Introduction

1. What is remarkable about international non-compliance is that it often triggers three interrelated disputes, occurring in three different venues, and generating three potential liabilities.

2. A recent trilogy of court decisions, broadly referred to in this outline as the *Flume* cases, provide a teachable moment, an opportunity to see, in real life, what a taxpayer with unreported foreign assets could face if caught.[1]

B. Key Facts for the Three *Flume* Cases

1. Husband and Wife are U.S. citizens who moved to Mexico in 1993. Before heading south, Husband worked as an urban planner and real estate developer in the United States. Husband was engaged in the same type of activities in Mexico, operating a real estate company that developed land, sold lots, and built high-end homes.

2. In 1995, Husband and another U.S. individual formed a corporation in Mexico called Franchise Food Service de Mexico S.A. de C.V. ("Franchise Food"). They started as equals, each owning 50%. Husband was also the president. Franchise Food was created in order to operate Mexican locations of Whataburger and Fanny Ice Cream.

3. In addition to Franchise Food, Husband and Wife formed at least two other foreign corporations, one of which was Wilshire Holdings, Inc. ("Wilshire"). This entity was originally formed in the Bahamas in 2000 and then reincorporated in Belize in 2001.

4. In 2005, Wilshire opened an account at UBS in Switzerland.

5. Husband and Wife filed timely Forms 1040 for 2001 through 2009, but they did not (i) report certain income generated by Franchise Food or Wilshire, (ii) report passive income generated by the UBS account, (iii) enclose Forms 5471, and (iv) separately file FBARs.

6. In the early 2000's, Husband hired return preparers with offices in the United States and Mexico to prepare annual Forms 1040 ("Mexican Accountants"). They prepared the Forms 1040 for the relevant years

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[1] The *Flume* cases consist of the following: *Flume v. Commissioner*, T.C. Memo 2017-21 (Tax Court case focused on penalties for unfiled Forms 5471); *United States v. Flume*, 122 AFTR 2d 2018-5641 (S.D. Texas 2018) (Order by District Court in response to Motion for Summary Judgment filed by the U.S. government regarding FBAR penalties) and *United States v. Flume*, 123 AFTR 2d 2019-2211 (S.D. Texas 2019) (Verdict by District Court regarding FBAR penalties); *Flume v. Commissioner*, T.C. Memo 2020-80 (Tax Court case focused on federal income taxes and tax-related penalties).

disclosing only the existence of Husband's account in Mexico, but not the larger account in Switzerland.

7. Husband did not file timely FBARs for 2007 or 2008. He filed them late, in June 2010, and even then he understated the value of the Swiss account by approximately $600,000 one year.

C. First Fight - Form 5471 Penalty Litigation in Tax Court

1. The first fight centered on non-disclosure of Husband's interest in the two foreign corporations, Franchise Foods and Wilshire.

2. IRS Audit and CDP Hearing

a. Husband did not pay the Form 5471 penalties, so the IRS sent him a pre-levy notice in December 2013.

b. Husband filed a timely request for a CDP hearing, claiming, among other things, that he was not required to file Forms 5471 for Wilshire for 2001 through 2009 because he had only a 9% interest, and thus was not a "U.S. shareholder" with a filing duty.

c. The Settlement Officer issued a Notice of Determination, concluding that the IRS was free to seize Husband's assets.

3. Tax Court Litigation Contesting Result of CDP Hearing

a. Husband filed a timely Petition with the Tax Court challenging the conclusions in the Notice of Determination.

b. The Tax Court reduced this case to its essence.

i. With respect to Franchise Food, the Tax Court concluded that Husband was obligated to file a Form 5471 each year.

ii. Regarding Wilshire, the Tax Court noted that Husband had a constant Form 5471 filing obligation, and Husband "merely provided self-serving testimony and a backdated document to support his claim that he maintained only a 9% ownership interest during the tax years in issue."

iii. Finally, the Tax Court rejected the notion that Husband should be relieved of penalties under a reasonable reliance theory because Husband was unable to demonstrate that the Mexican Accountants had sufficient qualifications, expertise, or access to the relevant data.

D. Second Fight – FBAR Penalty Litigation in District Court

1. While the IRS was seeking Form 5471 penalties in Tax Court, the DOJ was busy initiating a collection action in District Court to recoup "willful" FBAR penalties for 2007 and 2008.

2. Rulings by the District Court

   a. The District Court found that Husband had willfully violated his FBAR duties and upheld large penalties for the following reasons.

   b. First, the District Court indicated that Husband's testimony was "not credible" and contained "numerous contradictions."

   c. Second, the District Court characterized the financial structure used by Husband as a "sophisticated tax evasion scheme."

   d. Third, the Mexican Accountants sent Husband an annual reminder of his FBAR duties.

   e. Fourth, the fact that Husband disclosed a Mexican account on Schedule B shows that he was aware of the requirement and "made a conscious choice" not to similarly disclose the Swiss account.

   f. Fifth, Husband learned of the IRS's investigation into UBS by mid-2008, but opted not to file any FBARs until *after* UBS announced that it planned to turn over its records to the IRS.

   g. Sixth, Husband acted with "extreme recklessness" by failing to review his Forms 1040 before signing them.

   h. Finally, the District Court claimed it was "reckless" for Husband to place total reliance on the Mexican Accountants, particularly because he did not conduct any research on their credentials.

E. <u>Third Fight – Federal Income Tax Litigation in Tax Court</u>

1. The Tax Court addressed income tax matters in separate litigation.

2. The IRS claimed that Husband and Wife, as sole owners of Wilshire, had unreported Subpart F income stemming from the UBS account held in the name of Wilshire. The IRS also asserted penalties for negligence or, alternatively, substantial understatement of the correct tax liability.

3. The Tax Court held for the IRS on the tax and penalty issues.

II. Ongoing International Disclosure Programs

A. <u>Why Are Taxpayers Still Approaching the IRS?</u>

1. The IRS continues gathering data through multiple mechanisms:

a. Computer analysis of e-filed FBARs

b. Cross-referencing of Form 8938 data and FBAR data

c. Receipt of account data from foreign banks under FATCA

d. Data from millions of disclosures made since 2009

e. Deferred prosecution agreements with foreign banks

f. Whistleblowers

g. Wikileaks, Panama Papers, etc.

B. A Long Series of Voluntary Disclosure Programs

1. 2003 Offshore Voluntary Compliance Initiative ("OVCI")

2. Last Chance Compliance Initiative ("LCCI")

3. 2009 Offshore Voluntary Disclosure Program ("2009 OVDP")

4. 2011 Offshore Voluntary Disclosure Initiative ("2011 OVDI")

5. 2012 Offshore Voluntary Disclosure Program ("2012 OVDP")

6. 2012 Streamline Filing Compliance Procedure ("SFCP")

7. 2014 Offshore Voluntary Disclosure Program ("2014 OVDP")

8. Streamline Foreign Offshore Program ("SFOP")

9. Streamline Domestic Offshore Program ("SDOP")

10. Delinquent FBAR Submission Procedure ("DFSP")

11. Delinquent Int. Information Return Submission Procedure ("DIIRSP")

C. Challenges of Participating Now

1. The taxpayer must prove that the non-compliance was "non-willful."

2. The IRS and the courts have interpreted willful behavior broadly, identifying the following items as potential evidence of willful violations:

a. The taxpayer failed to inform his accountant about the existence of foreign accounts, assets, or companies, particularly when asked by accountant about such items during meeting.

b. The taxpayer failed to ask his accountant about potential U.S. tax and compliance issues with respect to foreign assets.

c. The taxpayer failed to complete the annual questionnaire/organizer distributed by his accountant or other return preparer.

d. The taxpayer incorrectly completed the annual questionnaire.

e. The taxpayer opened accounts in the name of a foreign company.

f. The taxpayer opened a numbered account.

g. The taxpayer had a nominee (*e.g.*, attorney, accountant, investment advisor, friend, relative, etc.) hold the foreign account for him.

h. The taxpayer told the foreign bank not to send account statements.

i. The taxpayer told the foreign bank not to invest in U.S. securities.

j. The taxpayer used a foreign passport (*i.e.*, not a U.S. passport) to open the account.

k. The taxpayer worked with a foreign attorney, accountant, or adviser in opening the foreign account.

l. The taxpayer provided the bank an address outside the United States as his residence for purposes of the foreign account.

m. The taxpayer only accessed the unreported foreign account while outside the United States, using a credit card linked to the account or taking cash withdrawals.

n. The taxpayer filed an FBAR reporting only some foreign accounts.

o. The taxpayer not only violated U.S. tax laws, but also had tax non-compliance in one or more foreign countries.

p. The taxpayer held foreign accounts or other assets in foreign countries with which he had no logical connection, such as living there, working there, operating a business there, etc.

q. The taxpayer used a computer program to self-prepare his returns, such as TurboTax, which specifically ask about foreign accounts.

r. The taxpayer reviewed the annual Form 1040 (including the specific information in Schedule B about foreign accounts and the need to file FBARs), signed the Form 1040 under penalties of perjury as being accurate and complete, yet took no actions whatsoever to learn more about a possible duty to file FBARs.

s. The taxpayer checked the box "no" in response to questions on Schedule B to Form 1040 about the existence of foreign accounts.

t. After the IRS started publicly attacking certain foreign banks, the taxpayer took actions to conceal the problems, such as transferring the funds to other foreign banks, converting the funds into foreign insurance policies, etc.

III. New Comprehensive Disclosure Practice

A. Introduction in 2018

1. In conjunction with the end of the OVDP, the IRS announced an updated voluntary disclosure practice ("UVDP") in November 2018.[2]

2. The UVDP applies to *all* types of taxes, including income, gift, estate, employment, excise, etc.

3. It also covers international *and* purely domestic matters.

B. Summary of Settlement Terms

1. Relevant Years

a. Cases generally will cover the most recent six closed tax years.

b. If the IRS and taxpayer cannot resolve a case by mutual agreement, then the IRS "has discretion to expand the scope to include the full duration of the noncompliance and may assert maximum penalties under the law with the approval of management."

2. Civil Fraud Penalty

a. Generally, the IRS will assert a civil fraud penalty, equal to 75% of the tax liability, to the one year during the disclosure period with the highest tax liability.

b. In "limited circumstances," Revenue Agents may apply the civil fraud penalty to more than one year, up to all six years, "based on the facts and circumstances of the case."

3. FBAR Penalties

a. The IRS announced that FBAR penalties, possibly including those for "willful" violations, will be asserted pursuant to the existing penalty guidelines found in Internal Revenue Manual § 4.26.16 and § 4.26.17. This is one of the biggest areas of concern for taxpayers with international violations.

4. Ability to Seek Reduced Penalties

[2] IRS Memorandum LB&I-09-1118-014 (Nov. 20, 2018).

a. Taxpayers are "not precluded" from (i) seeking an accuracy-related penalty under Section 6662 in the amount of 20% of the tax liability, instead of a civil fraud penalty at 75%, or (ii) requesting non-will FBAR penalties, in place of willful ones.

b. Reduced penalties will be "exceptional," and taxpayers must present "convincing evidence" to justify a reduction.

5. Perhaps No Information Return Penalties

a. Contrary to the harsh stance by the IRS regarding the disclosure period, civil fraud penalties, and FBAR penalties, taxpayers might escape sanctions for unfiled information returns. The IRS will not automatically assess these under the UVDP.

C. <u>IRS Introduces Form 14457 in 2020</u>

1. The UVDP, announced in 2018, was positive in theory, but it lacked initial implementation. Fortunately, in 2020, the IRS issued *new* Form 14457 (Voluntary Disclosure Practice Preclearance Request and Application), with Instructions. Some interesting aspects are examined below:

2. Part I of Form 14457 – Broad Coverage

a. In terms of what type of taxpayers can participate, Part I asks taxpayers to check the box indicating individual, partnership, corporation, trust, or executor of estate.

b. The Instructions expand on this notion, stating that the UVDP "is available to individuals (U.S. Citizens, Green Card Holders, Non-Resident Aliens, Expatriates, etc.) and business entities (Corporations, Partnerships, LLCs, Trusts, Estates)."

c. Part I confirms that the UVDP broadly covers all types of matters, breaking them down into the following categories: domestic, offshore, estate and gift taxes, employment taxes, virtual currency, and the catch-all, "other issues."

3. Take Your Non-willful Violations Elsewhere

a. Form 14457 and the Instructions contain language throughout alerting taxpayers that the IRS designed the UVDP exclusively for "willful" violations. Samples follow:

i. "Objective. The [UVDP] provides taxpayers whose conduct involved <u>*willful*</u> tax or tax-related noncompliance with a means to come into compliance with the tax law and avoid potential criminal prosecution."

ii. "You should consider applying for the [UVDP] if you engaged in *willful* noncompliance that exposes you to criminal liability for tax and tax-related crimes, you meet the eligibility requirements (discussed next), and you wish to come into tax compliance and avoid potential criminal prosecution."

b. "You can correct less serious non-compliance by filing amended or past due tax returns." The Instructions feature a list of "Other Compliance Options," which consist of the SFOP, SDOP, DIIRSP, DFSP, and QDP.

4. Participation without Full Payment

a. The IRS acknowledges in the Instructions that it has "historically required" taxpayers participating in disclosure programs to make full payment of all taxes, penalties, and interest. However, the IRS changed its mind when it comes to the UVDP, now allowing taxpayers to participate even if they lack the cash, provided that they make a complete financial disclosure and convince the IRS that full payment is unfeasible.

5. Pursuing Advisors

a. The IRS is not subtle about its intention of using data collected through the UVDP to pursue bad actors.

b. The IRS demands the following: (i) Identity of all "professional advisors and facilitators" (including attorneys, accountants, financial planners, private bankers, consultants, and the like) that provided any services to the taxpayer during the disclosure period, "regardless of their connection to or knowledge of your noncompliance;" (ii) Full contact information for all such individuals; (iii) Explanation about the type of advice and/or services that the individuals provided; (iv) Statement as to "whether you fully disclosed your noncompliance and/or if they helped facilitate it;" (v) Description of all interactions among the individuals related to the noncompliance; and (vi) List of all individuals who maintained records for the taxpayer.

6. Expectation of Post-UVDP Compliance

a. The UVDP, like most disclosure programs, creates an expectation of future compliance by participating taxpayers. This makes sense because, after a taxpayer fully comprehends his tax-related duties, he essentially lacks excuses for any future violations.

b. The Instructions warn that "[t]axpayers will be expected to comply with U.S. law for all tax years after the disclosure period and file returns according to standard filing procedures."

D. IRS Issues New Guidance in 2022

1. Observations

a. The IRS took action yet again, when it released the newest version of Form 14457 and Instructions in February 2022.[3]

b. Much of Form 14457 remains the same, but the IRS introduced important changes that are easy to overlook. Below is a review of *only* what is new.

2. Facilitating Initial Communications

a. Historically, taxpayers had to place an *original* signature on Part II and send it to the IRS by *mail*. This could be quite challenging when taxpayers applying for the UVDP were divorced, residing in a city different from their representatives, or living abroad. It was also difficult because of issues caused by COVID.

b. The IRS has seen the light, so to speak, deciding to simplify the application procedure. The Instructions to the newest Form 14457 state that the IRS now "accepts and encourages" submissions of both Parts I and Parts II by fax.

c. They further indicate that the IRS accepts photocopies, faxes, and scans of taxpayer signatures, provided that taxpayers or their representatives retain the original versions in their files for six years, just in case the IRS gets a hankering to see them.

3. Data about Past, Future, or Current IRS Battles

a. In determining whether it will grant "preclearance" to a taxpayer, the IRS is seeking additional information about tax disputes.

b. In particular, Line 9 of the new Part I requires taxpayers to disclose whether they, their spouses, or any related entities have received a Notice of Deficiency for any year covered by the UVDP. If so, taxpayers must acknowledge this and enclose a copy of the Notice of Deficiency.

c. In that same vein, Line 10 of the new Part I also mandates that taxpayers disclose if they, their spouses, or any related parties have litigated or are litigating any federal tax matters for any year covered by the UVDP in Tax Court, District Court, or the Court of Federal

[3] Internal Revenue Service, IR-2022-33 (Feb. 15, 2022); Form 14457 (Feb. 2022); Instructions.

Claims. If this is true, taxpayers need to reveal to the IRS the case caption, docket number, and other information.

4. Non-Tax Problems

a. Part I of Form 14457 probes for more data to determine whether a taxpayer will be eligible for the UVDP.

b. Among other things, it requires a taxpayer to reveal whether he, his spouse, or any related entities are currently under a civil audit or criminal investigation by the IRS or other authority.

c. The newest Instructions clarify and expand on this mandate. They first explain that relevant enforcement actions encompass those by the IRS, state agencies, *and* foreign governments.

d. However, they limit this by stating that taxpayers are not obligated to reveal criminal investigations with "zero nexus" to financial matters, such as when a taxpayer is the target of a state criminal investigation for assault charges related to a "bar room brawl."

5. Definition of "Financial Account"

a. The prior version of Form 14457 demanded data from the taxpayers about all non-compliant "financial accounts," but only the most recent version defines this key term.

b. The Instructions indicate that, for purposes of the UVDP, financial accounts encompass (i) securities, brokerage, savings, demand, checking, deposit, time deposit, and any other accounts maintained with a financial institution or a person functioning as one, and (ii) futures accounts, options accounts, insurance or annuity policies with cash surrender values, and shares in a mutual fund or similar pooled fund.

c. The Instructions underscore that the concept of financial account pertains to accounts held directly by taxpayers or through nominees, alter egos, or transferees.

d. Finally, the Instructions emphasize that taxpayers should "interpret broadly" the concept of financial account to cover any type of relationship with a third-party that was established to provide or engage in deposit-type services or other financial services, including virtual currency, gambling accounts, and other deposit-type arrangements, regardless of who provides such arrangements.

6. Accounts Held by Entities

a. Taxpayers must provide the IRS with an estimate of the highest aggregate value of the non-complaint foreign assets for each year during the six-year disclosure period.

b. The Instructions to the new Form 14457 clarify that a taxpayer can omit from this calculation values of accounts held by entities in which he had no financial interest, such as accounts over which he solely had signature authority.

c. However, warn the Instructions, if a taxpayer owns all or part of a foreign entity that holds a non-compliant account, such as a shareholder, then the taxpayer is deemed to have an interest in the account for purposes of figuring the highest value.

d. The Instructions offer the following two examples:

   i. Example 1. The taxpayer owns 50 percent of the shares in a foreign corporation, and family members own the remaining 50 percent. The corporation has an operating account in foreign bank. The taxpayer failed to file annual Forms 5471, to report his interest the corporation, and failed to file annual FBARs, to report his indirect interest in the account. For purposes of determining the highest value of non-compliant assets for the UVDP, the taxpayer must include his shares in the corporation and his "effective control" over the account.

   ii. Example 2. The taxpayer is a salaried employee of a foreign corporation, who has signature authority over a foreign account held by the corporation, but has no ownership interest in the corporation. The taxpayer can exclude the value of the account when calculating the value of non-compliant foreign assets, but he will still need to remedy his violations for not filing FBARs to report his signature authority over the account.

7. <u>Virtual Currency</u>

a. The previous Form 14457 was devoid of specific inquiries about virtual currency. This has completely shifted, with the newest version demanding significant data about this complex asset.

b. New Line 13 of Part I obligates taxpayers to list all noncompliant virtual currency, whether domestic or foreign.

c. Expanding on this disclosure duty, new Line 13 says that the list must cover the entire UVDP disclosure period, including virtual currency acquired or disposed of during such period, as well as virtual currency held through entities that the taxpayer directly or indirectly controlled, owned, or beneficially owned.

d. Taxpayers who used a "mixer" or "tumbler" in connection with virtual currency transactions must explain the reason for doing so.

e. The Instructions leave no doubt that the IRS is prodding taxpayers for all possible data about their cutting-edge assets. They acknowledge that virtual currency is a "dynamic area" and that the IRS is seeking, for purposes of the UVDP, information about items that might exceed what many define as "virtual currency."

8. <u>Interviews under Oath</u>

a. The Instructions to the new Form 14457 put taxpayers on notice that seeking relief under the UVDP likely will require more than just submitting paperwork.

b. In particular, they explain that a Revenue Agent "may require that you submit to an interview under oath to explain the facts provided in your voluntary disclosure, answer questions about return positions, provide information about promoters, and answer any other questions the [Revenue Agent] determines are relevant."

c. The Instructions caution of similar inquiries on the other end, when taxpayers accepted into the UVDP are discussing payment abilities. The Instructions indicate that a Revenue Officer "may require you to submit to an interview under oath to determine the viability of any proposed payment arrangements, verify the accuracy of statements made regarding assets and income, and answer any other questions the [Revenue Officer] determines are relevant."

9. <u>Expanded Descriptions of Non-Compliance</u>

a. The IRS has never wavered in its quest to gather details about wrongdoing by taxpayers.

b. The IRS has now expanded its demands to accommodate the evolution of the UVDP to cover all types of taxes.

c. The Instructions to Form 14457 set the tone, ordering taxpayers to describe the non-compliance "in complete and thorough detail."

i. With respect to estate, gift and generation-skipping transfer taxes, the Instructions broadly ask for all details, including estimates of tax liabilities.

ii. In situations involving employment tax problems, the Instructions require a schedule of unreported wages by quarter, an explanation of any issues with tax withholding, and a list of affected employees.

iii. The Instructions are the most expansive when it comes to virtual currency issues. They direct taxpayers to explain how they acquired the assets (*e.g.*, kiosk, centralized online, peer-to-peer platform, operator, exchange payment processor, custodial banker, etc.), how they held the assets (*e.g.*, exchange, hosted wallet, private wallet, etc.), the names of the virtual currencies, and an estimate of virtual currency transactions conducted.

10. <u>Penalties Galore</u>

a. The Instructions add a significant information about various types of penalties, as broken down below.

b. Fraud Penalties

i. When a voluntary disclosure involves fraud by a taxable entity, such as a Subchapter C corporation and by an individual related to such entity, the Instructions clarify that the IRS will assert a civil fraud penalty or a fraudulent failure to file penalty, as appropriate, *against both the entity and the individual for at least one year*.

c. Estate Tax Penalties

i. The Instructions indicate that the IRS will assert a civil fraud penalty or a fraudulent failure to file penalty, as appropriate, in all estate tax cases filed under the UVDP.

ii. However, the penalty will equal 50 percent of the tax underpayment, as opposed to the normal 75 percent.

iii. The Instructions offer various examples of how this fraud penalty will work, using situations involving assets omitted from, or undervalued on, Form 706 (U.S. Estate and Generation-Skipping Transfer Tax Return), deductions and credits overstated on Form 706, and an unfiled Form 706.

d. Gift Tax and Generation-Skipping Transfer Tax Penalties

i. As with estate taxes, the Instructions confirm that the IRS intends to asses a civil fraud penalty or a fraudulent failure to file penalty, as is fitting, in all UVDP cases involving gift tax and generation-skipping transfer tax.

ii. In situations involving fraudulent activity in just one year, the Instructions state that the penalty rate will be 50 percent, not 75 percent.

iii. However, in cases where the activity touches *multiple* years, the six-year disclosure period does not apply, the taxpayer must submit original or amended Forms 709 (U.S. Gift and Generation-Skipping Transfer Tax Return) for all relevant years, the IRS will impose the normal fraud penalty at a rate of 75 percent on the return with the highest tax liability, and the IRS will waive penalties on all other returns.

e. Employment Tax Penalties

i. Punishments involving employment tax violations are the most complex.

ii. On a positive note, the Instructions explain that the IRS will assert a fraud penalty to *only one* tax quarter/period, the one reflecting the highest employment tax liability, and the IRS will not impose accuracy-related penalties or delinquency penalties to any tax periods.

iii. On the negative side, the Instructions indicate that (i) the IRS will inflict failure-to-deposit penalties under Section 6656, (ii) employment tax liabilities will be calculated without applying the special reduced rates in Section 3509 and without the special interest-waiver rules in Section 6205, (iii) taxpayers cannot benefit from so-called Section 530 relief, (iv) the higher supplemental income tax withholding rate will apply where taxpayers did not withhold and remit to the IRS proper amounts from the wages of workers, and (v) taxpayers must file all necessary Forms W-2 (Wage and Tax Statement) or Forms W-2 (Corrected Wage and Tax Statement), if necessary.

iv. The Instructions contain an example.

(a) Example. The taxpayer failed to treat workers as employees and failed to withhold and remit employment taxes to the IRS. Under the UVDP, the IRS will assert one fraud penalty on the tax period with the highest tax liability, will waive accuracy-related penalties for all periods, will assert failure-to-deposit penalties for all periods, and will figure the tax liabilities by applying the higher supplemental income tax rates and without allowing reductions normally available under Section 3509 and/or Section 6205.

E. Involuntary UVDP Guidance in 2022

1. Revelation

a. The IRS *voluntarily* provided taxpayers guidance about the UVDP in 2018, 2020, and 2022. It released more data to taxpayers later in 2022, but this time it was *involuntarily*. A news source obtained the Voluntary Disclosure Practice Examiner Guide Paper ("Guide Paper") through a demand under the Freedom of Information Act and then disseminated it.[4]

2. <u>Kicking Taxpayers Out</u>

a. The Guide Paper contains lots of information about when and how a Revenue Agent can revoke a Preliminary Acceptance into the UVDP previously granted to a taxpayer.

b. If the taxpayer disagrees with the penalties asserted, does not fully cooperate with the audit process, or refuses to execute a Closing Agreement, then Revenue Agents "should consider recommending revocation of the taxpayer's Preliminary Acceptance."[5]

3. <u>Multiple Theories for Extending Assessment Periods</u>

a. The UVDP normally affects the most recent six years. However, Revenue Agents have discretion to broaden coverage to *all* prior years in which violations occurred, and the period can expand if the IRS revokes a taxpayer's Preliminary Acceptance and pursues taxes, penalties, and interest outside the UVDP framework.

b. In light of these realities, the Guide Paper urges Revenue Agents to analyze and apply *all* conceivable manners of maintaining assessment-periods open. It directs them to potential extensions resulting from civil fraud, failure to file international information returns, and substantial omissions of gross income on Forms 1040.[6]

c. The Guide Paper also warns Revenue Agents that they need to obtain all data possible to build a civil fraud case against a taxpayer instead of simply relying on the fact that participants in the UVDP generally must concede fraud in at least one year. This is because some taxpayers (who refuse to grant extensions, fully cooperate, execute a Closing Agreement, etc.) will be jettisoned from the UVDP by way of the revocation of their Preliminary Acceptance.

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[4] Internal Revenue Service. Voluntary Disclosure Practice Examiner Guide Paper (Rev. 1/26/22); IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022); Andrew Valverde, "IRS Voluntary Disclosure Guide Reveals New Details of Practice," 2022 Tax Notes Today Federal 138-3 (July 20, 2022).

[5] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 7.

[6] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pgs. 8, 9, 16, 17

i. The Guide Paper puts it in the following manner: Revenue Agents "must develop key facts which support the civil fraud penalty determination for all years covered by the [UVDP] regardless of the UVDP fraud penalty framework."[7]

ii. The Guide Paper also cautions Revenue Agents in another way: "Do not rely on the [Internal Revenue Code provision expanding assessment-periods in cases of fraud] to hold the expiring assessment statute open before making a civil fraud determination."[8]

4. Dead Taxpayers and Criminal Liability

a. Deceased taxpayers can participate in the UVDP, but they obviously cannot go to jail. The Guide Paper hints that others associated with the decedent sure can, though.

b. The Guide Paper instructs Revenue Agents to review the entire Form 14457, Form 56 (Notice Concerning Fiduciary Relationship), and all attachments. It goes on to state that Revenue Agents should "review the narrative to understand whose actions might lead to criminal exposure, the actions of the decedent, or the fiduciary, or someone else connected to the decedent (*e.g.*, an heir)."[9]

5. Building a Potential Case against Taxpayers

a. As explained earlier, participation in the UVDP does not guarantee that the IRS will not pursue criminal penalties against the taxpayer.

b. Moreover, the Guide Paper reveals that the IRS is concerned about ensuring that it can adequately sanction any taxpayer who starts down the UVDP path, but later provides false or incomplete data, refuses to cooperate fully, etc.

c. These and other apprehensions result in multiple mandates in the Guide Paper relating to Revenue Agents developing a thorough file against the taxpayer, just in case it becomes necessary.

i. The Guide Paper tells Revenue Agents to interview the taxpayer and then prepare a Memorandum of Interview ("MOI") shortly thereafter. In crafting the MOI, Revenue Agents are supposed to note "the exact words" used by the taxpayer, explain the context, and describe the taxpayer's

[7] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 12.
[8] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 10.
[9] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 8.

body language to convey additional meaning to his responses.[10] The Guide Paper also tells Revenue Agents to have the taxpayer review the MOI, correct it, and sign it under penalties of perjury.[11] Unsurprisingly, the Guide Paper underscores that the MOI "is helpful in supporting civil fraud and willful FBAR penalties."[12]

ii. The Guide Paper devotes significant time explaining to Revenue Agents when and how to construct a civil fraud case against a taxpayer. In situations where a Revenue Agent recommends revocation of Preliminary Acceptance, the Guide Paper instructs him to seek assistance from Fraud Technical Advisors and Fraud Enforcement Advisors, complete a Form 11661 (Fraud Development Recommendation), and "fully develop and support a fraud determination for all years covered by the [UVDP]."[13]

iii. In deciding whether a taxpayer acted fraudulently or willfully, the Guide Paper explains that Revenue Agents should be mindful of all the publicity, over many years, triggered by the Swiss bank program starting in 2008 and a long list of international voluntary disclosure programs announced by the IRS from 2009 forward.[14]

iv. The Guide Paper also emphasizes that Revenue Agents can and should use the taxpayer's own words against him.

(a) As explained earlier, a taxpayer must provide the IRS with an expansive "narrative" when submitting Part II of Form 14457 seeking Preliminary Acceptance. The Guide Paper explains the evidentiary value of such narrative: "In some cases, the narrative may provide sufficient admissions to assert fraud . . . The key is that the narrative is direct evidence about the taxpayer's state of mind and intent, whereas evidence

[10] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pgs. 13-14.
[11] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 13.
[12] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 13.
[13] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 19.
[14] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 35.

collected by [a Revenue Agent] concerning intent is circumstantial evidence."[15]

(b) The Guide Paper further encourages Revenue Agents to "rely on relevant admissions by taxpayers in the narrative that specifically describe their affirmative acts of tax and tax-related crimes (fraud)."[16]

v. The Guide Paper tells Revenue Agents that, if a taxpayer requests lesser penalties (*e.g.*, accuracy-related penalties instead of civil fraud or non-willful FBAR penalties instead of willful ones), then they should "probe" all defenses that the taxpayer raises in writing. Doing so "will help solidify and support the assertion of fraud and willful FBAR penalties and international information return penalties if the taxpayer becomes uncooperative."[17]

6. Taxpayers Cannot Back Out

a. The Guide Paper explains that taxpayers applying for the UVDP must agree to an examination by the IRS. It goes on to emphasize that once a taxpayer has submitted Part II of Form 14457 and received Preliminary Acceptance from the IRS, he cannot back out.

b. The Guide Paper states, in bold letters to ensure that IRS personnel do not miss it, that "revocation is at the discretion of the [IRS]" and a taxpayer cannot request revocation, seek removal, or opt-out.[18]

c. The Guide Paper also clarifies that a taxpayer cannot attempt to switch disclosure programs, which might occur if he were to learn after applying for the UVDP that he could have achieved a better settlement under the SDOP, SFOP, etc. The Guide Paper succinctly states the following about capricious taxpayers: "They are not eligible to participate in other avenues for compliance."[19]

7. Opening Closed Assessment-Periods

a. When dealing with federal tax matters, the IRS must assess additional taxes, penalties and interest while the relevant

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[15] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 19.
[16] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 12.
[17] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 36.
[18] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 29.
[19] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 29.

assessment-periods are still open. Moreover, once an assessment-period has closed, the IRS normally cannot re-open it again, even if the taxpayer were willing to allow it by signing a Form 872 (Consent to Extend the Time to Assess Tax).

b. The Guide Paper notifies Revenue Agents that things are different when it comes to FBAR penalties. It explains that the "FBAR statute may be extended or waived by the taxpayer *after* expiration. In other words, an expired FBAR statute can be resurrected with taxpayer consent."[20] The Guide Paper later states that "unlike Title 26 statutes, Title 31 FBAR statutes can be resurrected *after* the statute expires through the execution of a consent."[21] Consequently, the Guide Paper instructs Revenue Agents to solicit extensions of the FBAR penalty assessment-period in *all* UVDP cases.

IV. Updated IRS Stance on "Quiet Disclosures"

A. <u>Historic Warnings against Quiet Disclosures</u>

1. The IRS has warned taxpayers since 2009 *not* to make to circumvent such programs by making a so-called "quiet disclosure."

2. This means taxpayers pro-actively resolving issues by filing amended tax returns and/or information returns, without officially participating in a recognized disclosure program, with hopes that the IRS will process the returns in the regular course, not start an audit, and not impose penalties.

3. The IRS repeatedly announced that it planned to identify and harshly sanction attempted "quiet disclosures."[22]

B. <u>IRS Reverses Position in 2019</u>

1. With the introduction of the UVDP, the IRS has changed course, telling taxpayers that it is acceptable to make a "quiet disclosure," provided that there is no risk of criminality.[23]

2. The IRS stated the following: "Taxpayers who did not commit any tax or tax related crimes and do not need the voluntary disclosure practice to seek protection from potential criminal prosecution can continue to correct past mistakes using the procedures mentioned above or by filing an amended or

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[20] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 39 (emphasis added).
[21] IRS Voluntary Disclosure Practice Examiner's Guide Is Available, 2022 Tax Notes Today Federal 138-24 (July 19, 2022), pg. 49 (emphasis added).
[22] *See, e.g.*, Robert Goulder, "Quiet Disclosures Get No Love from IRS," 2010 Tax Notes Today 90-1 (May 11, 2010); Marie Sapirie, "Charges against HSBC Bank Bermuda Client Raise Quiet Disclosure Questions," 201 Tax Notes Today 98-1 (May 20, 2011).
[23] IRS Memorandum LB&I-09-1118-014 (Nov. 20, 2018).

past due tax return. When these returns are examined, examiners will follow existing law and guidance governing audits of the issues."[24]

C. Form 14457 and Instructions for UVDP

1. "You can correct less serious non-compliance by filing amended or past due tax returns." The Instructions feature a list of "Other Compliance Options," which consist of the SFOP, SDOP, DIIRSP, DFSP, and QDP.

V. Recent Procedures for Fixing Late Forms 1120-F

A. Overview

1. Foreign corporations with limited activities in the United States, sometimes are unaware of their duty to file annual Forms 1120-F (U.S. Income Tax Return of a Foreign Corporation).

2. In addition to normal penalties for late filing, late payment, and failure to enclose Forms 5472, foreign corporations face a formidable stick:

   a. The IRS disallows business-related deductions and credits to which the foreign corporations normally would have been entitled, such that they are taxed on *gross* income, instead of *net* income.

3. Cognizant of the harshness of the deduction-and-credit disallowance rule, the IRS created an exception. The IRS will ignore tardiness in situations where a foreign corporation can demonstrate that it acted reasonably and in good faith ("Late-Filing Waiver").[25]

4. Inconsistencies arose over the years about where foreign corporations should submit requests for Late-Filing Waivers, the degree of scrutiny to be applied by the IRS, the number of years that must be addressed, etc.

5. To standardize the process, the IRS issued instructions for handling late Forms 1120-F and requests for Late-Filing Waivers ("Guidelines").[26]

B. Description of Applicable Law – Section 882

1. Broad General Filing Duty

   a. A foreign corporation generally must file a Form 1120-F if it (i) was engaged in a U.S. trade or business, regardless of whether it derived any income that was effectively connected with such trade or business ("ECI"), (ii) has income, gains, or losses that are treated as if they were ECI, (iii) was not engaged in a U.S. trade or business,

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[24] IRS Memorandum LB&I-09-1118-014 (Nov. 20, 2018).
[25] Treas. Reg. § 1.882-4(a)(3)(ii).
[26] Internal Revenue Service. "LB&I Guidelines for Handling Delinquent Forms 1120-F and Requests for Waiver Pursuant to Treas. Reg. § 1.882-4(a)(3)(ii)." February 1, 2018.

but had other US-source income that was not fully paid through tax withholding, (iv) is making a claim for refund, (v) is claiming the benefit of any deductions or credits, or (vi) needs to file a Form 8833 (Treaty-Based Return Position) to disclose to the IRS that it is taking the position that a tax treaty overrules or modifies the normal rules found in the Internal Revenue Code.

2. Disallowance of Deductions and Credits

a. Section 882 generally allows foreign corporations that derive ECI to be taxed at the rates applicable to domestic corporations on "taxable income." In determining "taxable income," foreign corporations (i) include only the amount of gross income that is ECI, and (ii) then reduce such amount by claiming all deductions and credits.

b. Section 882(c) and the corresponding regulations allow foreign corporations to claim such tax benefits *only if* they file proper, timely Forms 1120-F with the IRS.

C. IRS Waiver of "Timely" Filing Requirement

1. The IRS can grant a Late-Filing Waiver, thereby allowing a foreign corporation to claim deductions and credits, under certain circumstances.

2. Current Rules and Standards

a. The IRS will permit a Late-Filing Waiver if the foreign corporation can show it acted "reasonably and in good faith" in failing to file a timely Form 1120-F or a "protective" Form 1120-F.[27]

b. The IRS must consider the following list of factors in deciding whether a foreign corporation meets the current standard for relief:

i. Whether the foreign corporation voluntarily identifies itself to the IRS before the IRS discovers the issue;

ii. Whether the corporation did not become aware of its ability to file a "protective" Form 1120-F by the normal deadline;

iii. Whether the corporation previously filed a Form 1120-F;

iv. Whether the foreign corporation failed to file a Form 1120-F because, after exercising reasonable diligence (taking into account its relevant experience and level of sophistication), the foreign corporation was unaware of the necessity;

[27] Treas. Reg. § 1.882-4(a)(3)(ii).

v. Whether the foreign corporation failed to file a Form 1120-F because of intervening events beyond its control; and

vi. Whether other mitigating or exacerbating factors exist.

D. New IRS Guidelines about Late-Filing Waiver

1. Centralized Filing - The Guidelines create two main categories.

a. Scenario 1 contemplates a foreign corporation that is not under audit, which voluntarily approaches LB&I about its unfiled Forms 1120-F for prior years. Here, the Guidelines tell LB&I personnel to instruct the foreign corporation to file late Forms 1120-F in the regular manner, pursuant to the Instructions to Form 1120-F.

b. Scenario 2 arises when LB&I gets assigned to audit a foreign corporation with respect to a late Form 1120-F. The actions of LB&I depend on whether the foreign corporation has already filed a request for a Late-Filing Waiver. If yes, then the Exam should develop the facts relevant to the request for a Late-Filing Waiver, reach a recommendation, and then follow the recommendation-processing rules. Conversely, if the foreign corporation has not previously filed a request for a Late-Filing Waiver, then Exam notifies the foreign corporation in writing of its ability to do so.

2. Penalties Anyone?

a. The Late-Filing Waiver allows a foreign corporation to escape the harsh treatment contemplated by Section 882(c)(2); that is, paying U.S. taxes on *gross* income effectively connected with a U.S. trade or business, without the benefit of many deductions and credits.

b. This is beneficial to a foreign corporation, no doubt, but it is far from *carte blanche*. Foreign corporations filing late Forms 1120-F often are subject to *other* penalties, like the following:

i. Delinquency penalties for late filing and/or payment

ii. Failure to disclose treaty position on Form 8833

iii. Failure to File Forms 5472

c. Silence Is Ominous

i. The standard for achieving a Late-Filing Waiver is "reasonable cause" and "good faith." This is identical or very similar to the thresholds for obtaining abatement of delinquency penalties, Form 8833 penalties, and Form 5472 penalties. Therefore, logic dictates that, if the IRS were to grant a Late-Filing Waiver then the IRS should also eliminate the potential penalties. However, the Guidelines are silent on this critical issue.

VI. Easing of Foreign Trust Reporting Rules

A. Overview

1. Taxpayers must file Forms 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts) and Forms 3520-A (Annual Information Return of Foreign Trust with a U.S. Owner) in certain situations.

2. Duties of Responsible Parties

   a. A "responsible party" generally must file a Form 3520 within 90 days of certain "reportable events." For these purposes, the term "responsible party" means (i) the grantor, in cases involving the creation of an inter vivos trust, (ii) the transferor, where there is a reportable event, other than a transfer upon death, and (iii) the executor of a decedent's estate.

   b. The term "reportable event" includes creation of a foreign trust by a U.S. person, the transfer of money or other property (directly, indirectly or constructively) to a foreign trust by a U.S. person, and the death of a U.S. person, if such person was treated as the "owner" of any portion of the foreign trust under the grantor trust rules or any portion of the foreign trust was included in the person's gross estate.

3. Duties of Owners

   a. If a U.S. person is treated as the "owner" of any portion of a foreign trust under the grantor trust rules at any time during a year, then the person (i) "shall submit" such information as the IRS prescribes with respect to the trust, and (ii) "shall be responsible to ensure" that the trust files Form 3520-A and furnishes the information required by the IRS to each U.S. person who is treated as the owner of any portion of the trust, or who receives (directly, indirectly, or constructively) any distribution from the trust.

4. Duties of Beneficiaries

   a. A U.S. person ordinarily must file a Form 3520 if such person receives (directly, indirectly, or constructively) during the year any distribution from a foreign trust.

5. Penalties for Violations

   a. The penalty for not filing a timely, complete, accurate Form 3520 is $10,000 or 35% of the so-called "gross reportable amount," whichever is larger.

b. If the violation involves Form 3520-A (pertaining to owners of foreign trusts) instead of Form 3520 (pertaining to responsible parties *and* beneficiaries), the penalty decreases from 35% to 5%.

c. Taxpayers might also be hit with a so-called "continuation penalty" of $10,000 per month if they refuse to become compliant within 90 days of notice from the IRS.

B. <u>Taxpayer Relief under Rev. Proc. 2020-17</u>

1. Overview

a. The primary purpose of Rev. Proc. 2020-17 is to create an *exemption* from certain information-reporting requirements (but not from income-reporting and tax-payment requirements) for some individuals with respect to their ownership of, and transactions with, certain types of foreign trusts.

2. Key Definitions

a. Understanding the key terms is tedious, but is necessary in order to grasp the benefits and limits of Rev. Proc. 2020-17.

b. Eligible Individual

i. An "eligible individual" is any individual who is, or who was at any time, (i) a U.S. citizen or U.S. resident, (ii) who, for any year whose general assessment-period remains open, was compliant "or comes into compliance" with his duty to file Forms 1040, and (iii) to the extent required, has reported as income on Forms 1040 or Forms 1040X contributions to, accretion in, and/or actual distributions from an "applicable tax-favored foreign trust."

ii. Rev. Proc. 2020-17 also states that only "U.S. individuals who have been compliant with respect to their income tax obligations related to such trusts may rely on" it.

c. Applies to Retirement *and* Non-Retirement Trusts

i. An "applicable tax-favored foreign trust" includes <u>*both*</u> "tax-favored foreign retirement trust" <u>*and*</u> "tax-favored foreign non-retirement trust," as described below.

ii. Tax-Favored <u>*Retirement*</u> Trust

(a) A "tax-favored retirement trust" means (i) a "trust, plan, fund, scheme, or other arrangement" (ii) created, organized, or otherwise established under the laws of a foreign country (iii) to operate exclusively (or almost exclusively) to provide, or to earn income for the provision of, pension or retirement benefits and ancillary or incidental benefits, and (iv) meets *all* the following requirements established under local law.

(1) The trust is generally tax-exempt or otherwise tax-favored under local law.

(2) Annual information-reporting with respect to the trust, its participants, or its beneficiaries is filed with, or otherwise available to, the local tax authorities.

(3) Contributions are limited to income earned from performing personal services.

(4) Contributions cannot exceed a percentage of earned income by the participant, they cannot surpass $50,000 per year, or they are subject to a lifetime max of $1 million.

(5) Withdrawals, distributions, or payments from the trust are contingent upon death, disability, or reaching a set retirement age, or penalties apply for earlier ones.

iii. Tax-Favored _Non-Retirement_ Savings Trust

(a) A "tax-favored non-retirement savings trust" means (i) a "trust, plan, fund, scheme, or other arrangement" (ii) created, organized, or otherwise established under the laws of a foreign country (iii) to operate exclusively (or almost exclusively) to provide, or to earn income for the provision of, medical, disability, or educational benefits, and (iv) meets *all* the following items under local law.

(1) The trust is generally tax-exempt or is otherwise tax-favored under local law.

(2) Annual information-reporting with respect to the trust, its participants, or its beneficiaries is filed with, or otherwise available to, the local tax authorities.

(3) Contributions cannot exceed $10,000 per year or $200,000 over a lifetime.

(4) Withdrawals, distributions, or payments from the trust are conditioned upon the provision of medical, disability, or educational benefits, or penalties apply to those occurring for any other purpose.

C. Prospective Matters – Future Filing Waiver

1. This IRS waives the duty to file Forms 3520 and Forms 3520-A to "eligible individuals" with respect to "tax-favored retirement trusts" or "tax-favored non-retirement savings trusts."

2. What was the IRS thinking?

a. These items are restricted under foreign law; and

b. Taxpayers already report them to the IRS on other international information returns.

D. Retroactive Matters – Abating Past Penalties

1. Generally, any "eligible individual" against whom the IRS has already assessed a penalty related to Forms 3520 and/or Forms 3520-A can seek an abatement or a refund, as appropriate, by filing a Form 843 (Claim for Refund and Request for Abatement).

E. Limitations of Rev. Proc. 2020-17

1. First, to be an "eligible individual," a taxpayer must have filed his annual Forms 1040 and reported *all* worldwide income, which ordinarily includes all contributions to, accretion in, and/or actual distributions from the "applicable tax-favored foreign trust."

2. Second, even if a taxpayer were entitled to a future filing waiver under Rev. Proc. 2020-17, he likely still would need to report the "applicable tax-favored foreign trust" on Form 8938, the FBAR, Part III of Schedule B of Form 1040 and, perhaps, elsewhere. The taxpayer, therefore, will not be relieved of any information-gathering or record-retention duties.

3. Third, the time for claiming an abatement or refund of penalties assessed for prior years might have already expired.

VII. International Withholding Compliance Program

A. Synopsis of Duties

1. Generally, if a foreign person derives investment-type income from U.S. sources, then the *gross amount* of such income is taxed at a flat rate of 30%.

2. The burden of collecting such tax and then remitting it to the IRS is placed on the person controlling the payment, commonly known as a U.S. withholding agent ("USWA").

3. These USWAs have an incentive to get the withholding done correctly, because they are personally liable if they fail to meet their duties.

4. There are three main U.S. tax withholding tax regimes.

   a. The first is the Foreign Account Tax Compliance Act, which imposes withholding in situations where foreign payees fail to provide information about U.S. recipients of payments.[28]

   b. The second is the withholding regime related to payments to foreign persons of fixed, determinable, annual, or periodic ("FDAP") income from U.S. sources.[29]

   c. There is a different set of withholding rules applicable to foreign persons selling U.S. real property. These were promulgated pursuant to the Foreign Investment in Real Property Tax Act ("FIRPTA"), which generally dictates that gains or losses realized by foreign persons from the sale, exchange, or other disposition of a "U.S. real property interest" are taxed in the same manner as income that is effectively connected to a U.S. trade or business.[30]

5. Complying with the information-reporting and tax-withholding duties is complicated. Depending on the circumstances, this might involve preparing and filing the following:

   a. Form 1042 (Annual Withholding Tax Return for U.S. Source Income for Foreign Persons),

   b. Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding),

   c. Form 8804 (Annual Return for Partnership Withholding Tax),

   d. Form 8805 (Foreign Partner's Information Statement of Section 1446 Withholding Tax),

   e. Form 8813 (Partnership Withholding Tax Payment Voucher), or

   f. Form 8828 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests).

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[28] Sections 1471 through 1474.
[29] Treas. Reg. § 1.1442-1; Treas. Reg. § 1.1442-2; Treas. Reg. § 1.1442-3.
[30] Section 897(a)(1).

B. New Mechanism to Rectify Foreign Payment Problems

1. Introduction

a. The IRS recognizes that significant non-compliance exists, many problems are caused by ignorance or confusion about complicated rules, taxpayers are reluctant to voluntarily remedy matters if doing so will trigger penalties, and getting as many taxpayers as possible back in the system is fundamental.

b. Therefore, the IRS introduced a new mechanism for resolving past international withholding issues ("Foreign Payment Program").[31]

2. Eligibility Criteria

a. To participate in the Foreign Payment Program, the USWA must (i) file all outstanding withholding tax returns, including related information returns, (ii) make "full payment" of the taxes due, and (iii) provide a statement containing an explanation of the areas or lines of business for which there was non-compliance, a clarification of how the non-compliance was discovered, a description of the corrective procedures implemented to ensure compliance in future years, and a copy of the communications by the USWA to employees or other relevant parties about the corrective procedures.

b. A USWA is not eligible for the Foreign Payment Program if he/it is already under audit.

3. Disclosure Period / Relevant Years

a. On a positive note, USWAs are required to file late returns for only the past six years. Extending beyond this six-year period requires managerial approval within the IRS.

4. Seeking Penalty Relief

a. When returns are filed under the Foreign Payment Program, Revenue Agents will review them *and* consider any acceptable penalty-abatement request.

5. Relevant IRS Office

a. The IRS instructs USWAs to send the materials to a particular IRS office in Illinois.

VIII. Disclosure Procedure for Former U.S Citizens

[31] IRS Memorandum LB&I-04-0219-002 (Feb. 27, 2019); Tax Analysts Document 2019-8432.

A. Overview

1. The IRS introduced in late 2019 the Relief Procedures for Certain Former Citizens ("RPCFC").

2. The RPCFC is designed to benefit taxpayers who (i) were U.S. citizens, (ii) have already expatriated, (iii) had no or minimal U.S. income tax liability in the years preceding expatriation, (iv) were effectively "off the grid" in terms of U.S. tax compliance in that they never filed Forms 1040 or international information returns, (v) would not have been subjected to the exit tax as a result of the Tax Liability Test or Net Worth Test, (v) but who were liable for the exit tax because they failed the Certification Test (*i.e.*, they did not have full U.S. tax compliance in the five years preceding expatriation), yet did not pay such tax.

B. General Information

1. The IRS recognizes that "[s]ome U.S. citizens, born in the United States to foreign parents, or born outside the United States to U.S. citizen parents, may be unaware of their status as U.S. citizens or the consequences of such status."

2. To meet the Certification Test and thus avoid being classified as a "covered expatriate," taxpayers must file a Form 8854 with their Form 1040 for the year of expatriation and certify full U.S. compliance for the past five years.

3. The RPCFC is an alternative means for satisfying the Certification Test for U.S. citizens who expatriated after March 18, 2010.

4. If the individuals submit the mandatory documents and meet the eligibility requirements for the RPCFC, then they will *not* be considered "covered expatriates" under Section 877A and thus will not be subject to the exit tax, will not be required to pay back income taxes, and will not be penalized for unfiled international information returns.

5. The IRS clarifies that the RPCFC is only available to taxpayers whose failure to file Forms 1040, international information returns, and FBARs was due to "non-willful conduct."

C. Qualification Criteria

1. Taxpayers must "strictly meet" all the following criteria:

    a. They relinquished U.S. citizenship after March 18, 2010;

    b. They have no filing history with the IRS;

    c. They had a net worth of less than $2 million, both at the time of expatriation and at the time of making a submission under the RPCFC, without taking into account any exceptions;

d. They have an aggregate tax liability of $25,000 or less for the five years before expatriating, calculated after applying all deductions, exclusions, exemptions, and credits, omitting any potential exit tax, and omitting any penalties and interest;

e. They complete and file all necessary U.S. tax returns and information returns for the relevant six years; and

f. They did not willfully violate any U.S. tax-related duties.

D. Example Provided by the IRS

1. "John was born in the United States while his non-U.S. parents were attending university for post-graduate studies. Shortly after John was born, the family returned to Country E. John is a citizen of Country E and lives and works in Country E. John renounced his citizenship on October 1, 2019, and received a Certificate of Loss of Nationality. John has never filed a U.S. income tax return and never applied for or received a Social Security Number. He wants to use the RPCFC to come into compliance with his U.S. tax obligations. He must report his worldwide income on Form 1040 for 2019 and the preceding five tax years (and may claim all available deductions and credits, including foreign tax credits, to the extent permitted) to determine the total tax. In each year, John had various sources of income, including small amounts of income from foreign mutual funds that are passive foreign investment companies. For 2014 through 2019, John submits the following tax returns required under these procedures: (i) 2019 Form 1040NR (with Form 1040 attached as an information return reporting worldwide income through October 1, 2019), with a total tax of $1,000, and (ii) Forms 1040 for 2014 through 2018, each of which shows a total tax of $4,800 on line 63. John uses his best efforts in computing his total tax for each year. John computed the income from his foreign mutual funds and reported them as ordinary income on the "other income" line of his Forms 1040. He should have also used Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) to make additional computations, but he failed to include that form with his return. John adds the "total tax" amounts for all his six tax returns submitted under the procedures; the amount is $25,000. John's total tax liabilities are within the limit for these procedures. John is eligible to use the RPCFC."

IX. Solutions for NRAs with U.S. Real Property Violations

A. Overview of General Rules

1. Passive income (including rent), from by U.S. sources, not connected with a U.S. trade or business, and received by a nonresident alien ("NRA") generally is subject to 30% income tax on the *gross* amount.

2. This means that the so-called USWA (normally the renter, lessee, or property manager) must reserve a significant portion of the total income and send it to the IRS, as opposed to the NRA.

3. By comparison, an NRA who is engaged in a U.S. trade or business during a year is taxed at the normal graduated/progressive rates on *net* income; that is, after taking into account the deductions that are effectively connected with the business.

B. Special Rules Exist for Certain Rental Real Estate

1. Section 871(d) provides that an NRA who obtains income from U.S. real property held for the production of income or from any interest in such property, which is not otherwise treated as income effectively connected with a U.S. trade or business, has the option of *electing* to treat all such income (including rental income) as effectively connected income.

2. The main benefits of the Section 871(d) election for an NRA are he can:

    a. convert the passive renting of U.S. real property into an active trade or business for U.S. tax purposes,

    b. avoid a flat tax rate of 30%on gross income, effectuated by tax withholding at source, and

    c. claim a multitude of tax deductions related to the property.

3. Once an NRA makes a Section 871(d) election for one year, it remains in effect for all later years, unless the IRS gives permission to revoke it.

4. An NRA who makes the Section 871(d) election reports income and deductions related to the U.S. real property on Schedule E (Supplemental Income and Loss from Rental Real Estate, Royalties, Partnerships, S Corporations, Estates, Trusts, REMICs, etc.) to Form 1040NR.

C. How to Make the Section 871(d) Election

1. Section 871 is vague about how to make the relevant election, limiting itself to stating that it "may be made only in such manner and at such time as the [IRS] may by regulations prescribe."

2. The regulations explain the election procedure in the following manner:

    a. "An election made under this section without the consent of the [IRS] shall be made for a taxable year by *filing with the income tax return* required under Section 6012 and the regulations thereunder for such taxable year a *statement* to the effect that the election is being made."

b. "This statement shall include (a) a complete schedule of all real property, or any interest in real property, of which the taxpayer is titular or beneficial owner, which is located in the United States, (b) an indication of the extent to which the taxpayer has direct or beneficial ownership in each such item of real property, or interest in real property, (c) the location of the real property or interest therein, (d) a description of any substantial improvements on any such property, and (e) an identification of any taxable year or years in respect of which a revocation or new election under this section has previously occurred."

D. Need for a Timely Tax Return

1. Section 874(a) generally provides that an NRA is not permitted to claim deductions, unless the NRA files an accurate, and timely Form 1040NR. This includes deductions related to rental real estate that become available to NRAs after making a Section 871(d) election.

E. Recent Report

1. NRAs are buying lots of U.S. property

a. A recent report by the Tax Inspector General for Tax Administration ("TIGTA") explains that NRAs have purchased a significant amount of U.S. real property in recent years, a large portion of which is used to generate rental income.

b. NRAs purchased $34.8 billion in 2013, $45.5 billion in 2014, $54.4 billion in 2015, and $43.5 billion in 2016.[32]

2. Main Categories of Non-Compliance

a. *First*, TIGTA discovered that lots of NRAs were claiming net income treatment on the annual Forms 1040NR, despite the fact that they never made a proper Section 871(d) election.

b. *Second*, TIGTA learned that some NRAs are double dipping, taking inconsistent tax positions in order to acquire two improper benefits. This is made possible, according to the TIGTA Report, because the IRS's systems do not adequately input or track the data about U.S. rental property that is supplied to the IRS in the first-year Section 871(d) election statement attached to Form 1040NR.

i. The initial benefit is that certain NRAs deduct rental expenses annually and subject the remaining net income to

[32] Treasury Inspector General for Tax Administration. Additional Controls Are Needed to Help Ensure that Nonresident Alien Individual Property Owners Comply with Tax Laws. Report No. 2017-30-048 (Aug. 23, 2017), pages 2-3.

the graduated tax rates, which are often less than the standard 30% withholding rates on gross income.

ii. The additional benefit comes when the property is later sold. Some unscrupulous NRAs conveniently forget to reduce their basis in the property by the amount of the depreciation expenses that they took over the years, thereby diminishing the total gain when they sell the property.

c. *Third*, some NRAs never file Forms 1040NR, never notify USWAs that they should be subject to a 30% tax rate on gross income, and thus never pay any amount of U.S. income taxes on rental income from U.S. real property.

3. IRS Accepts Suggestion from TIGTA

a. The most important recommendation by TIGTA was to develop and implement a "*compliance initiative*" to address the problems caused by NRAs who do not properly report U.S. rental income.

b. The IRS announced its "compliance campaign" in March 2020.[33]

F. <u>Solutions for NRAs Who Filed Form 1040NR But Did Not Make Election</u>

1. Make a Late Election Pursuant to Section 871 Regulations

a. NRAs can file an amended Form 1040NR within the designated period to retroactively make the Section 871(d) election, without seeking advanced permission from IRS.[34]

2. Make a Late Election Thanks to Section 9100 Relief

a. If an NRA is unable to file a retroactive election to cover all affected years because the first Form 1040NR was filed beyond the general refund-period, or if the NRA wants the explicit, advanced blessing of the IRS, another option remains: Seeking a PLR from the IRS pursuant to Treas. Reg. § 301.9100-3. This is commonly known as getting "Section 9100 relief."

b. The IRS has discretion to grant reasonable extensions for filing certain elections. The regulations provide that extension requests "will be granted" by the IRS when the taxpayer provides sufficient evidence to establish that (i) the taxpayer acted reasonably and in good faith, and (ii) granting the extension will not prejudice the interests of the U.S. government.

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[33] Andrew Velarde. "Latest LB&I Campaign Targets Nonresident Rental Income," Federal Tax Notes Today, Document No. 2020-11378 (Mar. 26, 2020).

[34] Treas. Reg. § 1.871-10(d)(1)(i).

G. Solutions for NRAs Who Never Filed Forms 1040NR

1. Section 874(a) generally deprives an NRA of the deductions related to U.S. rental property, unless he files a timely Form 1040NR.[35]

2. The IRS can waive the timely-filing duty if the NRA demonstrates to the satisfaction of the IRS that, based on all the facts and circumstances, he acted reasonably and in good faith in failing to file a Form 1040NR.[36]

X. Foreign Gifts, Big Penalties, and Concession

A. Introduction

1. Receiving a significant gift of money from a foreign person is a good-news-bad-news situation for U.S. persons.

   a. On the positive side, receipt of cash from abroad generally does *not* trigger U.S. income taxes; they get the money tax free.

   b. On the negative side, they must disclose the gift by filing a timely Form 3520 (Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts). If U.S. persons fail to submit this obscure international information return, the IRS penalizes them, of course.

2. Case of first impression, *Wrzesinski v. United States*.[37]

B. Special Rules - Receipt of Foreign Gifts

1. If a U.S. individual receives a gift of property (including money) from an individual who is not a U.S. person totaling more than $100,000 during a year, then he generally must file a Form 3520 with the IRS.[38]

2. The receipt of the foreign gift does *not* trigger any immediate U.S. income taxes for the recipient, solely an information-reporting duty.

3. The penalty is five percent of the unreported gift for each month Form 3520 is late, with a maximum penalty of 25 percent.[39]

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[35] Section 874(a); Treas. Reg. § 1.874-1(a); Treas. Reg. § 1.874-1(b).
[36] Treas. Reg. § 1.874-1(b)(2).
[37] *Wrzesinski v. United States*, Case No. 2:22-cv-03568, Eastern Dist. of Penn, Complaint, Sept. 1, 2022; Andrew Veldarde, "Son of Polish Lottery Winner Challenges Foreign Gift Penalty," 2022 Tax Notes Today Federal 174-26 (Sept. 7, 2022).
[38] Section 6039F(a); IRS Notice 97-34, Section VI.
[39] Section 6039F(c)(1)(B); IRS Notice 97-34, Section VI.

4. The IRS has authority to waive the penalty, though, if the taxpayer can demonstrate that the violation was due to reasonable cause.[40]

5. The IRS recently acknowledged that most taxpayers are oblivious to the need to file Form 3520 when they receive a foreign gift, particularly because such event does not trigger a taxable event for U.S. purposes. The IRS stated the following in a recent training guide:

   a. "In general, gifts and inheritances are not taxable to the recipient. Many taxpayers and representatives know that basic tenant of tax law but are not aware of the requirement to report large foreign gifts and inheritances under [Section] 6039F."[41]

C. Foreign Trust Compliance Campaign

1. In May 2018, the IRS introduced a "Compliance Campaign" centered on foreign trusts, Forms 3520, and Forms 3520-A.[42]

2. The Compliance Campaign was designed to stop shenanigans associated with foreign trusts. Unfortunately, taxpayers failing to file Forms 3520 to report foreign gifts got caught in the IRS's enforcement net, too.

D. First Case

1. The relevant case, *Wrzesinki v. United States*, centers solely on Form 3520 penalties linked to the receipt of foreign cash gifts.

2. The taxpayer file a Complaint in District Court in September 2022. The allegations relevant to this article consist of the following.

   a. The taxpayer was born, raised and educated in Poland, immigrating to the United States when he was 19 years old.

   b. He has been in public service, working as a police officer for nearly a decade.

   c. In 2010, his mother, both a citizen and resident of Poland, won the lottery there and decided to gift the taxpayer $830,000.

   d. The taxpayer called his tax advisor from Poland to inquire about any U.S. duties triggered by the receipt of the gift. The tax advisor, who

[40] Section 6039F(c)(2); IRS Notice 97-34, Section VII; I.R.M. § 20.1.9.10.5 (01-29-2021); I.R.M. § 8.11.5.6.3 (12-18-2015).
[41] Voluntary Disclosure Practice Examiner Guide Paper, 2022 Tax Notes Today Federal 138-24 (7/9/2022), pg. 44; *See also* IRS Chief Counsel, INFO 2013-0015 (March 29, 2013)
[42] Frank Agostino et al. "Examination of Large Foreign Gifts and Inheritances: Code Sec. 6039F, Notice 97-34 and Form 3520," 20 Journal of Tax Practice & Procedure 5 (2018).

is an Enrolled Agent with the IRS, expressly told the taxpayer that the gift did not cause U.S. income tax liabilities or any other duties.

e. The mother made the gift via four separate transfers, from Poland to the United States, spanning 2010 (a total of $350,000) and 2011 (a total of $480,000). Thus, the taxpayer received over $100,000 in cash gifts from a foreign person each year.

f. In early 2011, during preparation of the taxpayer's Form 1040 for 2010, he again asked the tax advisor if he needed to file anything with in connection with the gift from his mother. The tax advisor, as before, incorrectly told the taxpayer that nothing was due.

g. Nothing happened for a long time; the taxpayer did not receive additional gifts, and the IRS never audited him.

h. Things changed in 2018. The taxpayer wanted to engage in some re-gifting, sending a portion of the money that he received from his mother years ago to his godson in Poland.

i. The taxpayer thought that he, as a U.S. person, might have some tax-related duties when sending a gift abroad. Therefore, he did some searches about "foreign gifts" on the Internet.

j. This led him to various articles about duties of U.S. persons who receive, as oppose to give, money from foreign persons. Shocked by this information, the taxpayer contacted a local attorney with experience regarding international matters.

k. The attorney informed the taxpayer of his duty to file Forms 3520 in 2010 and 2011 to report the cash gifts from his mother. He also explained to the taxpayer that there might be a way for him to rectify matters with the IRS on a penalty-free basis, the DIIRSP.

l. The taxpayer, with the assistance of the attorney, filed Forms 3520 for 2010 and 2011 pursuant to the DIIRSP, along with statements explaining reasonable cause. This occurred in August 2018.

m. After nearly a year, the IRS sent the taxpayer two notices in May 2019, indicating that he owed total penalties of $207,500 for the late Forms 3520. That figure represented the highest possible amount, which was 25 percent of the gifts received.

n. In rejecting the DIIRSP application, the IRS notices concluded that ordinary business care and prudence requires taxpayers to make themselves aware of their duties and that ignorance of tax laws could not serve as a basis for reasonable cause.

o. The taxpayer disputed the IRS notices and penalties of $207,500 by filing a Protest Letter in June 2019. To strengthen his position, the taxpayer later filed a Supplemental Protest Letter, attaching a letter from the tax advisor in which he admits that the facts in the Complaint described above are accurate. The advisor, in other words, corroborated the taxpayer's reasonable-reliance defense.

p. Another year and a half passed. In December 2020, the Appeals Officer assigned to review the IRS penalties, Protest Letter and Supplemental Protest Letter issued a so-called Case Memo. He agreed to abate $166,000 of the total penalty of $207,500. That left a penalty of $41,500, or five percent of the total gifts that the taxpayer received from his mother.

q. The taxpayer paid the remaining $41,500. He then filed Claims for Refund with the IRS in March 2022, which the IRS swiftly denied. In doing so, the IRS took the position that the Claims for Refund did not establish reasonable cause and were "frivolous."

r. The taxpayer next filed his Complaint with the District Court, thereby initiating the Suit for Refund in September 2022.

E. Significance of Case

1. *Wrzesinki v. United States* might be of importance to the tax world.

2. First, the case will educate the public about the obscure duty to file Form 3520 upon receipt by U.S. persons of certain foreign gifts.

3. Second, the IRS will be forced to clarify its stance regarding what, exactly, constitutes reasonable cause in the context of complex international information returns.

4. Third, the IRS must explain the functioning, or perhaps malfunctioning, of the DIIRSP and its enticement to taxpayers of penalty-free resolution.

5. Fourth, the IRS will have to address whether its longstanding prohibition against "nuisance settlements" still exists.

6. For this and other reasons, taxpayers facing Form 3520 penalties, now and in the future, should be paying attention to this evolving case.

F. Government Concedes Case

1. The IRS quickly came under scrutiny for its handling of Form 3520 penalties in *Wrzesinski v. United States*, with commentators warning that an unfavorable decision for the IRS could open the proverbial can of worms.[43]

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[43] Hale E. Sheppard, "Foreign Gifts, Forms 3520, Big Penalties, and Pending Case," 177 Tax Notes Federal 57 (Oct. 3, 2022).

2. The tax attorneys at the Department of Justice ("DOJ"), who are charged with handling refund litigation, swiftly arrived at the same conclusion. They agreed to fully concede the case in favor of the taxpayer before they even filed an Answer to the initial Complaint lodged by the taxpayer.[44]

3. In other words, the IRS fully surrendered before it submitted any pleadings with the District Court, engaged in any discovery procedures, filed any legal briefs, or otherwise attempted to defend the IRS's earlier position that the taxpayer should be stuck with penalties totaling $41,500 for 2010 and 2011.

4. Taxpayers were so close to finally getting some guidance, from a court, on critical issues about foreign gifts and the large penalties for not reporting them. Unfortunately, because the government elected to quickly concede a case of first impression, taxpayers now must await future opportunities.

XI. IRS Lacks Authority to Assess Form 5471 Penalties

A. Introduction

1. The IRS must cherish certain aspects of tax enforcement, such as its ability to *automatically* assess penalties and collect when taxpayers file international information-returns that are late, inaccurate and/or incomplete.

2. Why is automatic assessment a big deal? Well, it means that the IRS is *not* required to first issue an Examination Report proposing penalties, then give the taxpayer a chance to seek pre-assessment review by the Appeals Office, and later issue a Notice of Deficiency, thereby triggering the taxpayer's right to dispute matters in Tax Court, again on a pre-assessment basis.

3. Among the returns historically hit with automatic penalties are Forms 5471 (Information Return of U.S. Persons with Respect to Certain Foreign Corporations).

B. Form 5471 Requirements and Penalties

1. Various categories of U.S. persons who are officers, directors, and/or shareholders of certain foreign corporations must file a Form 5471.[45]

2. If a person fails to file a Form 5471, files a late Form 5471, or files a timely but "substantially incomplete" Form 5471, then the IRS may assert an initial penalty of $10,000 per violation.[46]

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[44] *Wrzesinski v. United States*, District Court for the Eastern District of Pennsylvania, Status Report in Lieu of Answer, Case No. 2:22-cv-03568 (March 7, 2023); "Foreign Gift Penalties to be Refunded and Case Dismissed," 2022 Tax Notes Today 49-13 (March 7, 2023); Andrew Velarde, "DOJ Concedes in Polish Lotto Foreign Gift Penalty Case," 2023 Tax Notes Today 49-5 (March 14, 2023).
[45] Section 6038; Treas. Reg. § 1.6038-2; Section 6046; Treas. Reg. § 1.6046-1; Section 6679; Treas. Reg. § 301.6679-1; Instructions to Form 5471.
[46] Section 6038(b)(1); Treas. Reg. § 1.6038-2(k)(1)(i); Section 6046(f); Treas. Reg. § § 1.6046-1(k).

3. The IRS then imposes a so-called continuation penalty, at a rate of $10,000 per month, if the problem persists after notification by the IRS.[47] The continuation penalty is capped at $50,000.

4. The IRS will not levy penalties if there was "reasonable cause" for the violation. Additionally, the IRS will refrain from assessing penalties if the taxpayer filed a timely Form 5471 with certain omissions or inaccuracies, provided that it was “substantially complete.”[48]

C. <u>New Case of First Impression</u>

1. Background and Procedure

a. The taxpayer in *Farhy v. Comissioner* owned two corporations in Belize during the relevant years.[49]

b. According to the Tax Court, the taxpayer participated in an “illegal scheme” to reduce his income taxes, signed an affidavit admitting it, and was granted immunity from criminal prosecution, presumably in exchange for cooperating with the U.S. government in its investigation of others.

c. The taxpayer did not file timely Forms 5471 to disclose the Belizean corporations.

d. The Tax Court noted that the taxpayer’s inactions were “willful” and “not due to reasonable cause.”

e. In 2018, the IRS assessed initial penalties of $10,000 per violation, followed by continuation penalties reaching the maximum of $50,000. The IRS then commenced collection actions, sending the taxpayer a pre-levy notice in early 2019.

f. The taxpayer reacted by filing a timely request for a CDP hearing with the Appeals Office. He challenged the proposed levies on grounds that the IRS lacked authority to assess Form 5471 penalties in the first place.

g. The Appeals Office apparently disliked the taxpayer’s argument because it issued a Notice of Determination approving the IRS’s proposed levy to collect penalties. The taxpayer disagreed, of course, and filed a Petition with the Tax Court.

2. Decision by the Court

[47] Section 6038(b)(2); Treas. Reg. § 1.6038-2(k)(1)(ii); Section 6046(f); Treas. Reg. § § 1.6046-1(k).
[48] Treas. Reg. § 1.6038-2(k)(3)(i) and (ii).
[49] *Farhy v. Commissioner*, 160 T.C. No. 6 (2023).

a. The Tax Court began by describing the genesis of Form 5471 penalties, Section 6038 and Section 6038A.

b. It concluded that "[t]here is no statutory provision, in the [Internal Revenue] Code or otherwise, specifically authorizing assessment of these penalties."[50]

c. Next, the Tax Court turned to Section 6201 and other provisions, which *generally* allow the IRS to assess certain items and take collection actions. It underscored that, while Section 6201 includes the term "assessable penalties," it fails to define it. This oversight creates "uncertainty about which penalties the IRS may assess and ultimately collect through administrative means."[51]

d. The Tax Court discussed various tax provisions to support the notion that Congress has explicitly authorized the IRS to assess many types of penalties, but *not* Form 5471 penalties.

e. The Tax Court then identified a catch-all provision, which states that "[w]henever a civil fine, penalty, or pecuniary forfeiture is prescribed for the violation of an Act of Congress *without specifying the mode of recovery or enforcement thereof*, it may be recovered in a civil action."[52]

f. It explained that Section 6038 creates a Form 5471 filing duty and penalty, but omits an enforcement mechanism. The Tax Court exhibited restraint in holding in favor of the taxpayer, deciding that the IRS could *not* carry out its proposed levy to collect penalties.

3. Questions Raised by Case

a. *Farhy v. Commissioner* solves one issue, which is whether the IRS, under current law, can assess and collect Form 5471 penalties.

b. However, the case elicits many more questions than answers, such as the following:

i. Will the IRS challenge the Tax Court decision in with the proper Court of Appeals?

ii. Will the IRS issue an Action-on-Decision essentially announcing that it plans to ignore *Farhy v. Commisioner* for the moment and continue assessing and collecting Form 5471 penalties?

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[50] *Farhy v. Commissioner*, 106 T.C. No. 6 (2023), pg. 5.
[51] *Farhy v. Commissioner*, 106 T.C. No. 6 (2023), pg. 6.
[52] *Farhy v. Commissioner*, 106 T.C. No. 6 (2023), pg. 7 (citing 28 U.S.C. § 2461(a) (emphasis added)).

iii. Will the IRS cease assessing Form 5471 penalties?

iv. Will the IRS begin referring Form 5471 penalty matters to the Department of Justice, such that it can pursue actions against taxpayers in District Court?

v. Will large numbers of taxpayers who previously paid Form 5471 penalties, or who currently face such penalties, take administrative or judicial actions to recover or avoid them?

vi. Will the IRS concede such refund or abatement actions once filed?

vii. To avoid the drain on resources resulting such actions, will the IRS pro-actively grant penalty refunds or abatements?

viii. Will the IRS urge Congress to amend the Internal Revenue Code to ensure that *all* international information return penalties are subject to deficiency procedures, thereby allowing taxpayers to challenge penalties *before* the IRS assesses them, during audits, conferences with the Appeals Office, or Tax Court litigation?

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Using Tax Incentives to Increase Your Advisory Services

By Randy Crabtree

TRI-MERIT
SPECIALTY TAX PROFESSIONALS

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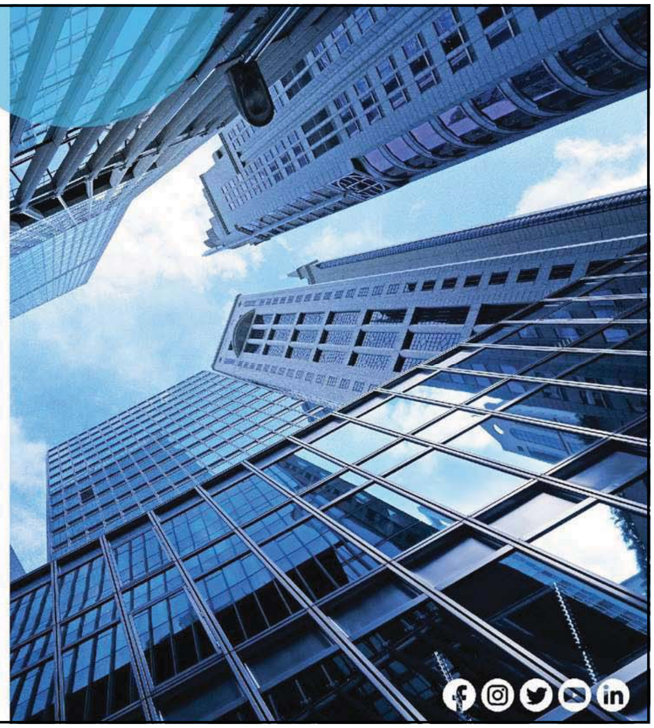

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Presenter – Randy Crabtree

- Co-founder and partner of Tri-Merit Specialty Tax Professionals.
- Host of The Unique CPA podcast, which is in the top 5% of all podcasts.
- Author for articles in Accounting Today, AICPA Tax, CPA Trendlines, Intuit.
- Frequent speaker on webinars, at conferences, and at accounting firms.
- A member of the Intuit Tax Council.
- Accounting Cornerstone Foundation board member

2

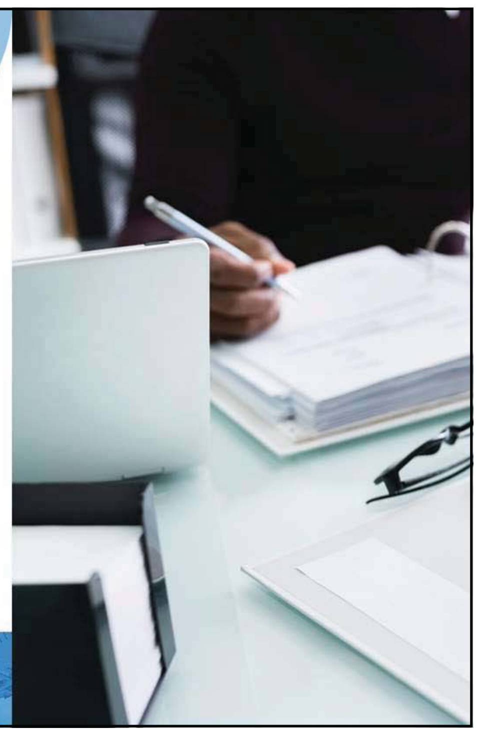
About Tri-Merit

- Tri-Merit supports Tax Preparers by serving as an extension of their advisory team to lessen the tax burden and increase cash flow for their clients.
- We spend more time on qualifying, quantifying and documenting which allows us to spend less time on defending credits and incentives.
- We work with companies to uncover tax savings opportunities through:

3

About Tri-Merit

- R&D tax credit, Cost Segregation, WOTC – The Work Opportunity tax Credit, 179D – the energy efficient commercial building deduction and 45L – a credit for developers of energy efficient residential property and ERC.
- We are comprised of engineers, scientists, CPAs and attorneys.
- We have offices across the country and serve clients in every state.



4

Tax Advisory Services

- Why lead with tax advisory services?
  - Proactively serving your clients needs
    - 79% of clients are willing to pay more for tax advice
    - 35% of tax professionals are providing tax planning services
  - Being able to show the value of the advice you are providing
  - Getting paid a premium based on the value provided
    - Do not undervalue your knowledge and expertise
  - Balancing seasonality and workload compression
  - Creating a better work-life balance
  - Avoid Burnout

5

Tax Advisory Services

- Examples of tax advisory services?
  - Effective and tax-efficient strategies for optimal tax management
  - Advising on specific entity types
  - Maximizing retirement savings
  - Representation in audits
  - Transfer pricing planning and compliance advice
  - Effective and tax-efficient planning for investments
  - Identity structure to maximize tax savings
    - Qualified Business Income Deduction QBI
    - Qualified Small Business Stock (QSBS)
  - Mergers and acquisition tax consulting
  - Maximizing SALT benefits
  - Identifying tax credits and incentives

6

R&D Tax Credit

7

R&D TAX CREDIT

- R&D tax credit planning opportunities:
  - Who can qualify:
    - Manufactures, Software Developers, Architects, Engineers, any taxpayer meeting the 4-part test.
  - Innovation occurring in response to COVID-19.
    - Pivoting to manufacturing new products, retail stores creating online stores, etc.

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R&D TAX CREDIT

- How to qualify
  - 4-part test to qualify
    - Permitted purpose
    - Technological in nature
    - Technical uncertainty
    - Process of experimentation
  - Overriding factor of economic risk

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R&D TAX CREDIT

- Expenses that qualify
  - Salaries and wages
  - Outside services
  - Supply costs (potential increase due to 174 pilot/prototype rules)
  - Rental or lease cost of computers

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R&D TAX CREDIT

- R&D Tax Credit Benefit
  - Benefit is about 6-10% of the qualified expenses.
  - Can be claimed on any open tax return.
    - NOL years could be brought forward to the current year
  - Companies with $50M or less in average gross receipts for the last 3 years that can claim the credit against AMT.

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R&D TAX CREDIT

- R&D Tax Credit Benefit for Start-up Companies
  - Companies can make an election to claim the credit against payroll taxes if they have:
    - Less than $5M in gross receipts in the current year.
    - No gross receipts further back than the last 5 tax years.
    - IRA increases this from a max of $250K to now $500K
    - IRA allows the credit to now also offset Medicare as well as Social Security tax.

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R&D TAX CREDIT

- IRS FAQs on Research Credit Claims (January 3rd, 2022)
  - Defined the information required when submitting a refund claim:
    - All the business components related to the credit claim
    - For each business component:
      - Identify all research activities performed
      - Name the individuals who performed each research activity
      - Note the information each individual sought to discover
    - The total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year

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Required Capitalization of §174 Expenses

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Who is Affected

- Common industries with §174 expenses:
  - Manufacturing
  - Software development
  - Architecture
  - Engineering
  - Need to look at any company that is using technology to develop or improve processes or products

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What is a §174 Expense?

- A "research and experimentation" expenditure is broadly defined as "all costs incident to the development or improvement of a product, process, technique, pilot model, formula, invention, patent, or similar property".

- R&E expenditures generally include all costs incidental to the development or improvement. Examples include costs of obtaining a patent, attorney fees, wages, utilities, overhead, materials, rent, depreciation, and software development costs, regardless of whether they are for the taxpayer's own use or held for sale to others.

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What's New?

- The Tax Cuts and Jobs Act of 2017 (TJCA) amended §174 to require capitalization of all research and experimentation (R&E) costs incurred in tax years beginning **after** December 31, 2021.
- Domestic R&E expenditures must be amortized over a 60-month period and international R&E expenditures must be amortized over a 180-month period.
- Depending on the scoring method used, this amendment was intended to generate between $15 and $150 billion in additional revenue over a 10-year period.

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What's the Problem?

- This was never intended to go into effect, with Washington insiders, industry lobbyists, and legislators themselves being of the understanding that this would be reversed prior to the implementation date.

- Taxpayers never had to separately identify §174 expenditures since they were fully deductible. Without a fix, many companies will be left scrambling to calculate and document §174 expenses for their 2022 tax year, with many presumably needing to make considerable tax payments based on increased income resulting from lack of first year deductions.

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Change in Accounting Method

- The IRS issued Rev Proc 2023-8 which clarified that, so long as the current year is the first year that these expenses are amortized, then a simple statement can be included with the return in lieu of a 3115 or 481(a).

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Interplay with the R&D Credit

- The R&D credit will offset some of the additional tax but not all of it.
- The R&D Credit (§41) is different from the calculation of §174 R&E expenses, with §174 expenses having broader inclusion.
- The R&D Credit still uses all expenses incurred during the year rather than just the amortization amount.

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§174 vs §41

Expense	174	41
Wages	Yes	Yes
Non-Taxable Benefits	Yes	No
Outsourced Expenses	Yes @ 100%	Yes @ 65%
Supply Costs	Yes	Yes
Depreciation	Yes	No
Overhead	Yes	No
G&A	Yes	No
Utilities	Yes	No
Indirect Expense Allocation	Yes	No
Rent	Yes	No
Securing a Patent Costs	Yes	No
Acquiring a Patent	No	No

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How to Advise the Client

Section 41 R&D Expenses + NQ Software Dev and Other Expenses + Wage Burden and Added Contract Costs + Foreign Research Expenses + Indirect Expenses = Section 174 Expenses

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EXAMPLE

(No increase in research expenses)

Example 1 – No increase in expenses

Example 1 - Flat R&D Expenses								
Tax Year	174 R&D expenditures	41 R&D Expenses	Ammortization expense	Net income old	Net income new	Increase in tax at 35%	280C Reduced R&D Tax Credit	Net Tax Increase
2022	$ 1,000,000	$ 800,000	$ 100,000	$ 1,500,000	$ 2,400,000	$ 315,000	$ 41,080	$ 273,920
2023	$ 1,000,000	$ 800,000	$ 300,000	$ 1,500,000	$ 2,200,000	$ 245,000	$ 41,080	$ 203,920
2024	$ 1,000,000	$ 800,000	$ 500,000	$ 1,500,000	$ 2,000,000	$ 175,000	$ 41,080	$ 133,920
2025	$ 1,000,000	$ 800,000	$ 700,000	$ 1,500,000	$ 1,800,000	$ 105,000	$ 41,080	$ 63,920
2026	$ 1,000,000	$ 800,000	$ 900,000	$ 1,500,000	$ 1,600,000	$ 35,000	$ 41,080	$ (6,080)
2027	$ 1,000,000	$ 800,000	$ 1,000,000	$ 1,500,000	$ 1,500,000	$ -	$ 41,080	$ (41,080)
Total Tax Increase						$ 875,000	$ 246,480	$ 628,520

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179D Energy Efficient Commercial Building Tax Deduction

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179D–Energy Efficient Commercial Building Deduction

- Two main users of the credit are:
  - Commercial building owners
  - Designers of government building and beginning in 2023 tax-exempt entities.
- Energy Policy Act of 2005
  - Created under the Energy Policy Act of 2005.
- Consolidated Appropriations Act, December 27th, 2020
  - The deduction was made permanent
- Inflation Reduction Act
  - Significant changes to the deduction

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179D–Energy Efficient Commercial Building Deduction

- Types of improvements
  - Completed new construction
  - Interior remodel
  - Additions
  - Enlargements
  - Retrofits
  - Improvements

26

179D–Energy Efficient Commercial Building Deduction

- Current Program Benefits
  - Accelerated depreciation for energy efficient commercial buildings.
  - A 50% reduction in energy or more results in a $1.80/$1.88 ft2 deduction.
  - Partial deductions (this changes in 2023)
    - HVAC | requires a 15% reduction* in energy for 60¢/SF
    - Lighting | requires a 25% reduction* in energy for 60¢/SF
    - Building Envelope | requires a 10% reduction* in energy for 60¢/SF

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179D–Energy Efficient Commercial Building Deduction

- Program Changes from the Inflation Reduction Act
  - Expands the Section 179D tax deduction for energy efficient commercial buildings to include tax-exempt entities.
  - Raises the maximum deduction value from $1.80/1.88 ft2 to $2.50-5.00 ft2 beginning 1/1/2023.
  - Reduces the threshold to qualify to 25% with credit increases as efficiency increases.
  - Eliminates the partial deduction and interim lighting rules
  - The deduction can now be taken on a specific commercial building every 3 years (previously, the deduction was permitted once over the life of the building).

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179D–Energy Efficient Commercial Building Deduction

- Commercial Buildings
  - Offices
  - Retail
  - Manufacturing
  - Parking garages
  - Warehouses
  - Storage facilities
  - Hospitals
  - Hospitality
  - Apartment buildings (4 Stories or more)
- Government Buildings
  - Schools and universities
  - Police and fire stations
  - Library
  - Village offices
  - Park district buildings

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179D–Energy Efficient Commercial Building Deduction

- Tax-Exempt
  - Charitable organizations
  - Churches and religious organizations
  - Private schools and universities
  - Private foundations
  - Political organizations
  - Other nonprofits
  - Native American tribal governments
  - Alaska Native Corporations

30

179D–Energy Efficient Commercial Building Deduction

- Current 179D Program Example:
  - 100,000 square foot building
  - HVAC all qualified @ $0.60 for $60,000 deduction.
  - Lighting all qualified @$0.60 for $60,000 deduction.
  - Envelope all qualified @$0.60 for $60,000 deduction.
  - Total deduction of $180,000 at 37% created a tax savings of $66,000
- For the building owner that is a time value of money benefit.
- For the designer of a government building, it is an additional deduction.
  - Schedule M adjustment

31

179D–Energy Efficient Commercial Building Deduction

- Starting 2023 179D Example:
  - 25% reduction and wage rules meet
    - 100,000 square foot building
    - Total deduction of $250,000 at 37% created a tax savings of $92,500 (100,000 x $2.50 x .37)
  - 50% reduction and wage rules meet
    - 100,000 square foot building
    - Total deduction of $500,000 at 37% created a tax savings of $185,000 (100,000 x $5.00 x .37)

32

179D–Energy Efficient Commercial Building Deduction

- 179D Example IRA -
  - 25% reduction and wage rules not meet
    - 100,000 square foot building
    - Total deduction of $50,000 at 37% created a tax savings of $18,500 (100,000 x $.50 x .37)
  - 50% reduction and wage rules not meet
    - 100,000 square foot building
    - Total deduction of $100,000 at 37% created a tax savings of $37,000 (100,000 x $1.00 x .37)

33

45L Credit For Developers of Energy Efficient Residential Properties

34

45L–Energy Efficient Credit for Residential Developers

- Developers of residential property
- Was defined in the Energy Policy Act of 2005
  - The CAA extended it through 2021
  - The Inflation Reduction Act further extended the program through 2032 and changed the program requirements.
- Allows developers/contractors of energy efficient properties to earn a tax credit for each qualifying unit.
  - General business credit, cannot offset AMT
- The credit must be claimed on the return for the year the property was leased or sold.

35

45L–Energy Efficient Credit for Residential Developers

- Current Program Requirements (through 2022)
  - Must be three stories or less above grade.
  - Developers can earn a $2,000 credit per unit.
  - Qualifying units must be substantially completed and be sold or have an initial lease in place.
  - The units must provide complete independent living facilities for one or more persons, that includes provisions for sleeping, eating, cooking and sanitation.

36

45L–Energy Efficient Credit for Residential Developers

- Current Program Requirements (cont.)
  - Properties must show an annual level of heating and cooling energy consumption at least 50% below the annual level of heating and cooling energy consumption of a "comparable dwelling unit"
    - Building envelope improvements must account for at least 1/5 of the 50% reduction.
  - Comparable dwelling unit is determined using 2006 IECC standards.
  - Manufactured Homes can meet a lesser energy consumption target and qualify for a $1,000 credit per unit.

37

45L–Energy Efficient Credit for Residential Developers

- Upcoming Changes from the IRA
  - Extends 45L program through 2032.
  - Qualification requirements change 1/1/2023
  - Credit now range from $2,500 to $5,000 per unit for Single-Family and Manufactured homes, and $500 to $5,000 per unit for Multifamily homes.
  - There is no longer a height limitation for multifamily properties
  - Sleeping units like dormitories, residence halls, support housing and cohousing can now be considered for 45L under the Multifamily program

38

45L–Energy Efficient Credit for Residential Developers

- Upcoming Changes from the IRA (cont.)
  - Properties must be certified through one of the following Energy Star Programs to be eligible for the $,2,500 credit.
    - ENERGY STAR Residential New Construction Program
    - ENERGY STAR Manufactured New Home Program
    - ENERGY STAR Multifamily New Construction Program
  - For the additional $2,500 credit properties must also meet the DoE Zero Energy Ready Home (ZERH) program requirements.
  - Credits for Multifamily properties will be reduced if prevailing wage requirements are not met ($500 vs $2,500)

39

45L–Energy Efficient Credit for Residential Developers

- Example – Developer of apartment buildings
  - In 2020 develops a 50 unit apartment building
    - 50 units qualified @ $2,000 = $100,000 credit
  - In 2023 the same 50 unit apartment building
    - Meets prevailing wage and ZERH requirements
    - 50 units qualified @ $5,000 = $250,000 credit

40

Cost Segregation

41

Cost Segregation

- Commercial or residential rental property owners.
- Breaking down depreciable real estate into individual components and identifying which components can be depreciated quicker.
  - Accelerating depreciation, deferring income taxes.
    - Taking assets otherwise depreciated at 27.5 or 39 years and reclassify them to 5, 7, or 15 years.
    - Certain assets can be bonus or 179 eligible.
  - New construction, purchases, remodels, additions, improvements

42

Cost Segregation

- Bonus Depreciation
  - Eligible property must have a 20-year useful life or less
  - Eligible property receives 100% bonus if acquired and placed in service after 9/27/17 and before 1/1/23
  - Bonus will phase down by 20% each year from 2023-2026
  - Used property now eligible

43

Cost Segregation

- Qualified Improvement Property (QIP)
  - Defined in the PATH act
  - Mistake on asset life in the TCJA
  - CARES Act fixes the mistake and now allows bonus on QIP.
  - Improvement to the interior of a nonresidential building.
    - Must be made after the building was placed in service.
    - Excludes enlargements, elevators, escalators, and internal structural framework of the building.
    - Improvements must be made by the entity claiming the deduction.

44

Cost Segregation

- Example – remodel of medical office.
  - Total costs were $2,464,000 originally classified as 39-year
  - After cost seg – 5/7-year $862,000, 15-year $148,000, 15-year QIP $1,208,000 and 39-year $246,000.
  - First year accelerated deprecation $2,224,300 compared to $63,000 without a cost seg study.

45

ERC Claims

46

The Employee Retention Credit

Qualifying Business

Any private-sector business or tax-exempt organization that carries on a trade or business and that meets EITHER of the following:

The business had a significant decline in gross receipts during any quarter. 50% in 2020 20% in 2021 Compared to 2019	The business was fully or partially suspended due to orders from the federal, state or local government limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19.

47

The Employee Retention Credit

- Partial Suspension
  - Limiting occupancy to provide for social distancing
    - Example restaurants
  - Requiring services to be performed only on an appointment basis (for businesses that previously offered walk-in service)
    - Would need to impact the ability to continue servicing the same number of customers.
  - Changing the format of service
    - Example going from indoor dining to carryout
  - Required reduction in hours of operations

48

Employee Retention Credit

	2020	2021
Credit Calculation	50% of up to $10,000 of **eligible** wages per employee per year. (3/13-12/31)	70% of up to $10,000 of **eligible** wages per employee per quarter (1/1/21-9/30/21)
Wages/Health Costs Capped	Annually	Quarterly
Maximum Credit Per Employee	$5,000	$21,000

49

The Employee Retention Credit

- Can supply chain issues qualify a business?
  - IRS FAQs and IRS Notice 2021-20
    - An employer may be considered to have a full or partial suspension of operations due to a governmental order if, under the facts and circumstances, the business's suppliers are unable to make deliveries of critical goods or materials due to a governmental order that causes the supplier to suspend its operations.

50

The Employee Retention Credit

- Can customer base issues qualify a business?
  - An employer that suspends some or all of its operations because its customers are subject to a government order requiring them to stay at home or otherwise causing a reduction in demand for its products or services is not considered to have a full or partial suspension of its operations due to a governmental order.

51

The Employee Retention Credit

- Do OSHA and CDC guidelines qualify as a government mandate?
  - OSHA's guidance for COVID-19 is not mandatory.
  - CDC's guidance for COVID-19 is not mandatory.
  - OSHA's memo to agents on enforcement creates no new obligations for businesses.
  - OSHA's General Duty Clause is a law predating the pandemic and therefore not an order due to COVID-19.
  - Even if this was able to create a mandate (which it cannot) you still need to meet the 10%, more than nominal, rule.
    - The above is from Dan Chodan's article published In "Think Outside the Tax Box"

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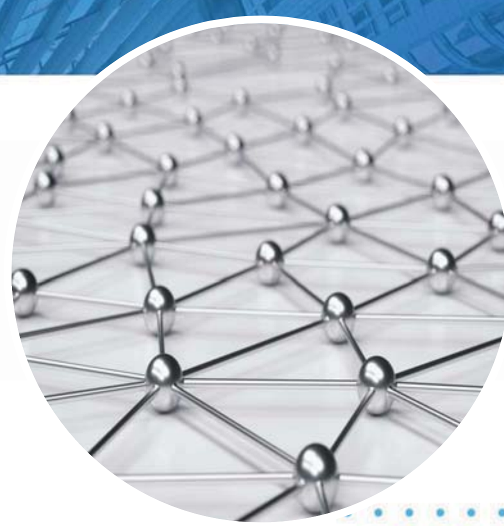
The Employee Retention Credit

- Income tax affects
  - IRS notice 2021-49
    - To the extent that an employer files an adjusted or amended return to reflect these clarifications and consequently owes additional tax, any penalties for failure to timely pay or deposit tax will not apply if the taxpayer can show reasonable cause and not willful neglect for those failures.

53

Work Opportunity Tax Credit



54

Work Opportunity Tax Credit (WOTC)

- Typically, employers that have at least 50 new hires per year are the best candidates
  - Restaurants, Manufacturers, Nonprofit, etc.
- New hire credit
- Was set to expired at the end of 2020 but was extended until 2025 in the CAA
- Incentivizes the hiring of individuals from targeted demographic groups who faced barriers to gaining/sustaining employment or with special employment needs

55

Work Opportunity Tax Credit (WOTC)

- Credit is between $2,400 and $9,600 per eligible employee
- Employees need to work at least 120 hours to qualify
- Need to apply within 28 days of hire
- For profit businesses offset federal income tax
- Nonprofit can qualify for veteran categories and use the credit to offset employer portion of SS taxes

56

Work Opportunity Tax Credit (WOTC)

- Employee Target Groups
  - SNAP Recipients - $2,400
  - Long-term Unemployed - $2,400
  - Temporary Assistance for Needy Families (TANF) - $2,400
  - Long-term TANF - $9,000
  - Supplemental Security Income Recipients - $$2,400
  - Vocational Rehabilitation Recipients - $2,400
  - Ex-felons - $2,400
  - Designated Community Residents - $2,400
  - Summer Youth Program - $1,200

57

Work Opportunity Tax Credit (WOTC)

- Veteran Target Groups
  - Veterans receiving SNAP - $2,400
  - Service-related Disability - $4,800 - $9,600
  - Temporary Assistance for Needy Families (TANF) - $2,400
  - Long-term Unemployed - $5,600
  - Short-term Unemployed - $2,400

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59

Understanding LLC & Partnership Basis

By Clint Davis

Understanding LLC and Partnership Basis

Opening Pandora's Box?

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1

Basis Introduction

Section 752 separates partnership liabilities into two categories: recourse liabilities and nonrecourse liabilities.

- **Section 1.752-1(a)(1) provides that a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss (EROL) for that liability under §1.752-2.**
- **Section 1.752-1(a)(2) provides that a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the EROL for that liability under §1.752-2.**

2

BUT, Schedule K-1 gives you three blocks

- Recourse ________________
- Nonrecourse _________________
- Qualified Nonrecourse _________________

- Qualified Nonrecourse is an at-risk term, not a basis term.
- So, the nonrecourse block is only for nonrecourse debt that does not qualify as qualified nonrecourse debt.

3

QUALIFIED NONRECOURSE FINANCING

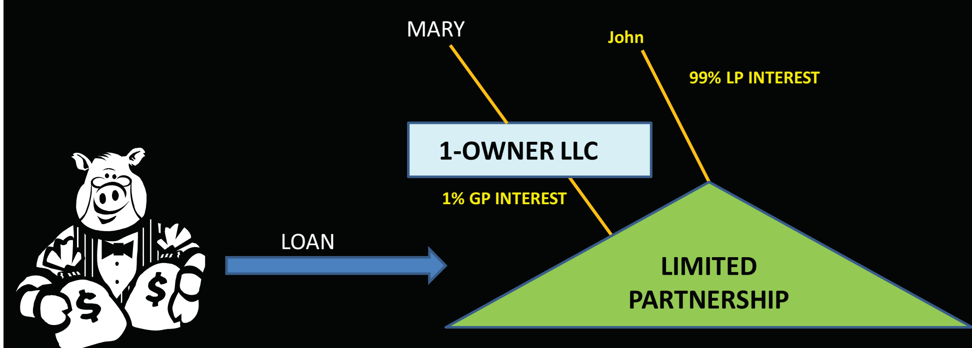
- NONRECOURSE
- NO CONVERSION
- HOLDING REAL PROPERTY
- GOVERNMENT OR QUALIFIED LENDER
  - NOT SELLER OR BROKER
  - IF RELATED, COMMERCIALLY REASONABLE

4

More Complexity: Special Rule for Single Member LLCs

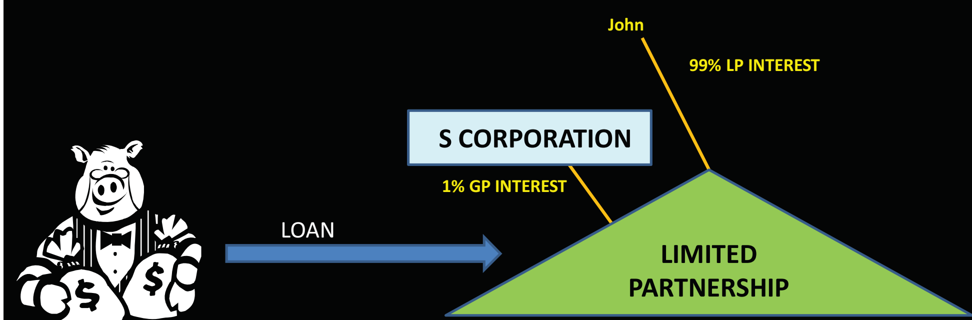
But in determining the extent to which a partner who owns an interest through a disregarded entity bears the economic risk of loss for a partnership recourse liability, payment obligations of the disregarded entity (including a disregarded single member LLC) are taken into account under Sec. 752 only to the extent of the disregarded entity's net value as of the allocation date. (However, this rule does not apply to an obligation of a disregarded entity to the extent that its owner otherwise is required to make a qualifying payment with respect to the entity's obligation e.g., through a guarantee.)

5



RESULT: THIS IS A NONRECOURSE LOAN TO THE EXTENT THE LOAN EXCEEDS THE VALUE OF THE LLC BECAUSE THE GENERAL PARTNER IS A DISREGARDED ENTITY.

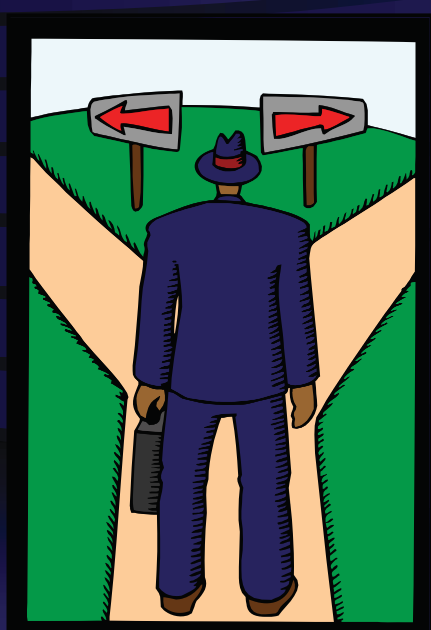
6



RESULT: THIS SHOULD BE A **RECOURSE** DEBT BECAUSE THE GENERAL PARTNER IS A REGARDED ENTITY AND THE GP IS LIABLE

More on this one later—Was once simple and is now very complex

7



THE LLC

- Agreements often require different allocation schemes for recourse v. nonrecourse deductions and may have various types of debt
- MUST identify
- Need to trace

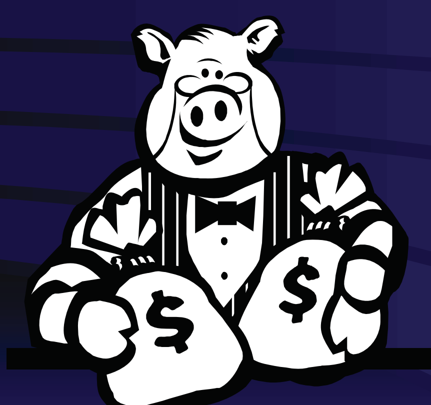
8

Different Types of Nonrecourse Debt

- Security Limited to Specific Property
- Recourse to the Entity but Nonrecourse to the Owners [Exculpatory Liabilities]
  - An LLC or LLP
  - A Limited Partnership where no GP is liable

9

KEY IS ALWAYS THE SAME



<u>IDENTIFY THE COLLATERAL POOL:</u>

<u>WHAT CAN THE CREDITOR REACH?</u>

10

Errors are often made with respect to nonrecourse and recourse deductions where there is exculpatory debt [nonrecourse under 752]

- In acting as a discussion leader for CE courses, I have found that approximately half of participants answer the following question incorrectly:
- On the following fact pattern how is the first-year loss allocated?

11

ASSETS		LIABILITIES AND CAPITAL	
CASH	$4,000,000	NONRECOURSE DEBT (EXCULPATORY LIABILITY TO BANK) (COMPANY LIABLE; NO MEMBER LIABLE; NO GUARANTEES)	$10,000,000
BUILDING	$10,000,000		
LAND	$1,000,000	CAPITAL:	
		A MEMBERS	$5,000,000
		B MEMBERS	-0-
TOTAL ASSETS	$15,000,000	TOTAL L&C	$15,000,000

Members have agreed to generally share profits and losses equally between classes.

First year loss is $250,000 solely attributed to depreciation on the building. Who gets the loss and why?

12

The first-year loss is a <u>RECOURSE DEDUCTION</u> and thus allocable solely to the Class A Members.

- Many participants were misled by the existence of a nonrecourse debt and were confused by the distinction between a nonrecourse debt and a nonrecourse deduction.
- It is common for an LLC to have nonrecourse debt and recourse deductions.
- Note that this is an "exculpatory liability" where the lender's recourse is to all Company assets and not merely to the building.
- Note that the answer in this example does not change if the lender's recourse is limited to real property as there is no minimum gain. Even after the deduction there would be $10,500,000 in basis against a debt of $10,000,000.

13

Partner Nonrecourse Debt Minimum Gain Chargeback

- **(ii) Notwithstanding any other provision of this Section ______ (other than Section __(i) which shall be applied first), if there is a net decrease in Partner Nonrecourse Debt Minimum Gain with respect to a Partner Nonrecourse Debt during any taxable year or other period for which allocations are made, any Partner with a share of such Partner Nonrecourse Debt Minimum Gain (determined under Treasury Regulations Section 1.704-2(i)(5)) as of the beginning of the year will be specially allocated items of Partnership income and gain for that period (and, if necessary, subsequent periods) in an amount equal to such Partner's share of the net decrease in the Partner Nonrecourse Debt Minimum Gain during such year determined in accordance with Treasury Regulations Section 1.704-2(g)(2). The items to be so allocated will be determined in accordance with Treasury Regulations Section 1.704-2(g). This Section ___(ii) is intended to comply with the partner nonrecourse debt minimum gain chargeback requirements of the Treasury Regulations, will be interpreted consistently with the Treasury Regulations and will be subject to all exceptions provided therein.**

14

MEMBER NONRECOURSE DEBT EXAMPLE

- JOHN AND MARY EACH CONTRIBUTE $1,000 AS CAPITAL TO JM, LLC. EACH RECEIVES 1,000 LLC SHARES.
- THE COMPANY AGREEMENT ALLOCATES GAINS AND LOSSES BY THE NUMBER OF SHARES.
- JOHN ALSO LOANS $100,000 TO THE LLC.
- THE FIRST PERIOD LOSS IS $50,000. HOW SHOULD IT BE ALLOCATED?

15

ANSWER

- **$2,000 OF LOSS IS A RECOURSE DEDUCTION AND IS ALLOCATED EVENLY TO JOHN AND MARY PER THE AGREEMENT.**
  - **NOTE: THE ALLOCATION HAS ECONOMIC EFFECT.**
- **THE REMAINING $48,000 IS A PARTNER NONRECOURSE DEDUCTION THAT MUST BE ALLOCATED SOLELY TO JOHN.**

16

PROOF

- Liquidate the LLC.
- The LLC has $52,000 in remaining assets and a $100,000 debt to John.
- Therefore, John is bearing the economic effect of $48,000 of loss.
- Even though allocation regulations say this is partner nonrecourse debt, for your reporting purposes, it's recourse debt on the K-1 to John.

17

De minimis Exception for Certain Partner Nonrecourse Debt

- Under a de minimis rule, a partner is not deemed to bear the economic risk of loss for a nonrecourse partnership loan from that partner (or that partner's affiliate) if the partner's interest in each and every item of income, gain, loss, deduction, or credit is 10% or less over the partnership's life, and if the loan constitutes qualified nonrecourse financing under the at-risk rules.

18

Recourse Liability

- A partnership liability is a "recourse liability" to the extent that one or more partners (or a related party) bears the ***economic risk of loss [EROL]***. IRC § 1.752-1(a)(1).

19

Related Persons Very Generally

- ***Constructive ownership of stock:*** Under Regs. Sec. 1.752-4(b)(1), a person is related to a partner if the person and the partner bear a relationship to each other that is specified in Sec. 267(b) or Sec. 707(b)(1), except for the following: "80 percent or more" is substituted for "more than 50 percent" each place it appears in those sections; a person's family is determined by excluding brothers and sisters; and Secs. 267(e)(1) and 267(f)(1)(A), containing related-person rules for passthrough entities and controlled groups, are disregarded.

20

Related Persons Very Generally

- The constructive-ownership-of-stock rules under Sec. 267(c)(1) provide that stock owned, directly or indirectly, by or for a partnership is considered as being owned proportionately by or for its partners.

When in doubt, go read the Regulations; they are extensive and contain exceptions.

21

Allocating Recourse Debt Basis

Congress instructed the Treasury Department to revise the regulations to address the problems caused by *"guaranties, assumptions, indemnity agreements and similar arrangements."*

Did they do that?

22

General Background: Basis Regulations Allocating Recourse Liabilities

- Economic risk of loss.
- Constructive Liquidation.
- Who ends up paying the liabilities when all the assets are gone?
- A mechanical test that does not always follow reality?
- Subject to an anti-abuse rule.

"Atom Bomb Test"

23

Final Regulations:

Bottom dollar payment obligations do not represent real EROL

Because those payment obligations are structured to insulate the obligor from having to pay their obligations. Moreover, bottom dollar guarantees are not relevant to loan risk underwriting generally. These obligations generally lack a significant non-tax commercial business purpose. Therefore, bottom dollar payment obligations should not be recognized as payment obligations.

24

NOT necessarily bottom-dollar payment obligations:

a maximum amount is placed on the partner's or related person's payment obligation,

a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability, or

there is a right of proportionate contribution running between partners or related persons who are co- obligors with respect to a payment obligation for which each of them is jointly and severally liable.

25

A bottom dollar payment obligation is recognized when a partner or related person is liable for at least 90 percent of the partner's or related person's initial payment obligation despite an indemnity, a reimbursement agreement, or a similar arrangement.

90% RULE

26

What are bottom-dollar payment obligations?

(1) with respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied; AND

27

What are bottom-dollar payment obligations?

(2) with respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation is recognized; AND

28

What are bottom-dollar payment obligations?

(3) an arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation.

29

REGULATIONS Allocating Recourse Debt Basis: T.D. 9877 (10/09/2019)

- **Rules on bottom dollar payment obligations generally apply to liabilities incurred or assumed by a partnership, and payment obligations imposed or undertaken with respect to a partnership liability, on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date.**

30

NEW REGULATIONS
Allocating Recourse
Debt Basis: T.D. 9877
(10/09/2019)

- **All the other final regs apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after 10/9/19, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date.**

31

Transition Relief

- **The final regs provide transition relief for any partner whose allocable share of partnership liabilities under Reg. § 1.752-2 exceed its adjusted basis in its partnership interest on October 5, 2016. Under this transitional relief, the partner can continue to apply the regs as they existed before the 752 temporary regs were issued with respect to a partnership liability for a seven-year period beginning October 5, 2016 to the extent that the partner's allocable share of partnership liabilities exceeds the partner's adjusted basis in its partnership interest on October 5, 2016.**

32

EXAMPLE 10

(10) Example 10. Guarantee of first and last dollars. (i) A, B, and C are equal members of a limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other.

33

EXAMPLE 10

(ii) Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section. Therefore, A's payment obligation is recognized under paragraph (b)(3) of this section. The amount of A's economic risk of loss under §1.752-2(b)(1) is $300.

34

EXAMPLE 10

(iii) Because B is obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is not recognized under paragraph (b)(3)(ii)(A) of this section. Accordingly, B bears no economic risk of loss under §1.752-2(b)(1) for ABC's liability.

(iv) $300 of ABC's liability is allocated to A under §1.752-2(a), and the remaining $700 liability is allocated to A, B, and C under §1.752-3.

35

EXAMPLE 11

11) Example 11. Indemnification of guarantees. (i) The facts are the same as in paragraph (f)(10) of this section (Example 10), except that, in addition, C agrees to indemnify A up to $100 that A pays with respect to its guarantee and agrees to indemnify B fully with respect to its guarantee.

36

EXAMPLE 11

(ii) The determination of whether C's indemnity is recognized under paragraph (b)(3) of this section is made without regard to whether C's indemnity itself causes A's guarantee not to be recognized. Because A's obligation would be recognized but for the effect of C's indemnity and C is obligated to pay A up to the full amount of C's indemnity if A pays any amount on its guarantee of ABC's liability, C's indemnity of A's guarantee is not a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and, therefore, is recognized under paragraph (b)(3) of this section. The amount of C's economic risk of loss under §1.752-2(b)(1) for its indemnity of A's guarantee is $100.

37

EXAMPLE 11

(iii) Because C's indemnity is recognized under paragraph (b)(3) of this section, A is treated as liable for $200 only to the extent any amount beyond $100 of the partnership liability is not satisfied. Thus, A is not liable if, and to the extent, any amount of the partnership liability is not otherwise satisfied, and the exception in paragraph (b)(3)(ii)(B) of this section does not apply. As a result, A's guarantee is a bottom dollar payment obligation under paragraph (b)(3)(ii)(C) of this section and is not recognized under paragraph (b)(3)(ii)(A) of this section. Therefore, A bears no economic risk of loss under §1.752-2(b)(1) for ABC's liability.

38

EXAMPLE 11

(iv) Because B's obligation is not recognized under paragraph (b)(3)(ii) of this section independent of C's indemnity of B's guarantee, C's indemnity is not recognized under paragraph (b)(3)(iii) of this section. Therefore, C bears no economic risk of loss under §1.752-2(b)(1) for its indemnity of B's guarantee.

(v) In sum, $100 of ABC's liability is allocated to C under §1.752-2(a) and the remaining $900 liability is allocated to A, B, and C under §1.752-3.

39

Disclosure Required:

Taxpayers must affirmatively disclose bottom dollar payment obligations by filing Form 8275, Disclosure Statement, or any successor form, with the return of the partnership for the taxable year in which a bottom dollar payment obligation is undertaken or modified. The final regulations clarify that identifying the payment obligation with respect to which disclosure is made includes stating whether the obligation is a guarantee, a reimbursement, an indemnity, or deficit restoration obligation.

40

Items to Disclose:

(1) Identify the statement as a disclosure of a bottom dollar payment obligation under section 752.

(2) Identification of the payment obligation with respect to which disclosure is made (including whether the obligation is a guarantee, a reimbursement, an indemnity, or an obligation to restore a deficit balance in a partner's capital account).

(3) The amount of the payment obligation.

41

Items to Disclose:

(4) The parties to the payment obligation.

(5) A statement of whether the payment obligation is treated as recognized for purposes of Regulation Section 1.752-2 (b)(3).

(6) If the payment obligation is recognized under Regulation Section 1.752-2 (b)(3)(ii)(B), the facts and circumstances that clearly establish that a partner or related person is liable for up to 90 percent of the partner's or related person's initial payment obligation and, but for an indemnity, a reimbursement agreement, or a similar arrangement, the partner's or related person's initial payment obligation would have been recognized under this paragraph (b)(3).

42

Anti-abuse rule in §1.752-2(j)(2) Tantamount to a Guarantee Rule [NOT subject to IRS discretion]

Arrangements tantamount to a guarantee--(i) In general. Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that—

(A) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan;

(B) The contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or a portion thereof; and

43

Anti-abuse rule in §1.752-2(j)(2) Tantamount to a Guarantee Rule [NOT subject to IRS discretion]

(C) With respect to the contractual obligations described in paragraphs (j)(2)(i)(A) and (B) of this section—

(1) one of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests; or

(2) another partner, or a person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation described in paragraphs (j)(2)(i)(A) and (B) of this section to be disregarded under paragraph (b)(3) of this section.

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Anti-abuse rule in §1.752-2(j)(2) Tantamount to a Guarantee Rule [NOT subject to IRS discretion]

(ii) Economic risk of loss. For purposes of this paragraph (j)(2), partners are considered to bear the economic risk of loss for a liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations.

- **For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability.**

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EXAMPLE

- **A partnership is formed by A and B for the purposes of buying and leasing computer equipment. A invested in this partnership, in part, to obtain the tax benefits arising from partnership losses The partnership borrows money on a nonrecourse basis to acquire a computer that is subject to an existing 2-year lease. In order to induce the lender to make the loan, B agrees to lease the computer under a "hell or high water" lease agreement that requires B to maintain the computer and continue making lease payments even if the computer is damaged or destroyed. The rental payments under the master lease are sufficient to fully amortize all amounts due under the loan and the master lease is pledged to the lender.**

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EXAMPLE

- A will have sufficient basis in its partnership interest to take full advantage of its share of partnership losses only if the loan is treated as a nonrecourse liability (which would be shared among the partners according to their partnership profits interests). Under the anti-abuse rule, however, the master lease may be treated as tantamount to a guarantee, with the result that the partnership liability will be treated as a recourse liability allocable only to B, the partner who, because of the master lease, may be treated as having the economic risk of loss for the entire liability.

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Regulations are clear—a guarantee by a limited partner does not create basis if the GP is liable on the debt

- What is the deemed satisfaction rule?
- What are the subrogation rights of a guarantor who pays the debt?

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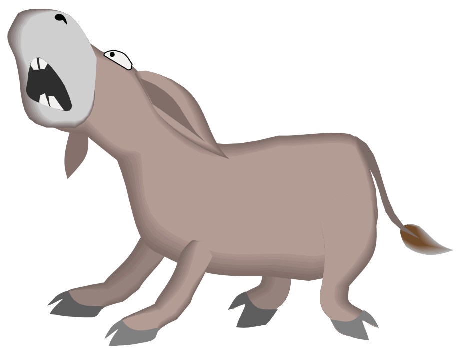
- **Under Regulations, you generally ASS-U-ME payment of obligations without regard to ability to actually pay—subject to an anti-abuse rule.**



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Example 3. Guarantee by limited partner; partner deemed to satisfy obligation.

E and F form a limited partnership. E, the general partner, contributes $2,000 and F, the limited partner, contributes $8,000 in cash to the partnership. The partnership agreement allocates losses 20% to E and 80% to F until F's capital account is reduced to zero, after which all losses are allocated to E. The partnership purchases depreciable property for $25,000 using its $10,000 cash and a $15,000 recourse loan from a bank. F guarantees payment of the $15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. In a constructive liquidation, the $15,000 liability becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition.

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E, as a general partner, would be obligated by operation of law to make a net contribution to the partnership of $15,000. Because E is assumed to satisfy that obligation, it is also assumed that F would not have to satisfy F's guarantee. The $15,000 mortgage is treated as a recourse liability because one or more partners bear the economic risk of loss. E's share of the liability is $15,000, and F's share is zero. ***This would be so even if E's net worth at the time of the determination is less than $15,000, <u>unless the facts and circumstances indicate a plan to circumvent or avoid E's obligation to contribute to the partnership</u>.***

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New Regulations Regarding Anti-Abuse T.D. 9877 (10/09/2019)

An obligation of a partner or related person to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.

So what looks like a recourse debt could become a nonrecourse debt OR vice versa.

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Factors indicating plan to circumvent or avoid an obligation

The presence or absence of a factor is based on all of the facts and circumstances at the time the partner or related person makes the payment obligation or if the obligation is modified, at the time of the modification.

The weight to be given to any particular factor depends on the particular case and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized.

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Seven factors indicating plan to circumvent or avoid an obligation

The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.

The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party.

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Seven factors indicating plan to circumvent or avoid an obligation

(C) The term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases). This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).

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Seven factors indicating plan to circumvent or avoid an obligation

(D) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.

(E) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

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Seven factors indicating plan to circumvent or avoid an obligation

(F) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(G) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

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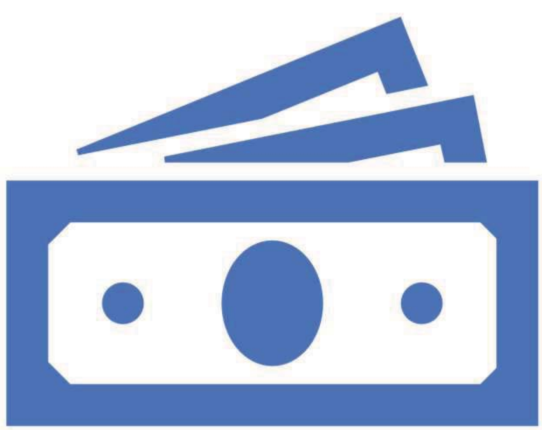

Plan to circumvent or avoid an obligation

- **Whether a debtor will have the ability to make payments when due, not necessarily to whether the debtor has sufficient assets to satisfy an obligation currently. Includes disregarded entities.**

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Example

In 2020, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2020, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under §1.752- 1(a)(2) in 2020. In 2022, A guarantees the entire amount of the liability. **The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.**

A's 2022 guarantee (payment obligation) is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the payment obligation.

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In this case, the following factors indicate a plan to circumvent or avoid A's payment obligation:

- **the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions;**
- **the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party;**
- **in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and**
- **the creditor did not receive executed documents with respect to the payment obligation from the partner or related person at the time the obligation was created.**

Absent the existence of other facts or circumstances that would weigh in favor of respecting A's guarantee, evidence of a plan to circumvent or avoid the obligation exists and, A's guarantee is not recognized. As a result, LLC's liability continues to be treated as nonrecourse.

DID THE TAX PREPARER LOOK INTO THE FACTS BEHIND THE GUARANTEE IN REPORTING?

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Doesn’t this create (or at least continue) confusion?

FOR EXAMPLE:

- **S corp GP with minimal capitalization.**
- **LP guarantees the debt.**
- **Existing regs say that the basis goes to the GP on an unrelated party loan to the limited partnership unless there is a plan to circumvent or avoid.**
- **<u>Anti-abuse seems to be for IRS benefit ONLY!</u>**
- **But can’t the IRS assert the deemed plan to circumvent or avoid language any time it is to the Service’s advantage?**

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So is the IRS able to play heads we win and tails you lose?

62

Deficit Restoration Obligations (DROs)

- 2019 final regulations differentiate DROs under the section 704(b) capital account rules from payment obligations, such as guarantees and indemnities. As a result of their differences, the regulations refine the list of factors in determining whether DROs will be respected for purposes of section 704(b) allocations and allocations of liabilities under section 752.

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NEW FINAL REGULATIONS
Deficit Restoration Obligations

Under §1.704-1(b)(2)(ii)(c)(2) of the existing regulations, a partner's DRO is not respected if the facts and circumstances indicate a plan to circumvent or avoid the partner's DRO.

New final regulations add a list of factors specific to DROs, to indicate when a plan to circumvent or avoid an obligation exists.

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Factors indicating a plan to circumvent or avoid:to circumvent or avoid a DRO:

- **The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation;**
- **The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership;** ***{Must you now ask for this?}***
- **The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in §1.704-1(b)(2)(iv) is negative; and**
- **The terms of the obligation are not provided to all the partners in the partnership in a timely manner.** ***{Presumably, a copy of the partnership/company agreement will suffice.}***

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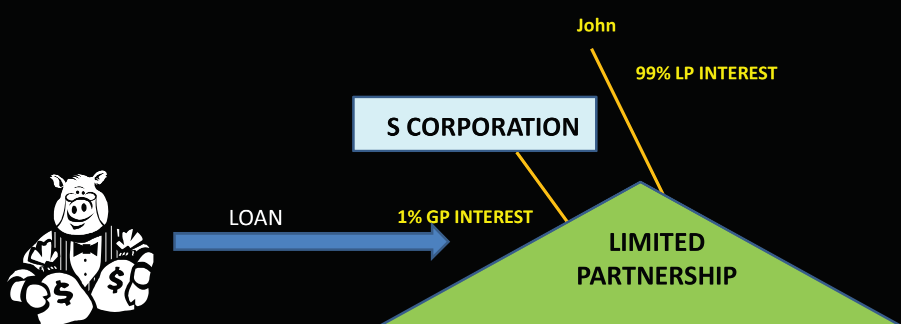
So, can the IRS now say this is a plan to circumvent or avoid?



Recall that the GP was getting the basis because of its deficit restoration obligation in the agreement or under state law.

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Some thoughts from BDO:

- **The allocation of liabilities by many partnerships may be altered to the extent that they run afoul of new anti-abuse provisions.**
- **Partners whose share of partnership liabilities are reduced may recognize gain on deemed distributions as a result.**
- **Taxpayers relying on allocations of recourse partnership liabilities to claim losses and support negative tax basis capital balances should consider whether changes to guarantees and similar arrangements are necessary to avoid gain recognition.**

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Some thoughts from BDO:

- **In addition, partners relying on deficit restoration obligations to support negative capital accounts may be allocated income to reduce or eliminate the negative balances if their restoration obligations are no longer respected.**
- **In particular, partners who have implemented limited or terminable DRO's should consider whether changes to their DRO obligations are necessary to avoid chargebacks of income.**

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Remember:

The Last Thing in Pandora's Box Was

HOPE

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Dealing With Erroneous Refunds – Errors Happen

By Bryan Camp

Erroneous Refunds

Presentation for 2023 Tax Alliance Conference

by
Bryan Camp
Professor of Law
Texas Tech University
School of Law

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Objectives

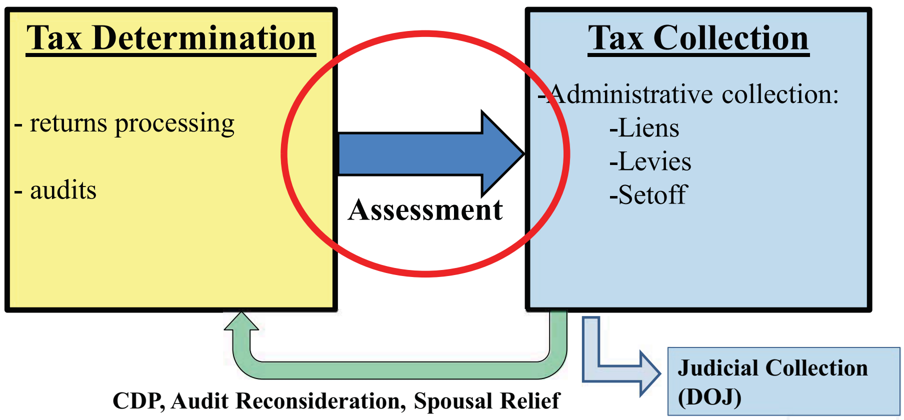
► Learning Terms:
  - **Assessments,**
  - **Abatements,**
  - **Overpayments,**
  - **Refunds**

► Rebate v. Non-Rebate Refunds

► Dealing with Erroneous Refunds

2

The Two Functional Boxes



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Assessments

1. Assessments v. Liabilities

Liabilities arise at end of tax period.

Assessments just record liabilities. §6203.

2. Illustrations

- *Ewing*, 914 F2d 499 (4^{th} Cir. 1991)
- *Espinosa*, 24 Fed.Appx. 825 (9^{th} Cir. 2001)

3. Functions of Assessments

- *Reflect* liability determination.
- Predicate for *administrative* collection.
  - -Sets amt to be collected by NFTLs/Levies.

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Assessments

4. The Legal Act of Assessment

☛appropriate signature on summary record of assessments. Treas. Reg. 310.6203-1.

☛Electronic summary ok. RACS Report 006. Rev. Rul. 2007-21 (collecting cases)

☛supporting documents; not in the summary.

5. Transactions Codes Are **NOT** Assessments

Just as assessments are not liabilities, TCs are not assessments! They *reflect* the act of assessment. E.g. TC 150 (returns); 300 (exam)

5

Abatements

1. IRS Abates Assessments not Liabilities. §6404

"(a) General rule. The Secretary is authorized ***to abate*** *the unpaid portion of* ***the assessment*** *of any tax or any liability in respect thereof, which—*

(1) is excessive in amount, ...

***

(c) Small tax balances. The Secretary is authorized ***to abate*** *the unpaid portion of* ***the assessment*** *of any tax...if...the administration and collection costs involved would not warrant collection of the amount due."*

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Abatements

2. Transaction Codes **ARE** Abatements

☛ Abatements are made by using an offsetting TC to the TC reflecting an assessment. *see* IRM 5.1.15. ADP Handbook (IRS Document 6209)

E.g. TC 291 can offset a prior TC 150; TC 301 can offset a prior TC 300.

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Abatements

3. Effect of Abatement TCs on *Liabilities*

None! Abatements *never* eliminate *liabilities*. E.g. *U.S. v. Buckner*, 264 B.R. 908 (2001).

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Abatements

4. Effect of Abatement TCs on Assessments

☛**Substantive** abatement under 6404(a) nukes assessment. *Crompton-Richmond Co. v. U.S.*, 311 F. Supp. 1184 (SDNY 1970).

☛**Non-substantive** abatement does **NOT** undo *act* of assessment. *In re Becker*, 407 F.3d 89 (2005) (erroneous abatements creating zero balance due didn't eliminate prior timely assessments and could be reversed after ASED). *In Re Buggee*, 99 F.3rd 740 (5th Cir. 1996)(same).

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Overpayments

1. The Common Law Meaning.
Excess of *payments* over *liabilities*. *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947).

2. The Statutory Meaning. §6401
Any payment received after CSED or for unassessed liability received after ASED. *E.g. Cohen v. U.S.*, 23 Cl. Ct. 717 (1991)(Payment made in response to untimely assessment was statutory overpayment).

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Overpayments

3. Overpayments Are Not Refunds!

IRS has discretion. §6402(a). *Pettibone Corp. v. U.S.*, 34 F.3d 536, 538 (7th Cir.1994)(*"Until the Commissioner exercises this discretion, the taxpayer has no right to payment."*)

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Refunds!

1. Rebate Refunds

Refund based on **substantive** determination or re-determination of liability. §6211(b)(2). E.g. one based on taxpayer claim on Form 1040 or 1040X. Or one based on a §6404(a) abatement.

2. Non-Rebate Refunds

A refund based on non-substantive reason, such as clerical error. *O'Bryant v. U.S.*, 49 F.3d 340 (7th Cir.1995)(IRS erroneously double-posted a claimed tax credit).

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Dealing W/ Rebate Refunds

1. Administrative Collection

IRS can use administrative collection tools if it re-assesses liability within applicable ASED. Re-assessment gives TP full Tax Court rights. *In Re Becker, supra*.

2. Judicial Collection

IRS (via DOJ) can file suit in federal district court under §7405. SOL is 2 years or 5 years. §6532(b).

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Dealing W/ Non-Rebate Refunds

1. Administrative Collection

Depends! Extinguishment theory: once paid, a tax is gone and an erroneous refund does not revive it. *Bilzarian v. U.S.*, 86 F.3d 1067 (11th Cir. 1996). IRS reduced to beg letters. But error unrelated to actual payment does not extinguish liability; IRS can still collect administratively.

2. Judicial Collection

IRS (via DOJ) can file suit in federal district court under §7405. SOL is 2 years or 5 years. §6532(b).

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How To Tell?

IRS categorizes erroneous refunds and permissible recovery options in IRM 21.4.5.5 ("Erroneous Refund Categories and Procedures").
Category A-C are rebate refunds
Category D are non-rebate refunds

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Examples

<u>1. Alex:</u> Reports liability of $4k on return, reports payments of $5k, requests refund of overpayment.

This is rebate refund. If later audit shows it to be erroneous---for example, the IRS erroneously allowed a duplicative Child Tax Credit for Alex and Alex's ex-spouse---IRS can follow deficiency procedures to assess correct amount and collect administratively. Standard stuff.

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Examples

2. Jody: Reports liability of $4k. Reports $3k in withholding, includes a check for $1k. Check gets recorded twice, resulting in $1k refund.

This is non-rebate refund. Reversal of TCs cannot correct error. Liability was fully paid, so cannot administratively revive it. TP owes IRS $1k for money had and received, not $1k in taxes. IRS can collect this $1k only by beg letter or suit. ...ain't gonna be no suit for $1k.

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Examples

3. Pat: Reports liability of $4k on return. Reports $3k in withholding but includes *no* payment for remaining $1k. One year later a different TP's $5k payment is posted to Pat's account generating a $4k refund.

This is a non-rebate refund. BUT now extinguishment theory not apply because Pat did not fully pay the liability. Not clear how IRS will deal with it. See IRM 21.4.5.5.

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Dealing w/ Erroneous Refunds

1. If refund came by check, don't cash it!
  - avoids it being income
  - avoids IRS adding interest
  - avoids possible criminal prosecution under 18 U.S. Code § 641

2. Return, if possible, in 3 weeks.
  - IRS website gives instructions...but
  - maybe better to call PPS?

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taxanalysts camp's compendium

The Mysteries of Erroneous Refunds

By Bryan T. Camp

Bryan T. Camp is a professor of law at Texas Tech University School of Law.

This column generally explores the laws and policies of tax administration to help guide readers through the thickets of particular procedural problems, while also giving them a sense of the larger tax administration forest.

Prof. Camp thanks Danshera Cords, Kristin Hickman, Phillip N. Jones, Leandra Lederman, and the usual anonymous suspects for their brave attempts to keep him from looking stupid. He takes full responsibility for any resulting failures.

Prof. Camp dedicates this column to his former boss, Lawrence H. Schattner, one of the finest attorneys in the IRS Office of Chief Counsel, and a reviewer who consistently added value to all drafts presented to him. (Note: Per 5 U.S.C. 2635.204(a), this dedication's fair market value is less — much less — than $20.)

I love my yearly tax refund. I know I'm not supposed to, but I do. Theorists argue that my refund represents an interest-free loan to the government and I am supposed to resent that for reasons grounded in the obsessive individualism of our culture. But even accepting the argument's premise, the value to me of that yearly manifestation of my forced savings outweighs the value of the interest I would theoretically earn in my checking account. I don't worry; I be happy.

I am not alone. In fiscal 2005 the IRS made lots of folks happy, refunding about $227.6 billion to individual taxpayers.[1] By almost any measure, the IRS does a great job of getting the right refund to the right taxpayer in a timely fashion. But errors happen. Worse, given the huge amounts involved, even small error rates add up. For example, even if the IRS had an error rate of just 1 percent, that would mean it issued more than $2.2 billion in erroneous refunds in 2005. That represents a lot of bridges to nowhere.

No one knows the actual error rate. That's part of the critique in a recent report from the Treasury Inspector General for Tax Administration: The IRS could do better in tracking and preventing erroneous refunds.[2] While TIGTA's suggestions might decrease the slippage in the gears of IRS campus operations, the report gives scant attention to how the IRS can recover erroneous refunds once they are issued. After all, once we accept that erroneous refunds inevitably happen, it makes sense to consider how to recover them. But TIGTA's sole recommendation on how to improve collection of erroneous refunds, which I discuss below, is simply laughable in light of how courts have interpreted the relevant statutes in the past 10 years.

Usually, the amount of erroneous refunds escapes attention. Recently, however, *USA Today* reported in horror that the IRS let slip some $200 million erroneous refunds from the failure of one computer program during 2005.[3] Worse, IRS Commissioner Mark Everson acknowledged that there is ''little chance IRS will collect the bulk of the erroneously issued checks.''[4] While the amount issued in error represents less than 0.1 percent of all refunds, it was enough for then-Senate Finance Committee Chair Chuck Grassley, R-Iowa, to grumble that ''it is not just that they're getting off scot-free — it's that the honest taxpayers become the suckers.''

Honest taxpayers are suckers because current law renders the IRS impotent to collect erroneous refunds. As a result, tens of thousands of taxpayers receive the government's unintended largesse and wallow in their windfalls. That is bad tax administration that no amount of TIGTA oversight can fix. It did not used to be that way. The IRS used to be able to collect most of the erroneous

[1]2005 Data Book, Table 1.

[2]TIGTA Report 2006-40-137, ''Improvements Are Needed to Better Identify and Prevent Erroneous Refunds.'' TIGTA notes that while the IRS campuses are supposed to create quarterly reports about erroneous refunds, the reports are not consistently produced by all campuses nor retained nor reviewed at a national level. ''No effort has been made to use these reports to track the increase or decrease in the numbers and types of errors being made that cause erroneous refunds.'' *Id.* at 5. Note that for the 2007 filing season, the IRS plans to offer split refunds for the first time, allowing taxpayers to split their refund among up to three direct deposit accounts. *See* Dustin Stamper, ''Taxpayer Assistance Blueprint Will Be 'Mind-Shaking,' DuMars Says,'' *Tax Notes*, Nov. 13, 2006, p. 612, *Doc 2006-22837, 2006 TNT 217-4*. That added complexity potentially increases the error rate.

[3]*See* ''How the IRS Failed to Stop $200M in Bogus Refunds,'' *USA Today*, Dec. 4, 2006, *available at* http://www.usatoday.com/money/perfi/taxes/2006-12-04-irs-bogus-refunds_x.htm (last visited Dec. 6, 2006).

[4]*Id.*

refunds efficiently. Now it must all too often write them off. This article tells the sad story of how the IRS lost its mojo and what must be done to get it back.

At one level, erroneous refunds are low-hanging fruits. In light of all the huffing and puffing about the tax gap — that mythical beast smokily mirrored more by assumptions than hard data — it is amazing that no one has suggested an admittedly modest, yet simple and solid, reform that would enable a quick and easy recovery of the occasional unavoidable erroneous refund. At another level, as the following details will demonstrate, this is an intricate and arcane area, a part of the tax administration forest that few visit without mishap.

> ***Honest taxpayers are suckers because current law renders the IRS impotent to collect erroneous refunds. Thousands of taxpayers receive the government's unintended largesse and wallow in their windfalls.***

Part I explains how erroneous refunds occur and how they relate to the law of tax administration. Part II reviews the legal doctrines governing their recovery and demonstrates how, as result of a contentious legal battle in the 1990s, current law leaves the IRS basically shooting blanks in trying to recover taxpayer windfalls. The TIGTA report focuses on *ex ante* solutions precisely because the IRS ability to collect them efficiently *ex post* is so compromised. Part III explains why the TIGTA collection recommendation makes little sense and, as is my habit, offers a simple legislative provision to help the IRS get its groove back. What is needed is a little statutory power pill to allow the IRS to interact firmly with taxpayers who try to keep money they should not have.

I. What Are Erroneous Refunds, Anyway?

Erroneous refunds come in two flavors: rebate and nonrebate. How they arise involves the interplay of several tax administration powers: the powers to assess, abate, and refund overpayments. I'll discuss each in turn and explain the difference between rebate and nonrebate erroneous refunds. That difference has important consequences for the recovery of the erroneous refund.

A. Assessments

Section 6201 gives the IRS the power to assess all taxes owed. Section 6203 says that an assessment is made by ''recording the liability of the taxpayer'' on the IRS books of account. Three points about assessments are important for understanding rebate and nonrebate erroneous refunds: the distinction between the dual functions of an assessment; the distinction between an administrative bookkeeping act and a legal assessment; and the distinction between the summary and the deficiency assessment procedures.

1. Liability versus collection. Tax administration boils down to two main functions: determination of liability and collection. Assessment plays a role in both. It has a dual function, pointing backwards to the determination function and forwards to the collection function. As to the first, assessment is more than just a simple bookkeeping entry. It is the result of an administrative process that represents the IRS's institutional judgment of what taxes are owed.[5] That the IRS usually accepts the liability shown on the taxpayer's return as the basis for the assessment does not in any way diminish the fact that it is the IRS's decision. That is why, as I have repeatedly emphasized, it is erroneous to say that taxpayers ''self-assess.'' It is also why one must always be alert to distinguish between *assessment* of the tax and *liability* for the tax.[6]

Assessment also plays an important role in the second function of tax administration: It is the culmination of the administrative liability determination process, and it also triggers the start of the collection process. That collection-propelling function is seen in two ways: A proper assessment enables the IRS to invoke its administrative collection powers of lien and levy, and a proper assessment triggers the separate 10-year period of limitations in which the IRS can collect the tax liability.[7]

2. Legal versus administrative. Legally, the act of assessment culminates in the ''recording'' authorized by section 6203. Reg. section 301.6203-1 expands on the statute by providing that ''the assessment shall be made by an assessment officer signing the summary record of assessment. The summary record, through supporting records, shall provide identification of the taxpayer, the character of the liability assessed, the taxable period, if applicable, and the amount of the assessment.'' Since the early 1960s, the IRS has kept its books electronically in a master file database.[8]

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[5]*Rambo v. United States*, 492 F.2d 1060, 1061 n.1 (6th Cir. 1974) (''Assessment is an administrative determination that a certain amount is currently due and owing as a tax. It makes the taxpayer a debtor in much the same way as would a judgment''); *Cohen v. Mayer*, 199 F. Supp. 331, 332 (D. N.J. 1961), *affirmed sub nom., Cohen v. Gross*, 316 F.2d 521 (3d Cir. 1963) (''assessment is a prescribed procedure for officially recording the fact and the amount of a taxpayer's administratively determined tax liability, with consequences somewhat similar to the reduction of a claim of judgment''); *Simon v. United States*, 261 F. Supp.2d 567, 573, *Doc 2003-20449, 2003 TNT 181-21* (M.D. La. 2003) (assessment ''is the culmination of a process whereby liability is determined''); *Pipola v. Chicco*, 169 F. Supp. 229, 231 (S.D.N.Y. 1959) (''The assessment is an administrative determination that one is indebted to the Government for taxes — in effect, it is a judgment for taxes found due'').

[6]Taxpayers are *liable* for taxes independent of the assessment. *See Ewing v. United States*, 914 F.2d 499, 502-503 (4th Cir. 1990), *cert. denied*, 111 S. Ct. 1683 (1991) (rejecting taxpayer's argument that, before assessment, there can be no tax liability and therefore no ''payment'' of taxes). That is why section 6501(a) allows the IRS to either assess *or* bring proceedings in court without assessment within three years after the return is filed. Think ''form'' for assessments and ''substance'' for liabilities.

[7]*Hibbs v. Winn*, 542 U.S. 88, 102, *Doc 2004-12400, 2004 TNT 115-11* (2004).

[8]Discussion of the woeful deficiencies of the master file database is beyond the scope of this article. I was once a small part of a large task force to develop a replacement, called the customer account data engine (CADE). CADE is a relational database that can be accessed and updated in real time and will

(Footnote continued on next page.)

A legal assessment is thus made on a ''summary record of assessment'' signed by an authorized IRS employee. Typically, all liabilities to be assessed over a given time period (usually one or two weeks) are aggregated onto a Form 23-C, ''Summary of Assessments,'' which is printed and signed once a week.[9] Each Form 23-C completes a cycle that begins with the receipt of the return or other supporting list or record identifying a particular tax liability and the creation of an account in the computerized IRS master file system. Each account, called a tax module, tracks a specific tax liability for a specific taxpayer for a specific tax period.[10] As its name suggests, a Form 23-C represents the sum of *all* assessments made during the cycle; it does not reflect any particular taxpayer account. That really frustrates taxpayers who request ''the'' record of assessment only to receive a simple one-page form that has a very large number on it and says nothing about *their* liabilities.

The supporting records required by the regulations come from computer entries in the tax module. When requested, the IRS will transpose the relevant data in the tax module onto a Form 4340, ''Certificate of Assessments and Payments.'' That is what links a given tax module to a given summary record. A Form 4340 creates a rebuttable presumption of a proper assessment, but really it is just a translation of the computer account and, as such, may be flawed.[11]

hopefully eliminate many of the problems with the creaky master file system. *See* Dustin Stamper, ''Support Growing for IRS E-Filing Portal, Everson Says,'' *Tax Notes*, Nov. 6, 2006, p. 608, *Doc 2006-22589*, or *2006 TNT 214-1* (''The IRS is tentatively planning to process 30 million returns in CADE in 2007''). My particular task force worked on developing definitions for various data elements in the database. CADE has great potential to significantly improve tax administration.

[9]The newer RACS Report-006 also serves as the summary record of assessment and, as I understand it, is signed electronically.

[10]There are two master file systems, one for individual taxpayers and one for business taxpayers. The IRS also keeps a separate system of non-master-file accounts whenever it needs to account for situations not covered by the software written for the master file. Changes to the master file software can take years to implement, and the barrage of tax code changes made by Congress means that the master file system is almost always out of date in some respect. The term ''tax module'' is imprecise, and while it is most commonly used the way I describe it in the text, it has other meanings as well. *See* my discussion in ''Failure of Collection Due Process, Pt. 1: The Collection Context,'' *Tax Notes*, Aug. 30, 2004, p. 969, n.12, *Doc 2004-16770*, *2004 TNT 169-32*.

[11]For an example of an erroneous Form 4340, see *Freije v. Commissioner*, 125 T.C. 14, *Doc 2005-15064, 2005 TNT 135-11* (2005) at note 5. The presumption of correctness is, however, very strong. The ''*Pursifull* saga'' contains a most illuminating discussion. *Compare Pursifull v. United States*, 92-2 U.S.T.C. para. 50,346 (S.D. Ohio 1992) (IRS motion for summary judgment denied and taxpayer entitled to further discovery on showing genuine dispute of the validity of the Form 4340 presented), *with Pursifull v. United States*, 1993 U.S. Dist. LEXIS 11738 (S.D. Ohio 1993) (taxpayer convinces magistrate judge to reject IRS renewed summary judgment motion after discovery), *and with Pursifull v. United States*, 849 F. Supp. 597, *Doc 93-9370, 93 TNT*

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Administratively, the IRS uses a three-digit computer transaction code (TC) to record each event in a tax module on the master file.[12] Importantly, no transaction recorded in the IRS computers is ever erased. Instead, the IRS enters an offsetting TC. A TC itself is not the assessment. For example, tax modules are generally opened with a debit TC 150, most often resulting from the liability reported on a taxpayer's return. The amount associated with the TC 150 is what gets rolled up into the weekly Form 23-C, but it's not until the Form 23-C is signed that the legal ''assessment'' has occurred. The act of inputting the computer code is not the legal act of assessment. Similarly, if a payment is erroneously credited to the wrong account, the erroneous credit TC cannot be erased. Instead, an offsetting TC is entered to reverse the mistake by inserting a debit amount equal to the erroneous credit. The offsetting TC is not an assessment and the question whether the amount reflected in the offsetting TC has to be rolled up into any summary document is a legal question, one that goes to the heart of erroneous refunds.[13]

The mere entry of computer transaction codes cannot erase an assessment in the sense that the administrative process by which the assessment was recorded is somehow undone.

In sum, the legal assessment document, the weekly Form 23-C, does not reflect all the TCs in any individual tax module. Moreover, the amount reflected in the Form 23-C does not necessarily include all TCs that adjust accounts. The administrative accounting for the taxpayer's balance due for any particular tax module is not conterminous with the legal concept of assessment. The court in *Simon v. United States* got it right when it said:

> Thus the positivistic equation of assessment with entry of a debt on the books is misguided. A debt

184-12 (S.D. Ohio 1993) (district judge reverses magistrate's recommendation and grants IRS summary judgment on strength of Form 4340).

[12]Transaction codes and their explanations are collected into a yearly bound publication, IRS Document 6209, *ADP Handbook*. The one I work from in this article is from 2003 and can be found at http://www.irs.gov/pub/irs-utl/document_6209-2003.pdf. Transaction codes are complex and difficult to decipher, even for most IRS employees. Each primary three-digit code can have secondary and tertiary codes associated with it. The *ADP Handbook* covers many other database coding systems as well and is useful for understanding transcripts.

[13]For example, TC 610 records a credit from a payment submitted along with the return and TC 612 records a debit equal to the amount of an erroneous TC 610 credit. The amount recorded by TC 612 is not reflected in a summary record of assessments.

> entry is only the culmination of an assessment, which begins when the IRS determines that a taxpayer is liable.[14]

One important consequence of the distinction between the legal act of assessment and the administrative act of bookkeeping is that the latter can never undo the former. That is, the mere entry of computer transaction codes cannot erase an assessment in the sense that the administrative process by which the assessment was recorded is somehow undone. For example, in *United States v. Reid* the court held that the insertion of credits on a taxpayer's account to reduce the balance due to zero did not ''eliminate'' the assessments: ''Crediting the taxpayer's account — no matter what the amount of the credit — does not undo this act of recording described in section 6203.''[15]

3. Summary versus deficiency procedures. The IRS uses a variety of procedures to assess tax liabilities. The two most relevant to the subject of erroneous refunds are the summary procedure and the deficiency procedure.

The summary procedure is the general rule, authorized by section 6201. All other assessment procedures are either statutory or administrative exceptions to the summary assessment process. It is called the summary procedure because the IRS simply and summarily records the taxpayer's liability, payments, and credits, based on the information before it, and then notifies the taxpayer if there is a balance due. The most typical example is when the IRS makes an assessment based on the taxpayer's return, such as the Form 1040 for income taxes or the Form 941 for employment taxes. The form might also be generated by an IRS employee. Before 1924 the IRS also used the summary process to record the results of income tax audits. It still uses that procedure to record the results of excise tax audits.

The key to section 6211 is the phrase 'tax imposed.'

The main statutory exception to summary assessment applies to the assessment of income, estate, and gift tax deficiencies. Whenever the IRS seeks to assess a deficiency, it must follow the special procedures set out in section 6213. Those require the IRS to send the taxpayer a notice of deficiency to the taxpayer's last known address. The notice of deficiency opens a window of opportunity for the taxpayer to petition for Tax Court review. While that window is open, the IRS cannot assess, absent a determination of jeopardy. The window stays open for at least 90 days, and if the taxpayer timely petitions the Tax Court, it stays open until the Tax Court issues its decision and the decision has become final. Only when that window closes can the IRS assess the tax liability and start to collect any balance due.

Understanding when the IRS must use the special deficiency procedures turns on what constitutes a deficiency. Section 6211 defines a deficiency. Good luck understanding it! It has to be one of the most difficult and densest statutes in the tax code. For this column, however, the important point of section 6211 is how it reinforces the distinction between a tax liability and an assessment. Section 6211 is all about finding the true and correct tax liability.

The key to section 6211 is the phrase ''tax imposed.'' That phrase means the true tax liability — the one that arose at the end of the applicable tax period — and is distinct from what is reflected on the IRS books. To see if what the IRS seeks to assess is a deficiency, the statute instructs one to first find what has been previously recorded in the IRS books. That is, section 6211(a)(1) says to first add the tax reported by the taxpayer to any tax previously assessed for that tax period. Call that the recorded tax. From that amount, one subtracts any rebates as defined in subsection (b)(2). A rebate results from the IRS's substantive redetermination of tax, a discovery that the true tax was less than what was previously recorded on the books. Let's call what remains on the IRS books after a rebate the recorded tax as substantively adjusted.[16] If what the IRS claims to be the tax imposed is greater than the recorded tax as substantively adjusted, the IRS seeks to assess a deficiency and must follow the special procedures.[17]

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[14]261 F. Supp.2d 567, 573, *Doc 2003-20449, 2003 TNT 181-21* (M.D. La. 2003).

[15]2000-1 U.S. Tax Cases (CCH) para. 50,340 (S.D. Ga. 2000). I will return to this point again when discussing how and why the IRS should be allowed to recover administratively erroneous refunds that result from bookkeeping errors.

[16]A rebate is any adjustment on the IRS books ''as was made on the ground that tax imposed . . . was less than the excess of the amount specified in subsection (a)(1) [that is, the recorded tax] over the rebates previously made.'' The iterative and self-referential nature of the definition makes it difficult to understand. The easiest way to approach it is to read the definition as if there were no prior rebates. Then one quickly sees that a rebate refers to some substantive redetermination of the proper tax owed. The ''rebate'' language was added in 1944 to deal with the new ''pay as you go'' system of tax collection. *See* S. Rep. No. 78-885, 78th Cong. 2d Sess., 1944 C.B. 858.

[17]For another good explanation, see Judge Niemeyer's excellent dissent in *Singleton v. United States*, 128 F.3d 833, *Doc 97-28978, 97 TNT 203-11* (4th Cir. 1997), gently pointing out the majority's complete failure to understand the concept. It is the iterative nature of the statute that makes it difficult to read. One sees that not only in the definition of rebate but also in the definition of deficiency, which is defined with reference to prior deficiencies. The self-referential structure of the statute makes it read like a chicken-and-egg puzzle. I think section 6211 could be successfully simplified by making more explicit the distinction between what the IRS now has determined to be the true and correct tax and what is recorded as reflecting the true tax. But taxwriters are loath to change administrative provisions. In 1952, as a young man of 25, Sheldon Cohen read through the entire IRC as part of a team making comprehensive revisions to the regulations. He noted in an e-mail to the author that, even today, most of the administrative provisions have not changed. He's right. In fact, a significant amount of language dating to the various revenue acts of the 1860s is still in the code — like statutory DNA — chopped up and recombined through the various codifications, but still there. For one example of that, see Bryan T. Camp, ''Tax Administration as Inquisitorial Process

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B. Abatements

Section 6404 gives the IRS the power to abate assessments. Just as assessments do not create tax liabilities, abatements do not extinguish tax liabilities. Abatements simply adjust the record on the IRS books. An abatement may or may not have anything to do with the taxpayer's tax liability. Moreover, just as not every upward adjustment to a tax module is an assessment, neither is every downward adjustment an abatement. I'll now expand on both points.

First, some abatements result from (and reflect) a substantive redetermination of tax and some do not. When the IRS discovers that the true tax liability (the tax imposed) is *less* than what is reflected in the assessment on the IRS books (the recorded tax as substantively adjusted), or when the assessment was made illegally, section 6404(a) authorizes abatement to properly reflect the liability or eliminate the illegal assessment. A common cause of a section 6404(a) abatement is an audit reconsideration after a section 6020(b) substitute for return.[18]

> ***Just as assessments do not create tax liabilities, abatements do not extinguish tax liabilities. Abatements simply adjust the record on the IRS books.***

If a section 6404(a) abatement later proves to have been erroneous on the merits, the IRS must follow the applicable assessment procedure to reassess the proper liability.[19] For income, gift, and estate taxes, that means the IRS must follow the deficiency procedures to reassess the tax and will be bound by the section 6501 limitations period.[20] That's a sensible result because in that situation, there is a potential disagreement over the true tax liability; requiring the IRS to follow the deficiency procedure here gives taxpayers not just prepayment but *preassessment* access to judicial review.

Other abatements do not result from (or reflect) a substantive redetermination of tax. For example, when the IRS decides that the assessed amount is not worth collecting because the costs of collection outweigh the amount to be recovered, section 6404(c) authorizes an abatement of the assessment. In contrast to section 6404(a) abatements, if the IRS later decides that an abatement made per section 6404(c) was erroneous (perhaps having found taxpayer assets that can be collected), it may reinstate the prior assessment without going through the deficiency procedures because no deficiency is at issue.[21] That is, there is no concern that the assessment may not properly reflect the true tax any more than when it was first made. So the taxpayer has no need for any preassessment judicial review.

A good example of the distinction between section 6404(a) and section 6404(c) abatements is *United States v. Buckner*, 264 B.R. 908, *Doc 2001-10251, 2001 TNT 69-13* (N.D. Ind. 2001). There, the IRS levied on the taxpayer's retirement plan. The taxpayer then filed bankruptcy and was personally discharged from liability for three years of income taxes. But the retirement account, not being part of the bankruptcy estate, remained liable *in rem*.[22] After receiving the discharge order, the IRS abated the assessments for those years but did not remove the levy from the retirement accounts. The taxpayer asked the bankruptcy court to order the IRS to release the levy, arguing that the abatement extinguished the assessment and the IRS could not revive it without creating a new assessment for the discharged years, which the bankruptcy discharge injunction forbade. The court refused to issue the order and instead held that the IRS could accept the levy proceeds and reverse the abatement without having to make a new assessment because the abatement did not result from a substantive redetermination of the taxpayer's liability. "Stated simply, a § 6404(c) abatement reflects a determination by the I.R.S. of a taxpayer's

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and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998," 56 *Fla. L. Rev.* 1, 36-77 (2004) (reviewing history of the summons powers). The historical reluctance to revise the administrative provisions means that the administrative provisions of the code no longer reflect a unified vision of tax administration. They are a jumble and in serious need of an overhaul.

[18]Similarly, section 6404(d) authorizes abatement when the IRS determines that interest assessed on a tax liability resulted from an unreasonable error or delay on the part of an IRS employee. That is again a redetermination of the liability decision represented by the assessment.

[19]*Carlin v. United States*, 100 F. Supp. 454, 455 (Ct. Cl. 1951) (referring to a time when the abatement power in section 6404(a) was lodged with the commissioner only and the abatement power in section 6404(c) was lodged with the collectors only, the court noted, "If the Commissioner abates the assessment, it ceases to exist or to have any effect thereafter. The Commissioner cannot subsequently rescind his actions or restore the assessment, but must rather make a new assessment unless, of course, the statute of limitations has previously expired") (citations omitted).

[20]*Id*. The running of the assessment limitations period, however, does not require the IRS to return money it has properly collected within the limitation period if the true and correct tax is more than the amount collected, even if the assessment is incorrect. *See Lewis v. Reynolds*, 284 U.S. 281 (1932) (expiration of assessment limitations period without assessment being recorded does not bar the IRS from retaining payments already received if they do not exceed the amount that could have been — but was not — properly assessed within the limitations period).

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[21]*See, e.g., Crompton-Richmond v. United States*, 311 F. Supp. 1184, 1186 (S.D. N.Y. 1970) ("An assessment abated under (a)(1) is thereby canceled and cannot be resurrected if the IRS later decides that its decision was incorrect. On the other hand, the IRS can revive an assessment abated under (c), because the abatement of an uncollectible tax . . . in effect . . . excuses its collector's obligation (in this case the Brooklyn District Director) to account for the tax liability, but does not excuse the taxpayer's liability").

[22]*See Johnson v. Home State Bank*, 501 U.S. 78, 84 (1991) ("A bankruptcy discharge distinguishes only one mode of enforcing a claim — namely, an action against the debtor in personam"); *see also In re Conston,* 181 B.R. 769, 773 (D. Del. 1995) (collecting cases).

collectability, and since the I.R.S. may account for collectable assets by simply entering a debit to reverse a prior credit, no formal reassessment procedure must be followed.''[23]

As to the second point, not every downward adjustment to a tax module is an abatement within the meaning of section 6404. For example, because erroneous increases cannot be erased, they must be offset by downward adjustments. It is not always clear, however, which administrative actions constitute a legal abatement and which do not. Unlike the careful description in the code of what constitutes an assessment, neither section 6404 nor its regulations provide guidance as to what it takes to effect a legal abatement. In practice, IRS employees may use different forms to make section 6404(a) abatements.[24] Further, one of the forms used to make a section 6404(a) abatement is also used to make a section 6404(c) abatement for taxes discharged in bankruptcy.[25]

It's not always clear which administrative actions constitute a legal abatement and which do not.

In deciding which accounting adjustments represent legal abatements (and, if so, what kind of an abatement), courts have traditionally looked at the substance of the transaction over the IRS form used to initiate it or the label of the transaction code used to enter it. The most important substantive issue is whether the administrative action represents, as does a proper assessment, the culmination of a proper administrative process, or whether it is just the result of a glitch in the system, a miscommunication, or a processing error. If the latter is the case, courts hold that no abatement has occurred and the IRS will not be bound by the administrative action of its employees, unless equity demands.[26] And, as anyone experienced in government litigation can tell you, getting equity against the government is a very demanding task.[27]

An excellent example of the focus on substance over form is *In re Bugge*.[28] There, in the course of preparing a taxpayer's account for collection, a revenue officer thought he discovered that the computer account was double-counting one of the taxpayer's liabilities. He therefore filled out the proper form and sent it to the service center, requesting that it abate the liability, '''since this is a duplicate assessment that [has] already been done using the correct [master file tax] and tax period.'''[29] The Fifth Circuit analyzed the situation as follows:

> The collections manager in this case never intended or approved an abatement of Bugge's entire tax liability. * * * In requesting the abatement, the collections officer intended, and received approval from his manager for, a reduction of Bugge's tax liability from two assessments of $327,379.82 each . . . to a single assessment of $327,379.82. This request was in accord with the IRS's discretionary authority under section 6404(a)(1) to abate an assessment that is ''excessive in amount.'' * * * However, when the regional service center processed the request and inadvertently eliminated Bugge's entire tax liability, it failed to act within the scope of the request that had been approved by the collections manager. In addition, by abating Bugge's actual and correct tax liability, it failed to act within the IRS's statutory authority to abate an excessive amount. * * * Because of a purely accidental and unintended processing error, the regional service center executed an unintended abatement lacking any authorization.[30]

Note that the *Bugge* opinion refers neither to the particular form used to request the abatement nor to the label of the particular transaction code used to reflect the adjustment to the taxpayer's account. Both were irrelevant to the court's analysis. Instead, the proper legal interpretation of the IRS action required consideration of institutional intent: whether the administrative action at issue resulted from a process truly reflective of an institutional decision to perform a section 6404(a) abatement or whether it resulted from serendipity, a comedy of errors.[31]

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[23]264 B.R. at 912.

[24]Form 5344, ''Examination Closing Record,'' is generally used for cases in Exam, *see* IRM 4.15.5.2, while Form 3870, ''Request for Adjustment,'' is used by other IRS functions; *see also* IRM 8.20.7.7.2 (01-31-2002), ''Abatement of Interest Claim Cases,'' for use of Form 3870 to make interest and penalty abatements per section 6404(e).

[25]IRM 5.19.17.15, ''Adjustment Methods for Discharged Liabilities.''

[26]*See, e.g., Kroyer v. United States*, 55 F.2d 495, 499 (Ct. Cl. 1932) (the government will not be ''bound by the bookkeeping errors of its agents, when such errors in no way affect the real equities of the case or result to the prejudice of'' the taxpayer).

[27]*See In re Becker*, 407 F.3d 89, *Doc 2005-9433, 2005 TNT 86-9* (2d Cir. 2005) (discussing the requirements of proving estoppel against the government for misapplication of payments).

[28]99 F.3d 740, *Doc 96-30396, 96 TNT 226-14* (5th Cir. 1996).

[29]*Id*. at 744 (quoting the request).

[30]*Id*. at 745 (footnote omitted).

[31]*See also Crompton-Richmond v. United States*, 331 F. Supp. 1184, 1187 (S.D. N.Y. 1970) (''whenever an abatement is issued because of a mistake of fact or bookkeeping error, the assessment can be reinstated, at least so long as this does not prejudice the taxpayer'' because the government is not bound by clerical errors of its agents); *In re Range v. United States*, 245 B.R. 266, 274-275 (S.D. Tex. 1999) (upholding as not clearly erroneous the Bankruptcy Court's decision that administrative action was not an abatement). The Second Circuit in *In re Becker*, 407 F.3d 89, 100, *Doc 2005-9433, 2005 TNT 86-9* (2d Cir. 2005), thought *Bugge* inconsistent with *Crompton-Richmond*, but despite some difference in language, both cases hold that not all administrative acts taken by IRS employees rise to the level of legal acts that bind the IRS as a matter of law. Both cases also leave open the possibility that equity (through the doctrine of estoppel) will undo any undue harm resulting from the legal rule.

In sum, despite the lack of applicable code provisions, cases like *Buckner* establish that not all abatements involve substantive redeterminations of a taxpayer's liability, and cases like *Bugge* establish that not all downward adjustments of the taxpayer's liability have the legal effect of abatements.

C. Rebate and Nonrebate Refunds

Section 6402 authorizes the IRS to refund overpayments to taxpayers. Practitioners and academics alike often overlook the distinction between an overpayment and a refund. They are two separate concepts. An overpayment occurs when a tax module shows a credit balance.[32] A refund is what gets paid to the taxpayer. Section 6402(a) does not *require* the IRS to refund an overpayment but instead permits the IRS to set off the overpayment against other outstanding kinds of taxes or other tax periods owed by the taxpayer. Section 6402(c), (d), and (e) also requires the IRS to set off any remaining overpayments against some state and federal nontax liabilities — such as federal contractor debt or child support payments — if properly requested by the benefiting entity. Thus, a refund is whatever the taxpayer gets after the IRS either exercises its discretion or obeys the statutory commands regarding disposition of the overpayment.[33]

> ***A rebate refund occurs when the taxpayer gets money back because the amount paid or credited is greater than the true liability properly reflected in the IRS books.***

A rebate refund occurs when the taxpayer gets money back because the amount paid or credited is greater than the true liability properly reflected in the IRS books.[34] My yearly refund that I love so much is a rebate refund because my amount paid is greater than my true tax. Erroneous earned income tax credit refunds are rebate refunds because the refundable credit is greater than the true tax liability. Likewise, the IRS sometimes determines the previous assessment was excessive because a taxpayer files an amended return that is accepted by the IRS, or because an audit results in a lower tax liability. In those cases, the assessment is abated under section 6404(a) and any resulting refund becomes a rebate within the meaning of section 6213(b). If the IRS later determines that it committed a substantive error in crediting my payments, in crediting the refundable credit, or in making the abatement, the refund becomes a rebate erroneous refund.[35]

In contrast, a nonrebate refund results from an action other than a redetermination of tax liability. For example, a refund arising from a section 6404(c) abatement would be a nonrebate refund. If that abatement was later determined to be erroneous, the refund would be a nonrebate erroneous refund. Likewise, a refund arising from a clerical error — either in adjusting the assessed tax downwards or adjusting the payments or credits upwards — is a nonrebate erroneous refund. In those cases, because the substance of the transaction does not involve a redetermination of tax liability, neither does the resulting refund. For the same reason, the erroneous crediting of another's payment, or a math error involving the taxpayer's own payments or refundable credits, are acts that result in nonrebate erroneous refunds.[36]

II. The Problem of Collecting Erroneous Refunds

A. Collecting Rebate Erroneous Refunds

On one hand, the law regarding the collection of rebate erroneous refunds is settled. The IRS and the courts have long agreed that just as the IRS must make a new assessment to undo an abatement made under section 6404(a), the IRS can collect a rebate erroneous refund — such as one resulting from a section 6404(a) abatement — only by reassessing the abated tax liability.[37] That's because the amount of the error (the difference between the true tax and the tax reflected in the IRS

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[32]Section 6401 also provides that payments assessed or collected after the expiration of the relevant limitation period are to be treated as overpayments. Those are statutory overpayments.

[33]*See, e.g., Pettibone v. United States,* 34 F.3d 536, 538, *Doc 94-8454, 94 TNT 182-15* (7th Cir. 1994) (''The Internal Revenue Code leaves to the Commissioner's discretion whether to apply overpayments to delinquencies or to refund them to the taxpayer. Until the Commissioner exercises this discretion, the taxpayer has no right to payment'') (internal citations omitted); *In re Luongo*, 259 F.3d 323, *Doc 2001-23380, 2001 TNT 175-46* (5th Cir. 2001) (mere overpayment could not constitute ''property of the estate'' within meaning of Bankruptcy Code section 541 because debtor had no interest in the overpayment until after the IRS had exercised its discretion to offset overpayment against other tax liabilities).

[34]Refunds are deemed made as of the date that an authorized IRS employee signs a schedule of overassessments, another summary document similar to the summary record of assessments. Reg. section 301.6407-1. That document used to be Form 1166 but can now be various other forms, some computer-generated. *See* Rev. Rul. 2001-40, 2001-2 C.B. 276, *Doc 2001-23872, 2001 TNT 180-10* (modifying Rev. Rul. 78-127, 1978-1 C.B. 436). The signing date is chiefly important for calculating interest, if any, due on refunds.

[35]There is an open question whether the IRS's erroneous determination that a prior assessment was illegal — and thus abated under section 6404(a)(3) — gives rise to a rebate or nonrebate refund. Discussion of that point is beyond the scope of this article.

[36]*See United States v. Frontone*, 383 F.3d 656, *Doc 2004-18042, 2004 TNT 176-13* (7th Cir. 2004) (discussing distinction).

[37]The earliest case I can find is *Carney Coal Co. v. Commissioner*, 10 B.T.A. 1397 (1928), and the latest case to reiterate the rule is *In re Becker*, 407 F.3d 89, 97 (2d Cir. 2005) (''If an assessment is properly abated pursuant to subsection (a)(1), (2), or (2) of I.R.C. § 6404, quoted above — all of which pertain to assessments made in error — the abatement entirely extinguishes the assessment. In order to undo that abatement, the IRS would be required to impose a new assessment; and, to be effective, that new assessment would need to be imposed within the limitations period''); *see also* GCM 36263, ''Legality of

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books after the abatement) is an error of judgment about the amount of true tax liability and so constitutes an alleged deficiency of tax. If the IRS discovers the error within the applicable limitations period, the taxpayer deserves the protections of the deficiency procedure (access to preassessment judicial review) before the liability can be assessed and collected.

B. Collecting Nonrebate Erroneous Refunds

On the other hand, the law regarding the collection of nonrebate erroneous refunds has long been confused and haphazard. Recall that nonrebate erroneous refunds do *not* represent any redetermination of the taxpayer's tax liability. They result from either an erroneous collection decision (abatement under section 6404(c)) or an erroneous processing action (for example, a clerical error). In theory, the IRS can collect nonrebate erroneous refunds in one of three ways: moral suasion; authorizing the Department of Justice to file a lawsuit under section 7405 (within the limitation period set out in section 6532(b)) for recovery of the erroneous refund; or administrative collection action. It is the last one in which confusion prevails. I'll now discuss each possibility in turn.

The law regarding the collection of nonrebate erroneous refunds has long been confused and haphazard.

The first two methods are not controversial. The IRS engages in moral suasion through pattern ''beg letters'' (forms 510C and 4728, ''Notice of Erroneous Refund''). The letters ask for the money back, explaining that the taxpayer has no right to the money. As to legal action, the government has the same common-law cause of action as does any other litigant for money wrongfully or erroneously paid. ''No statute is necessary to authorize the United States to sue in such a case. The right to sue is independent of statute.''[38] That common-law action for ''money had and received'' is declared in section 7405. Congress has self-imposed a limitation period in section 6532(b), which allows two years from the ''making of such refund'' to file suit under section 7405, unless the refund was induced by the taxpayer's fraud or misrepresentation of a material fact, in which case the IRS has five years to act. The courts have interpreted the phrase ''making of such refund'' to mean the date the check was cashed and ''cleared the Federal Reserve.''[39]

Although not controversial, neither of those two collection methods is satisfactory. The problem with moral suasion is, I hope, self-evident. I am not aware of any studies on how effective the IRS letters are. I assume many taxpayers do the right thing and return the payments. I also assume many taxpayers may not read the letters, may be confused about their account, may not believe the refund is erroneous, or else believe that nine-tenths of the law allows them to keep it anyway. Practitioners can help persuade clients to voluntarily return refunds by reminding them that taxpayers have been criminally prosecuted for cashing erroneous refund checks.[40]

Recovering erroneous refunds by suit under section 7405 is unsatisfactory for multiple reasons. First, it is a retail solution for a wholesale problem. It is working the case at the individual level and not the bulk processing level. And each case is worked, not by just one field agent, but by teams of government employees. First, the IRS team must discover the error and authorize the Department of Justice to sue. Then the DOJ team must file suit, and the court ''team'' must adjudicate, which by itself can take well over a year, assuming a summary judgment resolution.[41] So it forces collection of what is usually an obvious error into an inefficient adversarial process. Second, a section 7405 liability is harder to collect than is a tax liability. Courts are unlikely to treat a section 7405 judgment as a tax debt, which means no tax lien arises to protect the claim, no priority is given the claim in an ensuing bankruptcy, and the IRS cannot perform administrative levies.[42] Finally, the DOJ may not even agree to file suit. Only erroneous refunds larger than a specified base amount will be worth the cost to the government to prosecute. While I have no idea what that amount might be, of the few section 7405 cases reported, most are for hundreds of thousands, or millions, of

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Overpayment Offsets to Collect Unassessable Erroneous Refunds'' (1975) (reviewing case law).

[38]*United States v. Wurts*, 303 U.S. 414, 415 (1938).

[39]*United States v. Greene-Thapedi*, 398 F.3d 635, *Doc 2005-3339, 2005 TNT 33-17* (7th Cir. 2005); *United States v. Commonwealth Energy*, 235 F.3d 11, *Doc 2001-145, 2000 TNT 248-72* (1st Cir. 2000). That is consistent with the rule that interest owed on erroneous refunds starts on the date the taxpayer cashes or negotiates the check. *United States v. Mallah*, 882 F. Supp. 779, *Doc 95-1847, 95 TNT 26-34* (S.D. Ind. 1995); *La Follette v. United States*, 173 F. Supp. 388 (S.D. Cal. 1959). Accordingly, taxpayers who receive an erroneous refund should neither cash the check

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nor send it back, but should instead hold onto it, inform the IRS of the error, and wait for instructions. They should send it back only to someone who knows it is coming and knows how to process it. Sending it back blind just invites additional error.

[40]*United States v. McRee*, 7 F.3d 976 (11th Cir. 1996) (*en banc*) (upholding conviction under 18 U.S.C. section 641 of a taxpayer who, even though doing nothing to induce the erroneous refund, took elaborate actions to disperse the $350,000 refund check in offshore accounts).

[41]*See, e.g., United States v. Daum*, 968 F. Supp. 1037, *Doc 98-7010, 98 TNT 35-36* (W.D. Pa. 1997) (error discovered in Feb. 1995, moral suasion letter issued that Mar., followed by suit in Apr., and motion for summary judgment in Oct.; summary judgment granted 18 months later, on Apr. 30, 1997).

[42]*See, e.g., In re Able Roofing & Sheet Metal Co.*, 425 F.2d 699, 701 (5th Cir. 1970) (refusing to give a section 7405 claim the same priority in bankruptcy as taxes because ''a claim for refund erroneously made does not create a liability for taxes''). The status of a section 7405 judgment is not settled but treating it as a nontax debt is the most consistent result from the string of cases that I discuss below denying the IRS the ability to administratively recover nonrebate erroneous refunds.

dollars. I cannot find a reported case of the government suing for less than $10,000.[43]

C. The Erroneous Refund Revival Theory

The IRS would much prefer to fix administratively what is, almost by definition, an administrative error. And from the mid-1970s until early 1998 it did just that. The idea was first raised in 1970. The IRS Office of Chief Counsel studied the issue, and in two important general counsel memoranda, one issued in 1975 and the other in 1976, it developed a theory whereby the IRS could administratively recover so much of a nonrebate erroneous refund as was equal to or less than the original assessment.[44] The gist of the reasoning was this:

> If a non-rebate erroneous refund is made with respect to a year for which the taxpayer's tax has been assessed, which it would be if tax were shown by the taxpayer on a return, and to the extent that the amount of erroneous refund is not greater than the amount of tax that has been assessed and paid, then the erroneous refund is in effect a giving back to the taxpayer of his payment of assessed tax. In this case the tax has already been assessed, and in our opinion there is no requirement that the tax be reassessed before the normal collection procedures can be utilized.[45]

Based on that reasoning, the GCMs concluded that, as to nonrebate erroneous refunds, "the amount of the refund may be recovered by the usual tax collection procedures, including offset under Code § 6402(a), without use of the assessment or deficiency procedures."[46] Further, the IRS was bound by the 10-year limitation period for collection in section 6502 and not the 3-year period for assessment in section 6501.

That theory became known as the erroneous refund revival theory and resulted in a significant change in IRS practice.[47] To see how the IRS theory worked — and why it ultimately was rejected by the courts — I will use three simplified examples (I omit interest and penalties). The examples also illustrate how refunds may be smaller or larger than the assessed tax and how refunds may arise because of either erroneous crediting of payments or erroneous abatements of assessments.

> Example 1 (Alex): Alex reports a tax liability of $4,000 on the return, claims $2,000 in withholding credits, and sends a check to cover the $2,000 balance due. During processing, a clerk erroneously inputs the check twice. Assuming no setoffs, the system generates a refund to Alex of $2,000. When the error is discovered, a clerk enters a new debit TC to reverse the error and the tax module shows a balance due of $2,000. The new debit TC is not rolled into the summary record of assessments.
>
> Example 2 (Blair): Blair reports a tax liability of $4,000 on the return, claims $2,000 in withholding credits, and sends no payment to cover the balance due. The return is properly processed and shows a balance due of $2,000. A year later, Blair sends in the remaining payment. However, at that time a clerk also erroneously credits Blair's tax module with a payment of $7,000 received from another taxpayer for another tax liability. Assuming no setoffs, the system generates a refund to Blair of $7,000. When the error is discovered, the clerk enters new TC codes to reverse the error, leaving the account with a balance due of $7,000. Again, no new assessment is made.
>
> Example 3 (Cody): Cody reports a tax liability of $4,000 on the return, claims $2,000 in withholding credits, and does not pay the balance. The return is properly processed and shows a balance due of $2,000. However, four years later, when a field employee later submits a Form 3870, "Request for Abatement," requesting abatement of a different taxpayer's account in the amount of $4,000, the IRS campus processing clerk erroneously processes the request on Cody's account. The TC used by the clerk (TC 291) is translated onto the Form 4340 as "abatement prior to tax assessment." The reduced liability results in the tax module showing an overpayment of $2,000 that is then refunded. When the error is discovered, the IRS clerk enters a new debit TC to reverse the credit, thus creating a balance due of $4,000 in Cody's account. Again, the entry of the reversing credit transaction is not a new assessment.

The IRS erroneous refund revival theory would allow the IRS to administratively collect all $2,000 of the erroneous refund to Alex, $4,000 of the $7,000 erroneous

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[43]The smallest amount I could find, in an admittedly quick search, was at issue in *United States v. Korda*, 2005-2 U.S.T.C. para. 50,541 (M.D. Fla. 2005) ($10,209.81).

[44]GCM 36263 (May 9, 1975), *as modified by* GCM 36624 (Mar. 11, 1976) ("We regret that our reply to your inquiry of June 17, 1970 has been so long delayed"). I would sure love to know the story behind that unusual delay. The 1975 GCM thought that the IRS had to reassess, but the 1976 GCM concluded that to require reassessment made no sense for nonrebate refunds because the error causing the refund could not undo the prior assessment and the IRS could make only one assessment of a tax liability.

[45]GCM 36624 (Mar. 11, 1976).

[46]Recall that, as discussed above in note 16, the distinction between rebate and nonrebate refunds did not arise until after 1944. The GCMs pointed out that before 1944 the IRS had established the right to reassess erroneous refunds through the deficiency procedures. They reasoned that when Congress put the distinction between rebate and nonrebate refunds into section 6211's definition of deficiency, it could not have meant to suddenly deny what had previously been allowed: the ability to rectify the error administratively. If the IRS no longer had to reassess the nonrebate liability, that meant the original assessment's power to unleash the administrative collection tools was revived.

[47]*See* GCM 36624 ("We believe it would be particularly desirable to publish a decision to recover non-rebate erroneous refunds through the usual tax collection procedures, since this represents a change in past practice"). The IRS eventually put the procedure to recover nonrebate erroneous refunds in IRM 3.17.79.16. I can no longer find that section of the IRM online.

refund to Blair, and $4,000 from Cody (the $2,000 erroneous refund and the $2,000 unpaid on the original assessment). All of those amounts represent proper assessments that were never legally abated and remain unpaid. Even though Alex and Blair paid all their liability, the IRS theory says that the erroneous refunds mistakenly returned their tax payments to them (and then some, in Blair's case). In that way, the IRS theory focuses on the liability determination function of an assessment, reasoning that if the assessment properly reflects the true tax liability and if the account shows a balance due, what remains unpaid is a tax liability.[48]

> ***The IRS would much prefer to fix administratively what is, almost by definition, an administrative error.***

Thus, the IRS could administratively collect the entire $2,000 refund from Alex because Alex could not gainsay that the properly made assessment reflects the true tax liability. Likewise, the IRS can administratively collect $4,000 from Blair because that is the amount of the true tax liability that — when all is said and done — remains unpaid. However, because the erroneous refund to Blair exceeded the true tax liability by $3,000, the IRS would have bifurcated remedies: It could collect the $4,000 tax liability administratively but would have to file suit under section 7504 to collect the excess $3,000. Similarly, the IRS can collect $4,000 from Cody because the clerical error that caused the refund was not a legal abatement.[49]

D. The Extinguishment Theory

For the first 20 years, the IRS often won challenges to its erroneous refund revival theory in the lower courts.[50] However, the GCMs that developed the theory acknowledged one weakness: the doctrine of extinguishment. The courts first articulated that idea in 1929, in *Kelley v. United States*: "Once paid, a tax is gone, and a refund of the money does not restore it."[51] Thirty years later, the district court in *In re Marshall* relied on *Kelley* to reject the idea that a bankruptcy claim based on an erroneous refund was a claim for taxes entitled to special treatment.[52] In turn, the district court in *Rodriguez v. United States* relied on *Marshall* to conclude that "a refund is not, properly speaking, a tax amount," and therefore "the act of sending a refund cannot of itself revive or continue a preexisting tax liability."[53] The Fifth Circuit picked up on that argument in *United States v. Wilkes* in 1991 and, agreeing with both *Rodriguez* and *Marshall,* rejected the IRS erroneous refund revival theory. After that, it was all downhill, as the government lost in four other courts of appeals over the next six years.[54] Ultimately, the IRS conceded the issue in an action on decision dated May 4, 1998.[55] The government then abandoned the position on two appeals from lower court decisions that had upheld the theory, and the IRS changed its collection procedures in the Internal Revenue Manual.[56]

In contrast to the erroneous refund revival theory, the extinguishment theory focuses on the second function of an assessment as a precursor to administrative collection. The idea is that once a taxpayer pays any portion of the liability, the assessment can no longer serve as a proper precursor to administrative collection. Thus, as applied to the above three examples, the IRS would have no power to administratively collect any amount from Alex or Blair because they had fully paid the assessed liability. The extinguishment theory would permit collection of $2,000 from Cody because that was the portion of the original assessment that remained unpaid. But Cody's partial payment (the $2,000 in withholding credits) could not be

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[48]This reasoning is best seen in *Groetzinger v. Commissioner,* 69 T.C. 309 (1977).

[49]*Bugge, supra* note 28.

[50]*Davenport v. United States,* 136 B.R. 125 (W.D. Ky. 1991); *Sanfellipo v. United States,* 1990 U.S. Dist. LEXIS 18654 (N.D. Cal. 1990); and *Groetzinger v. Commissioner,* 69 T.C. 309 (1977). One district judge bravely rejected the opinions of five courts of appeals, only to have the government abandon the argument on appeal. *See Mildred Cotler Trust v. United States*, 2 F. Supp.2d 264, 270, *Doc 98-11750, 98 TNT 67-10* (E.D.N.Y. 1998), *rev'd*, 184 F.3d 168, 171, *Doc 1999-23590, 1999 TNT 132-10* (2d Cir. 1999) ("I recognize that a number of courts have reached a different conclusion in similar or related situations. Relying on a doctrine known as 'extinguishment,' these courts have concluded that a payment of taxes 'extinguishes' an underlying assessment, thus barring collection of taxes on the basis of that assessment. I find these opinions to be unpersuasive") (citations omitted).

[51]30 F.2d 193 (9th Cir. 1929). There, the IRS had erroneously refunded an estate tax and brought suit, on the equity side of the court, to recover the amount as an unpaid tax. The circuit court dismissed the suit because the government had an adequate

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remedy at law — being an action under the predecessor to section 7405 for recovery of an erroneous refund. Thus, the court made the critical distinction between liability for tax and liability for return of erroneously paid money, a distinction picked up later by the Seventh Circuit in *O'Bryant*.

[52]158 F. Supp. 793, 795 (N.D. Tex. 1958) ("When the plaintiffs paid their respective income taxes for the year 1943, such taxes as to the plaintiffs were extinguished and the subsequent refunds to the plaintiffs of a portion or all of the money paid by them as 1943 income taxes did not restore the taxes").

[53]629 F. Supp. 333, 344 (N.D. Ill. 1986).

[54]The circuits in which the IRS argued for the theory and lost were, in chronological order of the opinions being issued: *United States v. Wilkes*, 946 F.2d 1143, 1152 (5th Cir. 1991); *O'Bryant v. United States*, 49 F.3d 340, *Doc 95-3184, 95 TNT 57-15* (7th Cir. 1995); *Clark v. United States*, 63 F.3d 83, *Doc 95-8258, 95 TNT 171-10* (1st Cir. 1995); *Bilzerian v. United States*, 86 F.3d 1067, *Doc 96-19205, 96 TNT 130-4* (11th Cir. 1996); *Singleton v. United States*, 128 F.3d 833 (4th Cir. 1997).

[55]AOD GL-118964-97, 1998-1 C.B. 972 (action only), 1998 AOD LEXIS 8 (full memo). The acquiescence was for *Bilzerian*.

[56]*Mildred Cotler Trust v. United States*, 184 F.3d 168, 171 (2d Cir. 1999), *reversing* 2 F. Supp.2d 264 (E.D.N.Y. 1998) ("On appeal, the government has expressly abandoned its argument below, on which the district court relied"); *Stanley v. United States*, 140 F.3d 1023, 1027-1028, *Doc 98-11458, 98 TNT 65-62* (Fed. Cir. 1998), *reversing* 35 Fed. Cl. 493, *Doc 96-13281, 96 TNT 88-15* (Ct. Fed. Cl. 1996) ("the Government argued before the Court of Federal Claims that the erroneous refund could nevertheless be recovered on the basis of that [previous] assessment. . . . The Government on appeal wisely does not pursue this argument"). The new IRM provisions are at 25.6.7.

recovered, even by courts that improperly apply the extinguishment theory and say the IRS can perform a supplemental assessment of a nonrebate erroneous refund if done within three years. In short, properly applied, the extinguishment theory holds that the IRS can recover nonrebate erroneous refunds of ''paid taxes'' only through suit under section 7405.

In sum, under both the revival and extinguishment theories, the IRS will sometimes be forced into bifurcated remedies for administrative errors. The chief difference is that the IRS theory uses the original assessed liability to measure what can be recovered administratively because the assessment's liability determination function was unimpaired by the error. In contrast, the extinguishment theory focuses only on the *unpaid* assessed liability as the proper measure of what can be recovered administratively because the assessment's ''collection-propelling'' function is impaired, or cut down, by the taxpayer's payment.

E. Problems With Extinguishment Theory

The extinguishment theory does not jibe with good tax administration. It characterizes nonrebate erroneous refunds as a nontax liability yet insists the IRS can collect it using administrative collection tools if the IRS just timely assesses it. But the IRS can assess only tax liabilities. So by saying that nonrebate erroneous refunds are not tax liabilities, courts in fact disable the IRS from pretty much any administrative collection action.[57] Make no mistake about it: A nonrebate erroneous refund, by definition, results in a windfall to the lucky taxpayer. Whether the taxpayer is fully aware of the windfall or not does not change its character. The taxpayer is still getting the free use of the government's money. We're talking handouts here.[58] In that way, the extinguishment theory hurts those taxpayers who comply with their obligations and rewards taxpayers who avoid returning (whether through ignorance or obstinance) their undeserved (even if unsolicited) gain.

There is a central contradiction to the extinguishment theory. On one hand, courts hold that nonrebate erroneous refunds are *nontax liabilities* that neither raise nor revive any tax liability. They are instead simply common-law liabilities that arise from the wrongful holding of the government's money by the taxpayer. On the other hand, the same courts say that the IRS can reassess the refund if it acts within the assessment limitations period, using either its authority under section 6201 to assess or under section 6204 to make a ''supplemental assessment whenever it is ascertained that any assessment is imperfect or incomplete in any material respect.'' Here is how the *O'Bryant* court explained it:

> The money the O'Bryants have now is not the money that the IRS' original assessment contemplated, since that amount was already paid. Rather, it is a payment the IRS accidentally sent them. They owe it to the government because they have been unjustly enriched by it, not because they have not paid their taxes. Because it is a refund, the money the O'Bryants received is not part of the taxpaying transaction as the IRS asserts and therefore cannot be recovered through the § 6502 post-assessment collection procedures. It would not make sense to allow the IRS to use those procedures (which are premised on the taxpayer's not having paid his tax debt) to recover money it accidentally sent to the taxpayer. Rather, the agency is confined to the erroneous refund collection procedures available to it under the Tax Code — § 7405 and the deficiency/assessment procedures.[59]

Some courts — the ones that do not understand the difference between rebate and nonrebate refunds — insist the IRS must use the deficiency procedures to perform that theoretical reassessment. Look at the language from *Singleton*:

> Sections 6204(b) and 6213(a) [prescribing deficiency procedure] prohibit the IRS from issuing a supplemental assessment without first issuing a notice of deficiency and giving the taxpayer an opportunity to contest the assessment in Tax Court. The Court finds no applicable exception to these procedural requirements. Section 6213(a) applies to all assessments; it does not distinguish between assessments intended to reclaim rebate refunds versus those intended to reclaim non-rebate refunds.[60]

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[57]The IRS still has a limited ability to collect the erroneous refund through setoff, but courts do not permit setoffs after the applicable section 6532(b) limitations period for filing an erroneous refund recovery suit has expired. *PG&E v. United States*, 417 F.3d 1375, *Doc 2005-17029*, *2005 TNT 154-7* (Fed. Cir. 2005).

[58]Some examples are *Stanley*, *supra* note 56 ($600,000 + windfall); *O'Bryant*, *supra* note 54 ($7,000 + windfall); *Wilkes*, *supra* note 54 ($20,000 + windfall); *Clark*, *supra* note 54 ($25,000 + windfall); *Bilzerian*, *supra* note 54 ($125,000 + windfall); *Mildred Cotler Trust*, *supra* note 56 ($175,000 + windfall).

[59]49 F.3d at 347-348 (citations omitted). *Accord*, *Clark*, *supra* note 54, at 87 (''there is a fundamental difference between money taxpayers possess as the result of an erroneous refund and money they originally owed the IRS (their tax liability); taxpayers who received erroneous refunds owe the IRS because they have been unjustly enriched by it, not because they have not paid their taxes'') (quotations omitted); *Bilzerian*, *supra* note 54, at 1069 (''Today, we join these circuits and hold that once a tax liability is paid, no erroneous refund — whether rebate or non-rebate — can revive it''). *But see United States v. Frontone*, *supra* note 36 (answering yes to the question ''whether a claim for taxes based on an erroneous refund is a claim for taxes'' and noting that ''we acknowledge the tension between *O'Bryant*'s conception of when assessment is available [for erroneous refunds] and the broader conception suggested by *Bilzerian* and *Clark*'') (citations omitted).

[60]*Singleton v. United States*, *supra* note 17, at 837. In *Singleton* the IRS did try to make a supplemental assessment under section 6204. What the majority got wrong was reading section 6204 as always requiring the IRS to use deficiency procedures for all supplemental assessments. As the dissent correctly pointed out: ''The Tax Code does not prohibit supplemental assessments without a notice of deficiency. It prohibits supplemental assessments of a deficiency without a notice of deficiency.'' *Id*. at 840. But from the facts as recited in the case, it

(Footnote continued on next page.)

The contradiction here is that the IRS can assess only ''taxes . . . imposed by this title.''[61] If the liability to return nonrebate refunds is not ''imposed by this title'' but is instead a common-law liability for money had and received, the IRS *cannot* assess them. It has no authority to do so. And yet courts insist — in *dicta* mostly — that the IRS can.[62]

The reason courts keep saying that the IRS can assess refunds is because the legislative history to section 7504 instructs that the section was not meant to limit the IRS to recovery of erroneous refunds by lawsuit. When Congress first enacted the language now in section 7504, back in 1928, the committee report was clear that it did not intend the legislation to cut off the IRS's administrative remedies: ''Obviously, if the limitations period on the making of the assessments has not expired, the erroneous refund may be recovered by assessment in the ordinary manner.''[63]

The extinguishment theory hurts taxpayers who comply with their obligations and rewards taxpayers who avoid returning their undeserved (even if unsolicited) gain.

When the 1928 committee report was written, it was well established that erroneous refunds created tax liabilities. Recall that the distinction between rebate and nonrebate refunds did not arise until 1944: In 1928 *all* refunds were rebate refunds.[64] Recall further that the courts and the IRS have always agreed that to recover erroneous rebate refunds, the IRS must reassess.[65] That's based on the view that rebate refunds result from redetermination of the tax liability.[66] So, in 1928 it was true that every erroneous refund resulted in a deficiency of tax. The above quote from *Singleton* would have been perfectly true . . . in 1928.

So the question becomes whether Congress in 1944, when it changed the definition of rebate in section 6211, meant to undo what had been true in 1928. Did Congress mean to no longer allow the IRS the ability to administratively recover that class of refunds now removed from the definition of deficiency? Did Congress intend, by a definitional change, to suddenly restrict the IRS to suits under section 7504 to recover refunds that no longer qualified as a deficiency? The two GCMs issued in 1975 and 1976 thought not. The 1975 GCM expressed its conclusion this way:

> A rational interpretation of the statutory collection scheme as a whole requires the conclusion that tax collection procedures are applicable here [in the case of a nonrebate refund] as well as in the case of a rebate. If the procedures were not available here, the only means for recovery of the refund would be civil suit under Code § 7405. Yet there seems no reason why Congress [in 1944] would have intended a more restrictive rule for recovering refunds which are not rebates than for recovering rebates. Rather, the logical interpretation would be that rebates and non-rebate refunds may be recovered in the same manner except that the deficiency procedure must be used prior to the assessment of a rebate so the taxpayer may have access to the Tax Court where there is a question of liability for tax, whereas a non-rebate refund, not made on the basis of a determination of tax liability, may be recovered by simple assessment.[67]

The 1976 GCM modified that analysis by eliminating the requirement for reassessment. Focusing on the liability determination function of the assessment, it pointed

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appears the majority correctly identified the error as substantive. The taxpayer had included a schedule reporting a business tax credit but had correctly not taken the credit against the reported tax liability. The error correction/reject unit in the processing function determined that the taxpayer had made a mistake and so allowed the credit and assessed a much smaller tax liability than reported. That determination was an error. But it was substantive. Accordingly, the IRS was required to follow the deficiency procedures before making the supplemental assessment.

[61]Section 6201(a).

[62]*O'Bryant v. United States*, 839 F. Supp. 1321, 1325 (C.D. Ill. 1993), *aff'd*, 49 F.3d 340 (7th Cir. 1995) (''Most courts hold that the government is not limited to a Section 7405 action to recover an erroneous refund, but may collect by assessment in the ordinary manner, because the refund creates an underpayment'') (citations omitted) (collecting cases); *see also Bilzerian v. United States*, 887 F. Supp. 1509, 1514 (M.D. Fla. 1995), *rev'd on other grounds*, 86 F.3d 1067 (11th Cir. 1996) (The IRS ''is not limited to filing an action under § 7405 to recover an erroneous refund. Where the IRS has made [a] new assessment [of] the erroneously refunded amount, the IRS may collect this amount through ordinary collection procedures within a ten (10) year period after the assessment of the tax. 26 U.S.C. § 6502'') (citations omitted); *Purcella v. United States*, 1992 U.S. Dist. LEXIS 426 (D. Colo. 1992) (''The IRS could have recovered the [erroneous] refund by assessment in the ordinary manner. Yet it never assessed the [erroneous] refund as a tax and the previous assessment had already been satisfied'') (citations omitted).

[63]S. Rep. No. 960, 70th Cong., 1st Sess. 42 (1928).

[64]*See* note 16 *supra*.

[65]*See* note 37 *supra*. The requirement to reassess was independent of the process required for reassessment. For example, courts permitted the IRS to use the summary process to reassess erroneous refunds of excise taxes. *United States v. Tuthill Spring Co.*, 55 F.2d 415 (N.D. Ill. 1931). Recall that assessment of excise taxes never requires the IRS to follow the deficiency procedures, which apply only to income, estate, and gift taxes.

[66]The 1975 GCM lists the additional cases upholding the recovery of erroneous rebate refunds by reassessment: *Burnet v. Porter*, 283 U.S. 230 (1931); *Clark v. Comm'r*, 158 F.2d 851 (6th Cir. 1946); *Comm'r v. Newport Industries*, 121 F.2d 655, 657 (7th Cir. 1941); *Page v. Lafayette Worsted*, 66 F.2d 339 (1st Cir. 1933); *Richard E. Warner*, T.C. Memo. 1974-243; *Lucy L. Lawton*, 16 T.C. 725 (1951); *Etta Craig*, 18 B.T.A. 86 (1929).

[67]The *O'Bryant* court disregarded that argument, snapping, ''It is an unjustified leap of logic to say that because nonrebate refunds cannot be recovered by reassessment, they must be collectible by resort to the original assessment. There is no indication in the Code that Congress intended such a result and we refuse to reach it, especially when doing so would require us to mischaracterize an erroneous refund as a tax liability.'' 49 F.3d at 347.

out that a nonrebate refund did not change the true liability, which was already accurately reflected in the existing assessment. That is, just as a clerical error does not result in an abatement of tax under section 6404(a), neither does a nonrebate refund result in a new tax *liability* because it is just the giving back of a tax *payment*. Accordingly, not only was no reassessment necessary but it was not even permitted because there was no new tax liability to assess.

F. Problems With the Revival Theory

Although more rational than the extinguishment theory, the revival theory is far from perfect. It creates the opposite problem of the extinguishment theory: It gives the IRS more power to collect erroneous nonrebate refunds than rebate refunds. That is, while one cannot say that Congress, in changing the definition of rebate in 1944, intended to make the IRS *less able* to collect nonrebate erroneous refunds, neither can one say that Congress intended to suddenly enhance the IRS's ability to collect erroneous nonrebate refunds over rebate refunds. Yet that is what the revival theory does.

The first way in which the revival theory prefers nonrebate refunds concerns how liens arise. The law under section 6321 is well settled that the tax lien arises when there is a proper assessment, proper notice and demand of the unpaid amount, and a failure to pay.[68]

Alex illustrates the problem. Recall that Alex fully paid the assessed tax and so, under the established law regarding section 6321, no tax lien arises. Further, the IRS could not administratively collect a rebate erroneous refund made to Alex unless it could reassess within the section 6501 assessment limitations period, which is generally three years. But the revival theory allows the IRS to administratively collect a nonrebate erroneous refund from Alex at anytime within the section 6502 collection limitations period, which is generally 10 years. That's because the erroneous revival theory views an assessment, once established, as inviolate, so once the nonrebate refund is issued, all that would be needed to trigger the tax lien would be notice and demand and a failure to pay. The revival theory would thus give more tax lien protection to nonrebate refunds than rebate refunds.

The revival theory transforms section 6321 into the zombie lien statute.

The second way in which the revival theory prefers nonrebate refunds over rebate refunds concerns how liens are satisfied. Section 6322 provides that the tax lien ''continues until the liability for the amount so assessed . . . is satisfied or becomes unenforceable by reason of lapse of time.'' The revival theory transforms section 6321 into the zombie lien statute.

Blair illustrates the problem. Recall that Blair did not fully pay the tax initially. Accordingly, after notice and demand was made, and he continued his failure to pay, the tax lien arose. But then Blair sent in the remaining payment. At that point, when the ''liability for the amount so assessed . . . [was] satisfied,'' the tax lien was extinguished; it died.[69] But according to the revival theory, the processing error creating the nonrebate refund brings the tax lien back from the dead.

Cody illustrates how the tax lien is supposed to work. There, the tax lien arises because Cody has an unpaid balance due when the assessment is made. As long as any part of the assessment remains unpaid, the tax lien remains outstanding. It may secure a greater or lesser claim, depending on the payments and credits, but it can be extinguished only by full payment or running of the limitations period on collection. Once extinguished, however, it's dead and should stay dead. That is the teaching of section 6325, which provides that once the IRS determines a taxpayer has satisfied the ''liability,'' the IRS *must* issue a certificate releasing the lien. And the effect of the certificate of release is that the lien is extinguished and cannot be reinstated, in explicit contrast to the statute's allowance for the revival of liens on property from which they had been removed (through certificates of discharge or nonattachment).

III. The Needed Legislative Solution

A. The Limits of Administrative Solutions

In its September 29, 2006, report, TIGTA criticized the IRS for not doing more to collect erroneous refunds. After harrumphing about how much better the IRS could be in tracking and analyzing erroneous refunds, it came up with this recommendation for how the IRS might better collect them:

> The Wage and Investment Division, with input from the IRS Office of Chief Counsel, should consider revising its erroneous refund procedures to include a financial analysis conducted electronically by Submission Processing Accounting function employees working erroneous refund cases to determine collectibility on cases above a specific

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[68]*United States v. National Bank of Commerce*, 472 U.S. 713, 719-720 (1985) (proper assessment); *Blackston v. United States*, 778 F. Supp. 244 (D. Md. 1991) (notice and demand); *United States v. Wintner*, 200 F. Supp. 157 (N.D. Ohio 1961), *aff'd*, 312 F.2d 749 (6th Cir. 1963), *rev'd on other issues*, 375 U.S. 393 (1964) (failure to pay).

[69]This is another area in which the tax code needs rewriting. Section 6322 provides that the tax lien is extinguished when the taxpayer's liability is satisfied. Likewise, section 6325(a) requires the IRS to issue a certificate of release when it determines that a tax liability is satisfied. However, section 6432 provides for damages only when the IRS negligently or knowingly failed to release a lien within 30 days of determining that the related assessment is satisfied. Thus, current law leads to the anomalous result that the tax lien may be extinguished but the IRS incurs no penalty for not issuing a certificate of release, leaving in place the notice of federal tax lien declaring to the world that the tax lien still exists. *See Henderson v. United States*, 91 F. Supp.2d 995, *Doc 2000-23495*, *2000 TNT 176-67* (E.D. Wis. 2000) (no damages to the taxpayer who claimed to have satisfied his liability but concededly did not satisfy the erroneously assessed amount).

> dollar tolerance, and to refer those cases with collection potential directly to the local IRS Office of Chief Counsel. We believe adopting this change would be a more efficient use of resources.

That is a laughably lame suggestion. TIGTA wants low-level IRS employees to figure out whether taxpayers who have received erroneous refunds have enough assets to make the effort of obtaining a judgment worthwhile. The IRS management politely objected to the recommendation, citing lack of training. But there are much worse problems with TIGTA's idea.

First and most fundamentally, TIGTA's proposed solution puts the collection cart before the judgment horse. TIGTA wants the IRS to first determine whether a taxpayer has assets and only then refer the case to the DOJ. In almost no other context does the IRS make a collectibility decision before a liability decision. You do not see revenue agents inquiring whether taxpayers have the wherewithal to pay a deficiency![70] And for good reason: What is here today can be gone tomorrow, and vice versa. There is no correlation between a taxpayer's assets today and the ability of the government to collect from the taxpayer some two or three years down the road whenever the DOJ gets the section 7504 judgment.

TIGTA's suggestion is laughably lame: Low-level IRS employees should figure out whether taxpayers who have received erroneous refunds have enough assets to make the effort of obtaining a judgment worthwhile.

Second, TIGTA's suggestion would badly misapply IRS resources by draining significant amounts of full-time equivalents (FTEs) — the measurement of worker hours — from the primary mission of submissions processing. That's because a collectibility determination requires financial information about the taxpayers. The only source of financial information readily available to submission processing employees is the data used by the automated collection system (ACS): the data in the IRS data systems gathered from various returns by the taxpayer and third parties. That data is not reliable. People change bank accounts. People change employers. That data is also incomplete: Just because a bank sent in a 1099-INT for a taxpayer doesn't mean you know anything about the balance in that account.

At the collection stage, that bad and incomplete data does not matter because ACS just sends out a levy and if it hits, it hits. But what works well to collect an assessed tax would not at all work well to perform TIGTA's suggested financial analysis. You cannot use a levy to collect information unless you have an assessed tax. TIGTA's suggestion would require submissions-return employees to issue and track summonses. They would have to track down taxpayers to secure a valid Form 433A, ''Collection Information Statement.'' That is the work of field agents. It takes huge hunks of FTEs. Even if you could train submission processing employees to do all that, you would throw them into a hugely inefficient operation.

The basic problem facing the IRS is that current law does not provide a satisfactory framework for the collection of nonrebate erroneous refunds, no matter which theory you subscribe to. The IRS's erroneous revival theory and the alternative extinguishment theory create problems in the law. Meanwhile, the inability of the IRS to administratively collect nonrebate erroneous refunds results in huge windfalls for many taxpayers. What is needed is a legislative fix.

B. The Legislative Fix

In many ways, the current situation parallels that facing Congress when, in 1954, it enacted section 6201(a)(3). That section allows the IRS to assess the entire amount of erroneously allowed withholding credits, even when the resulting refund is larger than the assessed tax liability. The Senate committee report explained that Congress believed the IRS faced a problem with bifurcated recovery of erroneous refunds based on overstated withholding credits and accordingly wrote the statute to allow the IRS to make a single assessment to recover the entire erroneously refunded amount.[71] For example, if the erroneous refund to Cody had resulted from a mistake in recording the withholding credit (erroneously posting it as $12,000 instead of $2,000), resulting in a $10,000 refund, section 6201(a)(3) would permit the IRS to assess the entire $10,000 refund as a tax liability (thus allowing the IRS to administratively collect $12,000, the $2,000 erroneously applied to satisfy Cody's liability and the $10,000 refund). Unfortunately, while the purpose of section 6201(a)(3) was to prevent the necessity of bifurcated recovery procedures for a single erroneous refund, it covers only refunds made on the basis of one particular type of error.

Congress should act to prevent the necessity of bifurcated recovery procedures for any erroneous nonrebate refund. Congress should create two new provisions, one in Chapter 68, ''Additions to Tax, Additional Amounts, and Assessable Penalties,'' and one in Chapter 66, ''Limitations.'' The first would be a new section 6658 (current section 6658 would be renumbered as section 6659), titled ''Failure to Return Erroneous Refund.'' It would read: ''In the case of any person failing to return or repay any nonrebate erroneous refund after the Treasury secretary has requested its return or repayment by written notice (either in hard copy or electronic form) delivered in the manner prescribed in section 6303, the secretary may assess and collect a penalty in the amount of the erroneous refund.'' The second would be a new subsection

[70]While there are provisions for evaluating offers in compromise during examination, IRC 4.18.7.1(4) (''Offer in Compromise Filed During Audit'') and 5.8.26.1(4) (same), those provisions are used only in exceptional circumstances. *See* IRM 35.5.2.6(1) (stating that considering collection aspects of a deficiency determination should be ''highly unusual'').

[71]*See* H. Rep. No. 1337, 83d Cong., 2d Sess. (1954) at A404; S. Rep. No. 1622, 83d Cong., 2d Sess. (1954) at 572.

(n) in 6501 (the assessment limitations period; current sections 6501(n) and 6501(o) would be renumbered). It would be titled ''Special Rule for Certain Erroneous Refunds'' and would read: ''Assessment of the amount authorized by section 6658 must be made within five years from the date that the erroneous refund has cleared the Federal Reserve or otherwise been released to the person assessed.''

The reason that I suggest that particular arrangement, instead of adding another subsection to the section 6201 assessment authority, is that the policy behind the three-year period for assessments of liabilities is inapplicable to the kind of errors that create nonrebate erroneous refunds. The three-year limitations period for assessment represents congressional policy that the substance of the taxpayer's liability be settled — that is, properly reflected in an assessed liability — within three years from the due date of the return. A substantive error resulting in a rebate refund does not affect that policy because the policy goes toward the first function of an assessment — to properly reflect the true tax liability of a taxpayer. But a nonrebate refund does not implicate that policy because it has nothing to do with the first function of an assessment: the proper reflection of a tax liability. That is the insight from the 1975 and 1976 GCMs and is what formed the basis for the revival theory. Further, because a nonrebate erroneous refund is not connected with a substantive redetermination of tax, it can happen at any time. It does not make sense that the IRS's ability to administratively collect a nonrebate erroneous refund should turn on the happenstance of when it occurred.[72]

For those reasons, Congress should give the IRS a reasonable time in which to discover and collect back money erroneously refunded to taxpayers for reasons unconnected with substantive redeterminations of tax. The $200 million in erroneous refunds identified by *USA Today* should not be given up without giving the IRS a reasonable shot at collecting it back.

IV. Conclusion

I view law in general, and tax law in particular, as a slow-moving conversation between the various rulemaking authorities: the courts, Congress, and the government agencies charged with administering the law (here, the IRS). The conversation is ongoing and in the great tradition of fragmented democracy, each participant acts to check and balance the others. Sometimes that works to make the law better, but sometimes it makes the law worse. In the area of erroneous refunds, there has been a long awkward pause in the conversation and it is Congress's turn to speak. I hope Congress will do so here to advance the cause of good tax administration.

[72]The proposal also parallels how the IRS uses the section 6672 trust fund recovery penalty.

U.S. Tax Court Practice & Procedure

By Kyle Coleman

United States Tax Court Practice & Procedure

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BIOGRAPHY

Mr. Coleman's practice concentrates on federal tax related controversy matters, including litigation in Federal District Courts, the United States Tax Court, and the Court of Federal Claims. Mr. Coleman also represents taxpayers in Internal Revenue Service audits, appeals and collection actions. Kyle has been admitted to the Fifth Circuit Court of Appeals Bar, the United States Court of Appeals for the District of Columbia, the Northern District of Texas, the Eastern District of Texas, the District of Colorado and the United States Tax Court.

In addition to tax controversy, Mr. Coleman also represents clients in estate and business planning as well as asset protection. His practice includes entity formation, asset transfers and wills and trusts.

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HISTORY OF THE TAX COURT

- Created by Congress in 1924.
  - The Tax Court was created to provide a forum for taxpayers to contest tax deficiencies without first paying the tax.
- Mandated to "ride circuit"
  - The Tax Court comes to you (or nearby).
- The Court is comprised of 19 Judges appointed by the president and subject to Senate confirmation.

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TAX COURT STATISTICS

Congressional Budget Justification for Fiscal Year 2024

- Requested Budget - $65,700,000, a 14% increase over fiscal year 2023.
- FYE 2022
  - 29,002 cases filed; 17,569 (regular) – 11,433 (small cases).
  - 32,290 cases closed.

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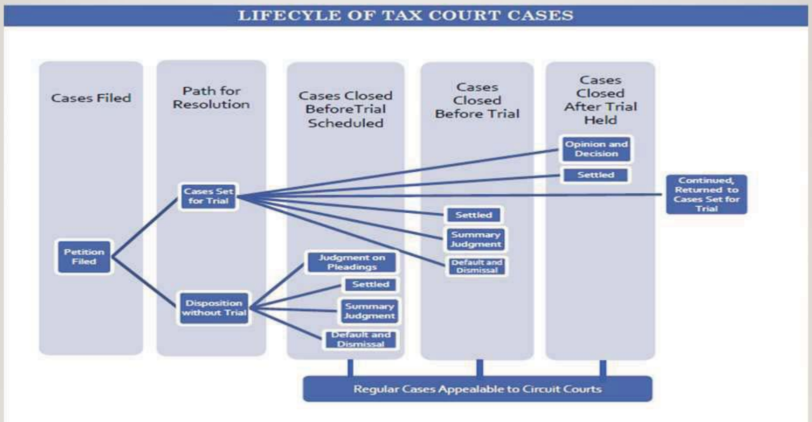
LIFECYCLE OF TAX COURT CASES



5

CASED FILED BASED ON JURISDICTION TYPE FYE 2022

CASES FILED BASED ON JURISDICTION TYPE
FISCAL YEAR 2022

JURISDICTION TYPE	FILED	PERCENT
Deficiency	27,854	96.04%
Lien/Levy	1,064	3.67%
Whistleblower	46	0.16%
Passport	25	0.08%
Declaratory Judgment, Exempt Organization	8	0.03%
Declaratory Judgment, Retirement Plan Revocation	5	0.02%
Disclosure	-0-	0.00%
TOTAL	29,002	100%

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TAX COURT JURISDICTION

- The Tax Court has limited jurisdiction.
- The following issues may be heard by the Tax Court under express statutory authorization.
  1. A notice of deficiency. [Secs. 6212, 6213]
  2. Notice of liability to transferee or fiduciary. [Sec. 6901]
  3. A notice of determination. [Secs. 7476, 7477, 7478, 7479, and 7428.]
  4. A notice of intention to disclose a redacted ruling, determination letter, technical advice memorandum or Chief Counsel advice. [Sec. 6110]

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TAX COURT JURISDICTION

- Tax Court issues continued.
  5. A notice of final partnership administrative adjustment. [Sec. 6226]
  6. A denial of an administrative adjustment request. [Sec. 6228]
  7. A denial of an award for administrative costs. [Sec. 7430(f)]
  8. A notice of final determination not to abate interest. [Sec. 6404(h)]
  9. A determination of employment status. [Sec. 7436]
  10. A notice of partnership adjustment. [Sec. 6247]

8

TAX COURT JURISDICTION

- Tax Court issues continued.
  11. A notice of adjustment with respect to nonpartnership items in an oversheltered return action, wherein the taxpayer seeks a declaratory judgement. [Sec. 6234]
  12. A denial of relief from joint and several liability on a joint return. [Sec. 6015]
  13. A notice of determination concerning collection action(s) under section 6320 and/or 6330. [Sec. 6320, 6330]
  14. A final determination denying the taxpayer's claim for a whistleblower award. [Sec. 7623]
  15. A notice of denial of or revocation of passport. [Sec. 7345]

9

SHOULD I FILE IN TAX COURT? PROS VS CONS

- Pros
  - Judge appointed to Court - very knowledgeable on tax issues.
  - No Full Payment First Rule – Notice of Deficiency is ticket to Tax Court.
  - Possible chance to have two bites at the apple to settle.
    1. IRS Appeals.
    2. IRS Trial Counsel.
  - Intended to be informal and less expensive Forum. See *Branerton Corp. v. Commissioner*, 61 T.C 691(1974).

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BRANERTON

Discovery and request for admissions may not be commenced by a party until after that party has made a meaningful, good-faith attempt to attain the Objections of Discovery through informal consultation or communication. The Tax Court is insistent that the parties use informal efforts to obtain needed information for the preparation of the case for trial. The Court expects the parties to discuss, deliberate, and exchange ideas, thoughts, and opinions on an informal basis for resorting to the methods specified in the Tax Court rules. Shortcuts to the use of formal Discovery will not be tolerated. See IRM 35.4.3.2(08-11-2004).

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SHOULD I FILE IN TAX COURT? PROS vs CONS

- <u>Cons</u>
  - Judge appointed to Court – very knowledgeable on tax issues.
  - If able to pay, may go to Federal District Court and have the case tried to a jury.
  - May be limited by Court's jurisdiction:
    - For example, 90 days to file Petition after receiving a Notice of Deficiency. If > 90 days, Tax Court is not an option.

12

FILING A TAX COURT PETITION

- The taxpayer must have a "ticket."
  - Notice of Deficiency
  - Any Notice of Denial listed previously under Tax Court Jurisdiction.
- If no "ticket," Tax Court is not available.

13

THE UNITED STATES TAX COURT RULES OF PRACTICE AND PROCEDURE

- IRC § 7453
  - The proceedings of the United States Tax Court and its divisions shall be conducted in accordance with such rules of practice and procedure (other than rules of evidence) as the Tax Court may prescribe and in accordance with the Federal Rules of Evidence.

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PETITION
TAX COURT RULE 34

- A Petition to the United States Tax Court must contain the information required by the Tax Court rules and must identify the issues presented. If the Petition does not comply with the rules, the case may be dismissed.
  - The specific requirements for a deficiency or a liability action are contained in subsection (b).
  - Petitions and other actions are contained under subheading (c).

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DISCOVERY

- Rule 70(a)
  - The general provisions for discovery are contained in Tax Court Rule 70. Again, the parties must observe the informal requirements of Branerton and Tax Court Rule 70(a) which specifically states, "The Court expects parties to attempt to attain the objectives of discovery through informal consultation or communication before utilizing Discovery procedures provided in these rules."
  - As a practical matter, no Discovery can be initiated in the United States Court until the parties have held a Branerton Conference as mentioned previously.

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TYPES OF DISCOVERY

- Rule 71 – Interrogatories. Limited to 25 written interrogatories.
- Rule 72 – Production of Documents. Unlimited in number.
- Rule 90 – Admissions. Unlimited in number
- Rules 74 – Depositions
  - With consent of the parties.
  - Without consent of the parties if certain circumstances met.
  - Under prior versions of the Rules, a party deposition could not be taken absent consent. No longer the rule!

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STIPULATIONS FOR TRIAL

- Rule 91 - The parties are required to stipulate, to the fullest extent to which complete or qualified agreement can or fairly should be reached, all matters not privileged that are relevant to the pending case, regardless of whether those matters involve fact or opinion or the application of law to fact. Included in matters required to be stipulated are all facts, all documents and papers or contents or aspects thereof, in all evidence that fairly should not be in dispute.
- 91(f) – Noncompliance is subject to judicial review.

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NOTICE SETTING CASE FOR TRIAL

- The Notice issued by the Court setting a case for trial is key to discovery deadlines.
- Rule 70(a)(2) - Discovery may not be commenced, without leave of Court, before the expiration of thirty (30) days after joinder of issue (see Rule 38). Discovery must be completed in the Motion to Compel or any other Motion with respect to that Discovery must be filed, unless the court orders otherwise, no later than 45 days before the date set for call of the case from a trial calendar.
- All procedural deadlines must be walked back from the trial date. For example, formal discovery must be served at least 75 days before trial for you to be able to have discovery responses reviewed by the Court.

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SAMPLE

Notice Setting Case for Trial

The Court's Standing Pre-Trial Order

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SUMMARY JUDGEMENT

- Rule 120 – Judgement on the Pleadings
- Rule 121 – Summary Judgement by Motion
- Rule 122 – Submission without Trial. Judge rules based upon briefing by the parties.
- Rule 123 – Default & Dismissal. Similar to the dreaded State Court DWOP!

  Dismissal for Want of Prosecution.

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PRETRIAL MEMORANDUM

Key Document for the Court. Gives the Court a road-map. There are also consequences if not complete.

Sample

Pretrial Memorandum

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TRIAL

- All Tax Court cases tried before the judge.
  - No Jury.
- Governed by Federal Rules of Evidence. Rule 143.
- Rule 131. Trial calendars.
- Rule 140. Place of Trial.

23

POST-TRIAL BRIEFS

- Rule 151 – Briefs must be filed after trail or submission of a case, except as otherwise directed by the presiding Judge or Special Trial Judge. The presiding Judge or Special Trial Judge may permit or direct the parties to make oral argument or file Memoranda of Points and Authorities, in addition to or in lieu of briefs. The Court may strike any brief that does not conform to the requirements of this rule.
- Rule 152 – Oral Findings of Fact or opinion.
  - In 25 years, I have never seen a Tax Court Judge utilize this Rule.

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PRO SE LITIGANTS

- Majority of litigants in Tax Court are *Pro Se*.
  - The Tax Court website is very taxpayer orientated.
  - Frequently Asked Questions.
  - Sample Petition

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Automated Collection System Updates

By Tiffany Morice

ACS- Automated Collection System

Presented by: Tiffany Morice

1

Text Chat

Voice Bots

Chat Bots

Collection Technology Efforts

2

Voice and Chat Bots

Launched

- Commissioner designated funding to implement Voice Bots and Chat Bots to improve telephone Level of Service and the Taxpayer experience.
- Unauthenticated Chat Bots launched December 2021
- Unauthenticated Voice Bots launched January 2022
- Authenticated Voice Bots launched June 2022
- Voice Bots are software powered by Artificial Intelligence (AI).
- Bots are designed to handle most basic collections concerns. This allows live assistors to work the complex issues.
- Both Voice and Chat Bots have English and Spanish applications to ensure continued services to taxpayers who speak limited English.

Voice bots

Unauthenticated (launched January 2022)

Offered on Accounts Management and Automated Collections Services Toll Free Phone Lines

Option to escalate to an assistor

Assist One-time payments, FAQ, Notice clarification

Authenticated (launched June 2022)

Offered on Accounts Management and Automated Collections Services Toll Free Phone Lines

Establish or modify short term (up to 180 days) and long-term payment plans.

Request transcripts, payment and payoff information

Ability to hear account/payment history and obtain current balance owed.

Text chat

Statistics

- Launched: 2017
- Utilizes a live assistor
- Unauthenticated vs. Authenticated
- Volume: 1,450,548 thru January 2023
- Average wait: 40 seconds
- Average handle: 6:25 (Unauthenticated) / 22:28 (Authenticated)
- Offered while searching IRS.GOV

DUT

Document Upload Tool (DUT)

- The DUT tool is a new way to help Taxpayers more efficiently submit documentation to the IRS
- Once the documents are uploaded into the tool, the phone assistor can see the documents in real-time
- It will not replace eFax
- Rolling out to all Call sites during Q1 and Q2 of FY23
- This program will be scalable in the future

Chat bots now available

Available through IRS.gov

www.irs.gov/payments

www.irs.gov/payments/payment-plans-installment-agreements

www.irs.gov/es/payments (Spanish)

www.irs.gov/es/payments/payment-plans-installment-agreements (Spanish)

Option to escalate to a live assistor

Offered while searching IRS.GOV- added for tax practitioners as well

Help taxpayer make one-time payments, provide FAQ & Notice clarification

If escalated to a live assistor:

- Gives assistors the ability to direct taxpayers to resources on irs.gov with direct hyperlinks and topic numbers.
- Allows live assistors to save resources for both the Service and the Public by directing taxpayers to the correct department before they ever make a phone call.

Voice and Chat Bots

Benefits

- Provide general information to taxpayers through authenticated and unauthenticated voice and digital channels with an emphasis on self-help options for taxpayers to resolve common collection questions without the need to speak with a live telephone assistor.
- Provide responses to taxpayers acting as a customer service “first responder” quickly fulfilling common requests for general information. The bots free up IRS telephone assistors to concentrate on more complex inquiries.
- Improve telephone level of service by satisfying taxpayers’ need to create and manage installment agreements through self-service conversational interactions; avoiding long wait times.
- Shows the IRS is stepping into the future for the benefit of our taxpayers and their representatives.

ACS Phone Assistors

ACS Tool Updates

- ✓ AMS update completed in 2022 which allows CRs to quickly navigate taxpayer accounts.
- ✓ IAT tool updates regularly to improve functionality and resolve errors which helps the call site representative help the taxpayer faster and more accurately with their concerns.
- ✓ Call in lines now have an automatic callback feature so the taxpayer no longer has to wait on the line and will be called back when it's their turn.
- ✓ Conversion to a new phone system was completed smoothly for all call site representatives.

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Questions

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