

Lifecycle of a Federal Tax Controversy

By Chaya Kundra

Chaya Kundra explains the various phases of IRS collections—notice, assessment, penalties, court action—and the options for paying an IRS debt.

Your client has just received an IRS notice that either advises you that (1) he *may* have a balance due; (2) the IRS is set to take collection action on what is owed or (3) your client is being investigated. After you convince your client to breathe again, your next move is to not ignore the IRS.

Like most entities, the IRS is bound by a statute of limitations (SOL). It has three years from the day your client files his return to make an assessment. From the date of the final assessment, the IRS then has 10 years to collect. It is important to keep in mind that currently the collection statute may be extended if your client voluntarily signs a Form 872, files for an Offer in Compromise (OIC), files for bankruptcy or requests a collection due process hearing (CDP). If your client has failed to file a return, the statute never begins to run. Should there be a large balance due or the IRS believes that tax collection is in jeopardy, the IRS may have the U.S. Department of Justice (DOJ) reduce your client's tax lien to a judgment—thus extending his collection statute beyond the 10 years.

Notice of Audit

We will start with the type of notice advising you that your client is under audit. The IRS often restricts itself to three methods of initial contact. The first is an audit letter advising you that your client's return

is under examination and some discrepancies have been found. The issues tend to be limited and are often simpler matters of substantiation and/or inadvertent omissions from your client's return. The notice provides you with 30 days to respond and it behooves you to send your written communicate to the IRS within this time period.

The second type of notice also advises of an examination, but the IRS wants a face-to-face meeting in response to their inquiry. This type of audit is more extensive and usually takes one day or more to conclude. Questions such as unreimbursed employment expenses and other itemized personal expenses listed on Schedule A, Schedule C business and/or Schedule E real estate expenses are often the focus. Here you also need to consider whether or not to bring your client to the audit. Because your client may be nervous or become emotional, it is important to use your best judgment when having him in attendance.

The third and final notice may start with a telephone call from an IRS revenue agent (RA). Even if you have a Power of Attorney (Form 2848) on file, the IRS may contact your client directly. It is important that you educate your client to give the RA your contact information. After initial telephone contact, the RA will quickly follow up with a letter. Instead of making you go to the trouble of bringing your client's records to the IRS, the RA is often happy to come to your office to examine your client's documents. Be mindful that the IRS may insist that the meeting take place at your client's place of business/home. Given the amount of disruption that is likely to ensue, you have a good chance of convincing the IRS otherwise. It is your and the IRS's intention to

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have the audit completed as comprehensively and as quickly as possible.

All audits should all be taken seriously. If your client does not file his return, the IRS may file a substitute for return (SFR) from third-party tax information submitted to the IRS on his behalf. If an SFR is filed, your client should have an opportunity to protest it with the same rights as if he had filed timely; however, without actually filing a return, the SOL never begins to run.

During an audit you are essentially working with two methods of proof.

The first is an issue of substantiation. Here you must produce records that justify the positions your client took on his return. This may include a bank statement analysis explaining whether the funds actually earned were reported; and if not, why. The second is often more legal in nature. The IRS will be questioning whether certain position(s) taken on the client's return are permitted under the Internal Revenue Code and related Treasury Regulations. Again, the RA is not all-knowing—even about taxes. If you or your client were given a tax opinion by an accountant or tax attorney, be sure to keep it on hand. If the position ends up not being accepted by the IRS, or otherwise conceded for resolution purposes, it may still get your client out of a negligence and/or fraud penalty.

Keep in mind that although it may seem to be the case, your auditor is not necessarily “out to get” you or your client. Sometimes she may not know how your client's business or industry functions. Therefore, you should be ready to educate the RA. However, do not be lured into a false sense of security. The government is also looking to see if what you say your client earned actually allows him to live/operate in the manner that seems apparent. Even with representation, it is not uncommon for the IRS to also request a tour of your client's home or office. Be sure to be present for such tours and answer any questions you can for your client. If the audit is of a business, ask that the tour be conducted before or after business hours. Because the IRS often starts work before you do, it may be better to conduct the tour prior to anyone being in the office. You may also want to ask your client to have someone present to open the office for the tour, but be sure to have it be someone who will say as little as possible to the RA as well as the rest of your client's staff.

Criminal Exposure

When your client fails to file a return, or fails to do so within any applicable statute extensions, he exposes himself to criminal penalties for failure to file. As the punishment is a misdemeanor, it carries with it a maximum sentence of one year imprisonment. And yes, the IRS does actually prosecute for this.

Were your client to file false return(s), otherwise fail to properly report income/expenses or be found responsible for failing to pay employment

taxes, he may be subject to felony charges that can result in multiple years of imprisonment. If your client is being investigated or has been indicted and has decided not to plea, he will face a full blown criminal trial before a federal court.

Thus, if your client is visited by an IRS special agent, or is likely to be visited, you must remind him to advise the IRS that he is represented by counsel. Further that the IRS is to contact you before proceeding further. It is often not in your client's best interest to speak to the IRS without you being present. An IRS special agent will identify himself as such and often advise that he is from criminal investigation division. If you are not an attorney, be sure to call one for your client straight away. Ideally the attorney will be experienced in criminal tax matters.

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Assessment

Toward the conclusion of your client's audit, the IRS will generate a revenue agent's report (RAR). This document identifies and delineates the respective positions of your client and the IRS on any outstanding issues as well as interest and penalty recommendations. While the RAR is usually provided toward the end of the audit, you may ask that it be generated during the audit to hone in on the issues. Nonetheless, once your RA has concluded her review, you may seek managerial review of her findings. Doing so gives you an opportunity to present the material to a “fresh” pair of eyes. If you are still not in agreement, the IRS will finalize the RAR memorializing its' position and your client will have 30 days to protest to the IRS Office of Appeals. Doing so affords your client another opportunity to present evidence and

reasons as to the correctness of your client's position. If you and the appeals officer (AO) cannot come to an agreement, then a Statutory Notice of Deficiency (SNOD) is generated affording your client the opportunity to go before the U.S. Tax Court (USTC). You can also decide to by-pass all review and wait for the SNOD. You have ninety 90 days to file your petition with the court—this increases to 120 days if your client is out of the country. Practitioners who have been working controversy cases for years will notice that the turn around time for case resolution has intensified. The IRS is under directives that require quicker resolution which has resulted in taxpayers being afforded shorter response times.

Trust Fund Penalties

If your client were involved in a business, the IRS may assess civil penalties for the extent and period(s) of involvement. Most common of such penalties are the civil trust fund. Such penalties are often assessed by an IRS revenue officer (RO) against person(s) deemed "responsible" for the business' failure to timely file and/or deposit federal payroll taxes. If there are multiple parties involved, the IRS will often conduct Responsible Party Interviews. While there was a time that the IRS would allow the practitioner to provide written answers in lieu of the client, the IRS now requires the taxpayer to be present. You should also be present. The IRS uses the Form 4180 in conducting its interviews. All persons selected for interview are asked the same questions and you may request that the interviews be conducted consecutively and on the same day. It is likely that the IRS will hold the interviews in your conference room. Although not a deposition, if your client brings documents, be prepared to have the IRS ask to see them. Nonetheless, you should plan on the interviews to take quite some time. The IRS will not skip questions and often completes the document by hand.

You also have the option of waiving the interview and having your client agree to the assessment. This may save both time and money, but it also takes away your client's rights to protest the assessment.

Prior to the assessment becoming final, your client may file a protest with the IRS Office of Appeals. Here a hearing will be conducted and you will be given the opportunity to present evidence as to why your client was not a responsible party under Code Sec. 6672.

Collection

When payment remains outstanding with no resolution alternative in place, the IRS will take forced collection action. In doing so, it may file a tax lien, levy/garnish your client's sources of funds, enforce a judgment against your client and/or his business, as well as begin to auction off assets. Such action often occurs when IRS notices for collection go unanswered. With the current climate at the IRS, it is better to respond sooner rather than later.

Today, IRS collection efforts are moving full steam ahead. Depending on the type of tax and the amount owed, your client's case could be sent to a local field office to be worked by a RO. In such situations, the RO will often introduce himself with a letter notifying you of their filing of a federal tax lien or intent to take levy action and advising you of your client's right to protest. It is a good idea to call the RO right away and begin discussing alternatives to full payment. If you are able to work with your client's RO, this is a good place to begin and end. If not, you will need to deal with the RO's manager, and if that does not work, then you will have to find a way to have the case moved to Appeals or the Taxpayer Advocate.

If you are in collections and the IRS had decided to take action that you do not agree with, you may request a collection due process (CDP) hearing, an equivalency hearing and/or a collection appeal request (CAP). If timely filed, the first option will allow for you to have your client's matter considered by an AO. If you do not agree with the AO, you are able to go before the courts on an abuse of discretion claim. An equivalency hearing may be filed at any time. It does not toll the SOL and it does not necessarily stop collection action. It does however move certain tax period(s) before an AO. These two options allow you to present alternatives to forced collection. Until October of this year, employment tax cases filed under an abuse of discretion standard had to be filed before the local federal district court. Now, both income tax and employment tax cases may be heard by the USTC.

A CAP requires certain time restrictions; but does not afford your client the opportunity to go to court. Further, it is often limited to whether or not the IRS followed proper procedure prior to taking the forced collection action.

Going to Court

If your client's balance due is for income tax, you may petition the USTC. This forum is comprised of individuals heavily experienced in tax law. Once you file the petition detailing your protest and what you intend to prove, an attorney with the IRS District Counsel's Office will respond with an Answer. More often than not, you will then be contacted by an independent AO who often has an accounting/legal background. She will discuss the position(s) your client has taken and the possibility of settlement.

During your conversations/negotiations, you may find yourself providing a brief outlining the issues and the cases relied upon. If the matter is resolved prior to trial, the AO will prepare work papers followed by Decision Documents memorializing your joint positions. It is important to review them prior to signing. If the two of you are unable to agree, the matter will be returned to the IRS Attorney assigned to your case.

You may further discuss settlement with the IRS attorney and then you will prepare for court. In preparing for court, the IRS is likely to serve you with a Branerton letter which is the IRS's form of an "informal" discovery request. This document should be read very carefully as the IRS may very well request depositions as well as the documents relied upon by your client in substantiating his position(s).

If your client's balance due concerns employment taxes, or should your client otherwise choose to appear before the U.S. District Court, your opposing counsel will be a civil tax attorney from DOJ. As in most civil cases argued, DOJ will oppose the assignment of a magistrate judge, request that discovery (potentially) and settlement negotiations not begin until after summary judgment motions are decided upon. Additionally, your judge is unlikely to have been a tax lawyer before taking the bench. It will be your job to educate, and if the issue is a novel and/or highly complex one, you may have a lot of work to do.

Payment

Once matters conclude and your client is left with a balance due, he may decide on resolution options.

[I]t is the job of the Taxpayer Advocate's Office (TAO) to assist when there is a breakdown of communication between you and the IRS.

The easiest way is of course to pay in full. This can be negotiated for immediate payment up to 90 days out. You may be afforded even more time, depending upon where your client's case is in the collection cycle. Nonetheless, for every day that there is an outstanding balance due, the IRS assesses interest and potentially penalties. While interest is statutory and seemingly endless, most penalty assessments max-out at 25 percent. Interest however, accrues on the principal tax, penalties and interest. Penalties and

interest are calculated from the day the tax should have been paid until the liability is satisfied in full.

If full payment is not possible, then look to alternatives for your client such as: Currently Non-Collectible status (CNC), bankruptcy, an Offer in Compromise (OIC), installment agreement (IA), an abatement request, a claim for refund or innocent spouse relief.

Currently Non-Collectible stops imminent collection action. You will have to prove that your client's finances make it impossible for him to pay his necessary living expenses, current taxes and repay the IRS at the same time. Because this is a temporary resolution, you will likely hear from the IRS again in a few months time.

Bankruptcy is an option if your client filed his income tax returns sufficiently long ago to render them eligible for discharge. Many taxes such as employment, excise, sales, etc., will survive the bankruptcy if not resolved as part of the estate. Do not be surprised if a client knocks on your door claiming that items were to have been discharged in bankruptcies from long ago and the IRS is still aiming to collect. Depending upon the type and timing of the bankruptcy, potential relief may exist from penalties and interest.

With an *Offer in Compromise (OIC)*, your client has three major alternatives. The first is Doubt as to Collectibility; this is where your client cannot full pay the balance prior to the expiration of the SOL. The second, often termed Effective Tax Administration (ETA) or other "just cause," is where your client's financials might show an ability to pay, but special circumstances exist as to why your client should not full pay. And the third is Doubt as to Liability, where your client does not owe the tax assessed.

Under Doubt as to Collectibility, you offer to satisfy your client's balance due for a smaller sum in full and final settlement. You will have to provide full finan-

cial disclosures and a narrative providing a history as to how your client's circumstances came about and why they will not occur again. In providing this history, you should request that your client describe his circumstances in his own words.

While financials are also required for an ETA, you must essentially demonstrate that it would be unjust to continue to attempt to collect the full tax given your client's current circumstances; *i.e.*, age, infirmity, being duped, *etc.*

Under Doubt as to Liability, you will need to provide a brief detailing why your client does not owe the tax and provide evidence of the same.

It is important to keep in mind that the IRS recently changed its guidelines in accepting OIC for consideration. Please look to these rules prior to submission. Some of the highlights include changes to the filing fee, the percentage down or upfront payment that is required and the submission of all documents that must be included in the financial disclosures. Remember, when submitting an OIC, you must list all outstanding tax periods. And, unless you are filing a Doubt as to Liability offer, when remitting an OIC your client is essentially agreeing that the assessments themselves are correct.

Installment Agreement

Here, your client promises to full pay the IRS in smaller increments over a specific period of time, but before the expiration of the SOL. If less than \$25,000 is owed, the IRS is not likely to require financial information as it would for other types of installment agreements. If full payment prior to the expiration of the collection statute is not an option, you may advise your client to consider a Partial Pay Installment Agreement (PPIA). Under a PPIA, the equity in your client's assets is paid up front and the remainder of what can be paid by your client monthly is remitted over the remaining life of the statute.

Abatement

This option is available when your client is in a position to full pay the principal tax liability and can

offer reasonable cause for not being able to file/pay his taxes timely. You are asking that the penalties and related interest be therefore abated. For interest itself to be abated, you must prove that the IRS performed a managerial or ministerial act to have caused a delay in the resolution of your client's matter.

Claim for Refund

Your client can full pay a portion of the liability and have the matter reconsidered first by the IRS, and if the IRS denies the request, then by the courts. In this case you would start by filing a Form 843.

Innocent Spouse

When filing a joint return, your client and his spouse are held jointly and severably liable. Your client may file a claim for innocent spouse relief when he does not believe that he should be held responsible for payment on the resulting tax. There are a number of hoops that you may have to jump through to prove this to be the case—especially if your client is still married. If you are asked to file for such relief and both the husband and wife request that you represent them, you may want to think twice about this decision. It may be in everyone's best interest that you refer the spouse to alternate tax counsel.

Regardless of the resolution option selected, it is very important that you keep the SOL in mind as it will continue to impact the viability of your client's choice(s).

Finally, it is the job of the Taxpayer Advocate's Office (TAO) to assist when there is a breakdown of communication between you and the IRS. You are to exhaust your client's administrative remedies prior to contacting the TAO. And the TAO may be contacted directly if your client is about to face an imminent hardship based on an IRS action. If you are on a strict timeline, you may want to consider the CAP as it may take the TAO longer than 48 hours to respond.

For further information on the issues discussed herein, please feel free to consult the IRS website at www.irs.gov.

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