

**DANCING WITH A GRIZZLY BEAR:  
STRATEGIES IN DEALING WITH THE IRS**

**Presented by**

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## **I. BUILDING YOUR FORTRESS UPON A STRONG FOUNDATION: PROTECTING VS. DESTROYING YOUR DEFENSES ON AUDIT.**

- A. Conduct the Audit with Litigation in Mind.** Immediately after receiving the notice of audit, the advocate should begin developing his or her overall strategy:
1. Classify the issues and where they are best resolved; audit, appeals, or trial.
  2. Narrow the issues when possible and, by all means, rarely telegraph the existence of issues or assume they will necessarily be identified.
  3. Keep alive trade-off issues once identified.
  4. Absent a need to shift the burden of proof under Section 7491, resist the government's efforts to explore facts that relate to an issue on which either the IRS or the particular agent is predisposed. Why help your adversary hurt your client?
  5. Educate the agent on the facts favorable to your case and assist him in writing his report (thereby laying the foundation for later obtaining an admission in either the Answer, Request for Admissions, or Stipulation).
  6. Preserve your opponent's error until the most advantageous moment for disclosure. Remember that audit is generally about defense and trial is generally about offense.
  7. Avoid inadvertent or irresponsible admissions by you or your client (an increased threat under the Service's new emphasis on taxpayer interviews, conduct of the audit at the taxpayer's place of business, and requirement of more detailed Protests).
  8. Remain ever sensitive to statute of limitations and other time pressures.
  9. Select, where possible, the issues you want to litigate via Form 870 planning or otherwise.
  10. In order to shift the burden of proof under Section 7491(a), document cooperation but cooperation does not mean waiving privileges, limitations periods, or other rights that protect taxpayers.

**B. Know the Hot Issues and Techniques at the IRS.** With respect to individuals and small businesses, the IRS has recently been focusing on the following items and techniques, among others:

1. Unreported income – direct and indirect methods of proof.
2. Tours of business operations, including multiple locations.
3. Requests for taxpayer interviews.
4. Loss of limitations such as passive, hobby, at risk, etc.
5. Business use of planes.
6. Accounting methods such as repair and maintenance practices.
7. Executive compensation, particularly in S corporations.
8. Business use of cars or trucks.
9. Club dues and contemporaneous documentation.
10. Payroll tax reporting and treatment of fringe benefits.

**C. The “Rules of Engagement” during Audit Within Context of IRS “Quality Examination Process.”**

1. Where are the “Rules of Engagement” found? IRM § 4.51.1
2. Do the rules only apply beyond LB&I cases?
3. How do the rules function and what should the taxpayer do if the Agent violates the rules?
4. Purpose of the Rules of Engagement.
  - (a) Clarify roles, responsibilities, and lines of authority to ensure accountability and effectively manage audit interactions
  - (b) Facilitate getting the right answer for a particular issue
  - (c) Promote consistency among similarly-situated taxpayers
  - (d) Reinforce the importance of integrity and ethical behavior

5. Applicability of the Rules of Engagement.
  - (a) Theoretically only applies to LMSB / LB&I
  - (b) Use of modified Rules of Engagement for SB/SE cases
6. Establishing the Audit Plan
  - (a) What items should be addressed in the audit plan?
  - (b) What are reasonable time limits for the plan?
  - (c) What should a party do if the other party violates the plan?
7. Leadership Roles within the IRS Audit Teams
  - (a) Revenue Agent
  - (b) Team Manager
  - (c) Technical Advisor
  - (d) Territory Manager
  - (e) Director Field Operations
  - (f) Industry Director
  - (g) Commissioner / Deputy
8. Criteria for Elevating Issues within the IRS
  - (a) Dispute within IRS audit teams
  - (b) Dispute between IRS team and taxpayer
  - (c) Need for specialized expertise
  - (d) Involves a precedent-setting issue
  - (e) Lack of published guidance on a particular issue
  - (f) Question about consistency of treatment within industry

**D. Who Should and Should Not Handle The Audit?**

1. The taxpayer who represents himself has a fool for a client.
2. Upon the first hint that anything may be construed as some form of fraud or misrepresentation by the taxpayer, everything must stop immediately, a lawyer who handles criminal tax defense needs to be hired, and a *Kovel* agreement executed between the taxpayer, the lawyer, and the accountant to extend the attorney-client privilege to any incriminating discussions. May need to bring in forensic accountant.
3. If at all possible, avoid any contact between the taxpayer (who will not be prepared to handle surprise issues) and the agent (who may have been given a host of lies from a disgruntled employer or other informant, undisclosed banking information, etc.).
4. Section 7521(c) grants the representative the right to handle any interview without the taxpayer present, absent a summons:

(c) REPRESENTATIVES HOLDING POWER OF ATTORNEY. – Any attorney, certified public accountant, enrolled actuary, or any other person permitted to represent the taxpayer before the Internal Revenue Service who is not disbarred or suspended from practice before the Internal Revenue Service and who has a written power of attorney executed by the taxpayer may be authorized by such taxpayer to represent the taxpayer in any interview described in subsection(a). *An officer or employee of the Internal Revenue Service may not require a taxpayer to accompany the representative in the absence of an administrative summons issued to the taxpayer under subchapter A of chapter 78. Such an officer or employee, with the consent of the immediate supervisor of such officer or employee, may notify the taxpayer directly that such officer or employee believes such representative is responsible for unreasonable delay or hindrance of an Internal Revenue Service examination or investigation of the taxpayer.*

5. Generally, a CPA, not a lawyer, should handle the face-to-face audit, unless it is an estate or gift tax audit where legal issues predominate. In that instance, a lawyer should represent the taxpayer in the audit by the IRS Estate & Gift Tax Attorney should be handled by a lawyer.
6. In large cases, cases likely to go to litigation, and “egg-shell” audits, a lawyer needs to be engaged early, stay in the back ground, and help develop a strategy.

**E. First Meeting**

1. Preparation by the taxpayer’s representative” previously discussed foundation.
  - (a) Even before receiving an audit notice, you should consider “pressure testing” returns for larger clients from time to time under the IRS Industry-Specific Audit Guidelines and preparing an “Audit Ready” file on the more significant issues.
  - (b) Beyond that conduct, follow the “pre-audit audit” outlined in the foundation section with an eye on the potential information that a well prepared agent may have.
2. Preparation by IRS agent will likely include all information related filings with the IRS and public property, SEC, and similar filings. It may also include internet searches and credit base searches, as well as informants, information from competitors, foreign bank treaty disclosures, and the like.
3. IN LB&I cases, tie down QEP Risk Analysis, Rules of Engagement, etc.
4. In SBSE cases, ask about QEP and Rules of Engagement equivalents, as well as asking for any Form 1099 or other income information that taxpayer or her accountant may have overlooked.
5. Be prepared for sweeping questions regarding any known omitted income, overstated deductions, shelter activity, and foreign bank accounts.

**F. IDRs, Summonses, Privileges, and Objections.**

1. Unlike summonses, Information Document Requests (IDRs) have no statutory authorization beyond the general power bestowed upon the Secretary to examine returns.
2. Timely responses to IDRs, however, help establish cooperation and generally foreclose the issuance of a summons.
3. A new IRS program will dramatically increase the number of summonses.
4. While the IRS wins the overwhelming majority of summons fights, the *Powell* doctrine generally imposes four conjunctive requirements before a summons can be enforced:
  - (a) The IRS issued purpose (*i.e.*, not harassment, force consent to limitations extension, etc.);
  - (b) The information sought is relevant to an existing examination;
  - (c) All administrative and statutory procedures have been satisfied; and
  - (d) The information is not already in the possession of the IRS. *United States v. Powell*, 379 U.S. 48, 57-58 (1964).
5. Additionally, normal discovery objections apply such as overly broad, unduly burdensome, vague, inadequate time to comply, and lack of possession, custody, and control.
6. Also, the IRS cannot force a taxpayer to create a new document or translate an old one (where means of translation are available in the community).
7. Special restrictions apply to third-party record keeper summonses and “John Doe” summonses (which seek the identity of persons who are unknown but believed to be violating the Internal Revenue Code).
8. The IRS cannot compel taxpayers to waive privileges, though any conduct by the taxpayer OR HIS REPRESENTATIVE which is inconsistent with the maintenance of the privilege can operate as a waiver.

9. The most common privileges include.
- (a) Section 7525 tax practitioner privileges
  - (b) Attorney-client privilege
  - (c) Attorney work product protection
  - (d) Fifth Amendment right against self-incrimination (generally viewed by the IRS as a confession of guilt)
  - (e) Spousal privilege
  - (f) Priest-penitent privilege
  - (g) Doctor-patient privilege
10. Accountant/Client Privilege Issues.
- (a) Protection for Certain Tax Practitioner Communications. Section 7525(a)(1) extends the same common law attorney-client protection of confidentiality to any communication between a taxpayer and any “federally authorized tax practitioner” that would have been privileged if it were a communication between a taxpayer and an attorney.
  - (b) Matters Covered. The privilege may be asserted only in:
    - \* Non-criminal tax matters before the Internal Revenue Service; and
    - \* Any non-criminal tax proceeding in federal court brought by or against the United States.
  - (c) Federally Authorized Tax Practitioner. The term “federally authorized tax practitioner” means any individual who is authorized to practice before the IRS if such practice is subject to federal regulation under 31 U.S.C. § 330. In other words, the phrase includes CPAs, enrolled agents, and enrolled actuaries.
  - (d) Tax Advice. The term “tax advice” means any advice given within the scope of the individual’s authority to practice before the IRS. In other words, it includes tax advice and tax representation.

(e) Obvious Limitations of Section 7525.

- (i) Uncovered Return Preparers. By its terms, new Section 7525 is applicable only to communications between a taxpayer and a “federally authorized tax practitioner.” This phrase includes CPAs, enrolled agents, and enrolled actuaries. Other accountants, bookkeepers, and possibly agents of otherwise qualified federally authorized tax practitioners do not appear to be included.
- (ii) State, Local & Foreign Tax Matters. The phrase “tax advice” is defined with reference to practice before the Internal Revenue Service or in a proceeding before a federal court.

Query: Are state and foreign tax matters automatically excluded by this definition?

The new provisions apparently do not cover state court foreclosure actions where one issue might be the priority of the federal tax lien.

(f) Non-Criminal Only. The extension of privilege to “any non-criminal tax proceeding in Federal Court brought by or against the United States” in Section 7525(a)(2)(B) was inserted by the Senate (or the conference committee) and was designed to be broader than the House version, which had only covered tax litigation.

- (i) Criminal Matters Excluded. The statute appears to be specifically inapplicable in criminal proceedings before the Internal Revenue Service and in criminal proceedings in a Federal Court. (However, see the discussion below regarding the dividing line between civil and criminal matters.)
- (ii) Bankruptcy Covered? Bankruptcy is not a non-criminal federal court matter “by or against the United States” until an adversary proceeding is filed. Does the new provision cover all bankruptcy cases in which the United States is a party, or just cases in which a determination of tax liability is involved?
- (iii) Result. As a practical matter, the §7525 privilege disappears when a client’s freedom is in jeopardy—in the criminal tax arena.

- (g) Tax Return Preparation Not Covered. The privilege for tax advice is the same as if the professional were an attorney. This means, among other things, that the privilege does not attach to the preparation of tax returns or to other areas where a communication ordinarily would not be privileged if made to an attorney. Federal courts have denied attorney-client privilege to tax return preparation work on different grounds.
- (i) Not Legal Advice? Some courts have held that the preparation of tax returns is not legal advice. *See United States v. Davis*, 636 F.2d 1028 (5th Cir. Unit A), *cert denied*, 454 U.S. 862 (1981); *United States v. Gurtner*, 474 F.2d 297 (9th Cir. 1973); *Canaday v. United States*, 354 F.2d 849 (8th Cir. 1966). *In re Grand Jury Investigation (Schroeder)*, 842 F.2d 1223 (11th Cir. 1987).
- (ii) Not Confidential? Some courts acknowledge an element of legal advice in the preparation of returns, but deny privilege based on a lack of expectation of confidentiality or a waiver. *United States v. Lawless*, 709 F.2d 485 (7th Cir. 1983) (no expectation of confidentiality in information to be included on return); *Dorokee Co. v. United States*, 697 F.2d 277 (10th Cir. 1983); *United States v. Cote*, 456 F.2d 142 (8th Cir. 1972) (disclosure waives privilege not only as to disclosed data but also as to details underlying the information on the return); *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984) (waiver by inclusion on return).
- (iii) Contrary Position. *But see Colton v. United States*, 306 F.2d 633, 637 (2d Cir. 1962) (“There can, of course, be no question that the giving of tax advice and the preparation of tax returns \* \* \* are basically matters sufficiently within the professional competence of an attorney to make them prima facie subject to the attorney-client privilege.”) *United States v. Abrahams*, 90-1 U.S.T.C. §50,310 (9th Cir. 1990) (“Although communications made solely for tax preparation are not privileged, communications made to acquire legal advice about what to claim on tax returns may be privileged.”)

(h) Civil v. Criminal. The inapplicability of the privilege in “criminal matters” will require a determination of when an otherwise civil tax dispute becomes a criminal matter. Often an agent has made a determination to refer a matter to the Criminal Investigation Division but continues to work on the case until formal referral is made. A practitioner advising a client in this circumstance will be at risk to reveal communications that occur after the matter becomes “criminal.”

(i) The *LaSalle National Bank* Issue Again. Special agents have duties to investigate both criminal and civil liabilities. Is it automatically a criminal matter if a special agent is involved? The Supreme Court defined in *LaSalle National Bank* that a matter is not criminal until there has been an institutional referral to the Department of Justice, which standard was adopted in Code § 7602(c). *United States v. LaSalle National Bank*, 437 U.S. 298 (1978).

(ii) Reinstatement of Privilege? Assume a criminal investigation was commenced, the practitioner was forced to disgorge otherwise privileged information, and now the criminal case has been killed. Does the privilege reinstate itself?

(iii) Business Advice v. Tax Advice. Section 7525 is also limited to “tax advice.” The “gray area” dividing business advice and tax advice is still being debated by the courts in traditional attorney-client cases. Further confusion likely will develop in interpreting this new statute.

11. Recommendations to Seek to Bolster *Kovel* Accountant Privileges. Certain safeguards should be followed to ensure that the attorney-client privilege or the work product doctrine applies as fully as possible.

(a) Burden. The party asserting the attorney-client or work product privilege has the burden of sustaining the privilege.

That burden cannot be discharged by a blanket claim of privilege.

Instead, the claimant must produce sufficient evidence to establish privilege for each item for which it is claimed.

- (b) Documentation. Take care to document the commencement of the attorney-client privilege. A well-thought-out engagement letter certainly will help.
- (c) Avoid Multiple Roles. To the extent possible, try to avoid situations in which a professional must fulfill multiple roles.

Where finances or other circumstances make multiple professionals impractical, try to delineate when a professional acts as counsel (or as an adjunct to counsel) by having a separate engagement letter.

If the issue is particularly sensitive, the consultant and examination representative should be different from the return preparer.

- (d) Execute a Contract. Use a Kovel contract between the attorney and the consultant. Make sure it says that the consultant is being retained to assist the attorney's rendition of legal services to the client, that the consultant will work under the direction and control of the attorney, that the consultant is expected to keep all information obtained from the client or his agents confidential, and that all consultant workpapers are the property of the attorney.
- (e) Protect Work Product. Document the commencement of the "specific claim" which gives rise to a work product privilege. Actual litigation need not have commenced, nor need an attorney have been hired.

**G. Know Your Opponent's Case.** As the administrative efforts are drawing to an unresolved close, obtain as much information as possible about the government's case:

1. Hold an informal conference with agent and supervisor.
2. Request the IRS files under the Freedom of Information Act (FOIA) and Privacy Act.
  - (a) Where the type of tax involved (*i.e.*, income, estate, gift and certain other specified taxes) is subject to the deficiency procedures of the Code, the FOIA request should generally be made shortly after the issuance of the statutory notice of deficiency.

- (b) Should require production prior to filing of Petition in Tax Court or Claims Court or complaint in Federal District Court. Otherwise, Service will argue that taxpayer must rely on judicial discovery (*i.e.*, two-edged discovery) rather than one-edged FOIA discovery.
- (c) FOIA Request during the audit will offend the agent who is accustomed to one-edged discovery in his or her favor.
- (d) Under the FOIA, the Service has ten days to respond to formal Request but the IRS Disclosure Office is typically forced to ask for a thirty-day extension. Taxpayer should always agree to the extension absent some extraordinary circumstances such as refusal by the Service to waive its "judicial discovery" objection.
- (e) Service may raise a number of objections to formal request such as disclosure may jeopardize tax investigation, governmental privilege against disclosure of internal thought processes, Section 6103 violation, etc.
- (f) Nonetheless, IRS must produce partially privileged documents, albeit in redacted form, and should produce a *Vaughn* list itemizing the documents withheld and the claimed exemptions.

## **I. TEFRA Partnership Procedures**

1. Since 1982, audits of partnerships (involving more than 10 individual partners or any entity partners) have been subject to the TEFRA Unified Partnership Procedures.
2. Generally, those procedures require that all partnership items (and penalties relating to partnership items) must be determined in a single partnership proceeding under Sections 6221 and 6226(f). At the conclusion of that proceeding, the IRS can assess any resulting taxes by way of a Computational Adjustment under Section 6230(a)(8) – unless a partner-level “affected item” proceeding is needed to resolve partner-level fact questions.
3. The TEFRA Rules are horribly complex, not necessarily logical, and require special knowledge to serve opportunities and avoid pitfalls. *See United States v. Home Concrete and Supply, LLC*, 132 S. Ct. 1836 (2012); *Jade Trading, LLC v. United States*, 598 F.3d 1372 (Fed. Cir. 2010); and *Tigers Eye Trading, LLC v. Commissioner*, 138 T.C. No. 6 (2012), *on appeal*, D.C. Cir., Docket No. 12-1148.

## **II. WINNING YOUR CASE WITHOUT A WAR: APPEALS**

### **A. Carefully Decide When and If to Go to the Appellate Division.**

1. Except in rare situations, you will always have at least one opportunity to settle your case with the IRS Appellate Division.
  - (a) Pre-Petition Protest Route
    - (i) Why and when should you go pre-Petition?
    - (ii) What should the Formal Protest contain?
    - (iii) What is the IRS policy about returning cases to Exam?
  - (b) Post-Petition Protest Route
    - (i) Why and when should you go post-Petition?
    - (ii) Does a different dynamic exist if the case is docketed?
  - (c) What is the negotiation process, pre-petition and post-petition?
    - (i) What is the mission of the Appeals office?
    - (ii) How does the taxpayer introduce its position?
    - (iii) Who makes the first settlement offer?
    - (iv) How do you bridge the gap?
2. You should always pursue this opportunity. Focusing primarily on "hazards of litigation," the Appellate Division reaches compromises on approximately 85% of its cases and it is rare indeed that a case, handled properly, does not present some litigation hazards for the government.
3. The tough issue lies in whether you go directly to Appeals by protesting the Revenue Agent's Report, or wait until after (i) you petition the Tax Court or (ii) you file a claim for refund following expiration of the limitations period on the assessment of additional taxes.
  - (a) The beast that will not die from the taxpayer's perspective, the worst thing that can happen in terms of delay and expense is for Appeals to "send the case back" to Exam.

- (i) That threat generally only arises when the taxpayer files a protest because the Tax Court imposes time limitations that will not tolerate those sorts of delays.
  - (ii) The threat is heightened by the current struggle between Exam and Appeals over Exam's position that the case MUST be sent back to Exam whenever ANY new information is provided.
  - (iii) Often, the ultimate response by Exam can take six to twelve months and result in a response that merely restates the position in the RAR.
- (b) In theory, Appeals has a policy against raising "new issues" because to do so reduces Appeals to "Exam II" and discourages taxpayers from using Appeals. In practice, new issues arise directly or indirectly in discussions with some regularity. Under Appeals Guidelines, Appeals should not raise new issues unless they are substantial and the outcome is fairly certain.
- (c) The exposure in filing a Protest is that any new issues raised by the Appellate Conferee can be included in the Notice of Deficiency. While the Appellate Division does not often raise new issues, the results are severe when it does:
- (i) The taxpayer must contest a higher amount of tax than he would have if he had properly timed a claim for refund.
  - (ii) The taxpayer who intends to go to Tax Court now must bear the burden of persuasion on that issue – a burden which would have been imposed upon the government had the taxpayer filed a Petition in Tax Court first. Indeed, under the Service's internal procedures, only the clearest and strongest of "new issues" may be raised after the case is in court. In short, a new issue may be raised by Appeals in a pre-petition case that, even if discovered, would never be raised by Appeals in a post-petition case.

Consequently, your ability to negotiate forcefully may well be undermined. Moreover, there could conceivably be malpractice consequences for unreasonably assuming this added exposure.

- (d) On the other hand, the IRS has unsuccessfully raised at least two potential adverse consequences in response to "bypassing" appeals on the front-end:
- (i) To the extent that the strength of your case is sufficient to justify imposing your litigation costs upon the IRS (*i.e.*, after substantially prevailing, you are able to establish that the position of the United States was not substantially justified), Sections 7430(b)(1) and (a) may bar your collection of costs. The government will likely argue that (i) you failed to "exhaust the administrative remedies available" to you and/or (ii) you have therefore "unreasonably protracted such proceeding." You, of course, would argue (i) Section 7430 does not say that you must exhaust your administrative remedies before you file suit; (ii) your timing is relevant, if at all, only to the reasonableness of the costs; and (iii) the remedy was meaningless as evidenced by the fact that the IRS refused to settle/concede a position that was not substantially justified.
  - (ii) The IRS can assert the \$5,000 penalty provided by Section 6673 for "Instituting Proceedings Before the Tax Court Primarily for Delay, Etc." As amended by the 1986 Tax Reform Act, that section provides:

Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay, that the taxpayer's position in such proceedings is frivolous or groundless, or that the taxpayer unreasonably failed to pursue available administrative remedies, damages in an amount not in excess of \$5,000 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as a part of the tax.

Note that only the unreasonable failure to pursue available administrative remedies is punishable. The taxpayer should argue reasonableness in addition to the three points previously mentioned. Where the penalty is asserted, the IRS will likely argue the converse and that, in contrast to Section 7430, Section 6673 does contemplate that the "exhaustion" should occur prior to the "institution" of the litigation. This latter argument is grammatically flawed and has been rejected by the Tax Court.

- (iii) Cure.
  - a. Whether you intend to file suit in either District Court or the Court of Federal Claims, agree to pay the amount set forth in the examination report, file a claim for refund after the limitations period for assessment of additional deficiencies has expired but before the two-year anniversary of your payment, and request a pre-litigation Appellate Conference upon the disallowance of your claim.
  - b. When you intend to file suit in the Tax Court, the more aggressive approach is to recognize, where appropriate, that: (i) the prospects of the Court now refusing to grant costs because of the timing of the Appeals Conference pale in comparison to the risk of raising new issues; and (ii) the Section 6673 penalty was designed for "failure to provide the Service with substantiation" cases and is not likely to be imposed in cases involving legitimate disputes over the facts or the law. In short, petition the Court first.

**B. IRS Appeals Office: Ex Parte Communications Between Appeals and Other Internal Revenue Service Employees.**

1. An “ex parte communication” is a communication that takes place between any Appeals employee (e.g., Appeals Officers, Settlement Officers, Appeals Team Case Leaders, Appeals Tax Computation Specialists) and employees of other IRS functions, without the taxpayer/representative being given an opportunity to participate in the communication. (Rev. Proc. 2012-18).
2. Ex parte communications between Appeals employees and Exam employees are prohibited to the extent the communications appear to compromise Appeals’ independence
3. Appeals will not participate in:
  - (a) IRS meetings discussing specific taxpayer cases, including
    - (i) accuracy of facts presented by the taxpayer and the relative importance of the facts to the determination.
    - (ii) Discussions of the relative merits or alternative legal interpretations of authorities cited in a protest or in a report prepared by the Exam Agent.
    - (iii) Discussions of Exam Agent’s perception of the demeanor or credibility of the taxpayer or taxpayer’s representative.
    - (iv) Discussions regarding the Exam Agent’s views concerning the strengths and weaknesses of the case or the parties’ positions in the case.
    - (v) Communications from the Exam officer to advocate for a particular result or to object to a potential resolution of the case or an issue in the case.
  - (b) Development or review of audit techniques.
  - (c) Development or review of coordinated issue papers.
  - (d) Development or review of technical guidance for Compliance or Counsel in cross-functional settings.
  - (e) Identification or development of specific issues or cases in cross-functional settings.
  - (f) Identification of cases for litigation.

4. The term “ex parte communication” does not include the following (not an exhaustive list):
  - (a) Database Inquiries – Inquiries conducted in an electronic environment are not considered communications because they do not involve a dialogue or interaction between two or more individuals.
  - (b) Communications Solely Between or Among Appeals Employees.
  - (c) Communications in Which the Taxpayer/Representative Is Given an Opportunity to Participate but chooses not to participate.
    - (i) For oral communications, the taxpayer/representative will be given a reasonable opportunity to attend a meeting or be a participant in a conference call between Appeals and the originating function when the strengths and weaknesses of the facts, issues, or positions in the taxpayer’s case are discussed.
    - (ii) A taxpayer/representative is considered to have been given an “opportunity to participate” with respect to a written communication that is received by Appeals if the taxpayer/representative is furnished a copy of the written communication and given a chance to respond to it either orally or in writing.
    - (iii) If the taxpayer/representative is unable to participate in the meeting or conference call at the scheduled time, reasonable accommodations will be made to reschedule it
  - (d) Communications with IRS Functions Other than Originating Functions.
5. Most breaches of the ex parte communication rules may be cured by timely notifying the taxpayer/representative of the situation, sharing the communication or information in question, and affording the taxpayer/representative a reasonable period of time within which to respond. The specific administrative remedy that may be made available in any particular case is within the sole discretion of Appeals

6. Communications between Appeals and an Exam Agent regarding ministerial, administrative, or procedural matters during any stage of a case are permissible without involving the taxpayer/representative.
7. The same rules apply to discussions between Appeals Officers and other IRS employees in the Collection function, such as CDP appeals, collection appeals program cases, offers in compromise, and trust fund recovery penalty cases.
8. The ex parte communication rules do not apply to communications in connection with Post-Appeals Mediation proceedings.
9. Appeals Officers are entitled to obtain legal advice from attorneys in the Chief Counsel's Office, but they are not bound by the advice received.
  - (a) Appeals employees should not communicate ex parte regarding an issue in a case pending before them with a field attorney if the field attorney personally provided legal advice regarding the same issue in the same case to the Exam Agent or personally served as an advocate for the Exam Agent regarding the same issue in the same case.
10. The ex parte communication rules do not apply to communications between Appeals and Chief Counsel in connection with cases docketed in the United States Tax Court.
  - (a) Communications between Appeals and Exam in docketed cases are still subject to the ex parte communication rules if the case is within Appeals' settlement jurisdiction.

**C. IRS Appeals Office: Alternative Dispute Resolution.** As part of the Restructuring and Reform Act of 1998, Congress directed the IRS to develop alternative dispute resolution procedures. Thus, section 7123(b) now mandates:

SEC. 7123(b). Alternative Dispute Resolution Procedures.—

(1) Mediation.—The Secretary shall prescribe procedures under which a taxpayer or the Internal Revenue Service Office of Appeals may request non-binding mediation on any issue unresolved at the conclusion of

(A) appeals procedures; \* \* \*

The IRS developed procedures whereby a taxpayer can request mediation of factual and legal issues after settlement discussions with the Appeals Office have proved unsuccessful. Rev. Proc. 2002-44, 2002-2 C.B. 10.

1. Mediation Procedures:
  - (a) Rev. Proc. 2002-44 establishes the Appeals mediation procedure. Mediation is a nonbinding process that uses the services of a mediator, as a neutral third party, to help Appeals and the taxpayer reach their own negotiated settlement. The mediators can include a non-IRS co-mediator. The mediator will act as a facilitator, assist in defining the issues, and promote settlement negotiations between Appeals and the taxpayer. The mediator will not have settlement authority in the mediation process and will not render a decision regarding any issue in dispute. The mediator should inform and discuss with Appeals and the taxpayer the rules and procedures concerning the mediation process. The Service previously allowed taxpayers to request mediation for factual issues involving an adjustment of \$1 million or more that were already in the Appeals administrative process. *See* Announcements 98-99 and 2001-9.
  - (b) Significant changes to Announcements 98-99 and 2001-9 made by Rev. Proc. 2002-44 include:
    - (i) Mediation is no longer limited to issues involving an adjustment of \$1 million or more;
    - (ii) Legal issues are now eligible for mediation;
    - (iii) Industry Specialization Program (ISP) issues and Appeals coordinated Issues (ACI) are now eligible for mediation;
    - (iv) Mediation is now available for an issue for which the taxpayer intends to seek competent authority assistance;
    - (v) Mediation is now available after unsuccessful attempts to enter into a closing agreement under § 7121;
    - (vi) Collection cases are excluded from mediation;
    - (vii) Issues for which mediation would not be consistent with sound tax administration are excluded from mediation;
    - (viii) Frivolous issues are excluded from mediation; and

- (ix) Cases where the taxpayer did not act in good faith during settlement negotiations are excluded from mediation.
- (c) The taxpayer seeks approval for mediation by sending a written request to the appropriate appeals Team Manager. The taxpayer should also send a copy of the written request to the appropriate Appeals Area Director and to the Chief Appeals, 1099 14th Street, N.W., Suite 4200 – East, Washington, DC 20005, Attn: Appeals LBSP Operations. Generally the Appeals Team Manager will respond to the taxpayer and the Team Case Leader or Appeals Officer within two weeks after the Appeals Team Manager receives the taxpayer's request for mediation.
- (d) If Appeals approves the mediation request, the Appeals Team Manager will inform the taxpayer and the Team Case Leader or Appeals Officer, and schedule a conference or conference call that may include a representative from Appeals LBSP Operations, Headquarters Appeals – to discuss the mediation process. Although no formal appeal procedure exists for the denial of a mediation request, a taxpayer may request a conference with the Appeals Team Manager to discuss the denial. The denial of a mediation request is not subject to judicial review.
- (e) The taxpayer and Appeals will enter into a written agreement to mediate.
- (f) The taxpayer and the Appeals Team Manager will select the mediator. This mediation procedure requires the use of an Appeals employee who is a trained mediator. Headquarters Appeals will pay the expenses associated with the Appeals mediator. The taxpayer may also elect to use a non-Internal Revenue Service co-mediator, at the taxpayer's expense.
- (g) To ensure that one party is not in a position to exert undue influence on the mediator, there will be no *ex parte* contacts with the mediator outside the mediation session.

## 2. Arbitration Procedures.

- (a) Rev. Proc. 2006-44, 2006-44 I.R.B. 800 formally establishes the Appeals arbitration program, which is designed to improve tax administration, provide customer service, and reduce taxpayer burden. Arbitration is available for cases within Appeals jurisdiction that meet the

operation requirements of the program. Generally, this program is available for cases in which a limited number of factual issues remain unresolved following settlement discussions in Appeals.

- (b) The arbitration procedure may be used to resolve issues while a case is in Appeals, after settlement discussions are unsuccessful and, generally, when all other issues are resolved but for the specific factual issue(s) for which arbitration is being requested. The arbitration procedure does not create any special authority for settlement by Appeals.
- (c) Arbitration is available:
  - (i) Only for factual issues;
  - (ii) For factual issues for which a request for competent authority assistance has not yet been filed;
  - (iii) For factual issues unresolved at the conclusion of unsuccessful attempts to enter into a closing agreement under I.R.C. § 7121.
- (d) Arbitration will not be available for:
  - (i) Legal issues;
  - (ii) Cases in which arbitration is not appropriate under either 5 U.S.C. § 572 or 5 U.S.C. § 575, which provide the general authority and guidelines for the use of alternative of dispute resolution in the administrative process;
  - (iii) Issues docketed in any court;
  - (iv) Issues in a taxpayer's case designated for litigation;
  - (v) Compliance Coordinated (formerly Industry Specialization Program) Issues (CCI) or Appeals Coordinated Issues (ACI);
  - (vi) Issues for which a request for competent authority assistance has been filed under the provisions of Rev. Proc. 2002-52, or any successor guidance, including issues in cases submitted to the competent authority under the simultaneous appeals procedure;

- (vii) Collection cases, except for those involving: (i) an unsuccessful attempt to enter into a compromise under I.R.C. § 7122; and (ii) trust fund recovery penalty (TFRP) cases that involve whether a person: (a) was required to collect, truthfully account for, and pay over income, employment, or excise taxes; (b) was willful in attempting in any manner to evade or defeat any aforementioned tax or the payment thereof; and (c) is liable for the TFRP under I.R.C. § 6672; as provided for in any subsequent guidance issued by the Service;
  - (viii) Issues for which arbitration would not be consistent with sound tax administration, *e.g.*, issues governed by closing agreements, by *res judicata*, or controlling Supreme Court precedent;
  - (ix) “Whipsaw” issues, *i.e.*, issues for which resolution with respect to one party might result in inconsistent treatment in the absence of the participation of another party;
  - (x) Frivolous issues, such as, but not limited to, those identified in Rev. Proc. 2001-41, 2001-2 C.B. 173, which defines frivolous issues and sets forth the Service's policy against making technical rulings on such issues;
  - (xi) Cases in which the taxpayer did not act in good faith during Appeals settlement negotiations, *e.g.*, failure to respond to document requests, failure to respond timely to offers to settle, failure to address arguments and precedents raised by Appeals; or
  - (xii) Issues that have been otherwise identified as excluded from the arbitration program.
- (e) Arbitration is optional for both the taxpayer and Appeals. A taxpayer may submit a request to arbitrate by sending a written request to the appropriate Appeals Team Manager and a copy to the Chief, Appeals, 1099 14<sup>th</sup> Street, NW, Suite 4200 East, Washington, DC 20005, Attn: Office of Tax Policy and Procedure.
  - (f) Upon approval of the request to arbitrate, the Parties will enter into a written agreement to arbitrate. *See* Exhibit 1 of this revenue procedure for a model agreement to arbitrate.

- (g) Generally, no later than thirty (30) days after completion of the arbitration proceeding, the Arbitrator will prepare a written report and submit a copy to the Administrator. Because the Arbitrator is limited to the task of finding facts, the report will not provide any decision or reasoning that represents an interpretation of the law. Neither Party may appeal the decision of the Arbitrator or contest the decision in any judicial proceeding, including, but not limited to, the Tax Court, United States Court of Federal Claims or a federal district or appellate court. Once the Arbitrator renders a decision on all or some issues through the arbitration process, Appeals will use established procedures to close the case, including preparation of a specific matters closing agreement (Form 906).

3. Accelerated Issue Resolution (AIR)

- (a) Designed to expeditiously resolve examination issues in coordinated industry cases that are the same or similar to issues resolved by Appeals for other tax years. Rev. Proc. 94-67.
- (b) The taxpayer initiates the process by submitting a written request to the Case Manager in the office of the District Director with jurisdiction over the return or returns of the Coordinated Examination Program taxpayer currently under examination. The written request must contain:
  - (i) a complete statement of the issues, facts, law, and arguments;
  - (ii) a statement as to whether the taxpayer has ever applied for competent authority assistance for the AIR issues for the years under consideration or for prior years and whether the taxpayer intends to seek relief from double taxation for the AIR issues;
  - (iii) true copies of all contracts and pertinent documents as well as certified English translations of any applicable foreign laws and copies of those laws;
  - (iv) a statement that the inspection or examination of the books and records under the AIR procedures will not preclude or impede a later inspection or examination and that the IRS will not have to comply with the procedural reopening requirements for the later inspection or examination; and
  - (v) a perjury statement.

- (c) The IRS Team manager can accept the AIR offer for some or all issues if all of the following criteria are satisfied:
  - (i) the facts (which must be fully developed) are substantially the same as the facts in the year settled by Appeals;
  - (ii) the relevant legal authority is unchanged;
  - (iii) Appeals settled the issue independently of other issues; and
  - (iv) the issue was settled with respect to the same taxpayer (including consolidated and unconsolidated subsidiaries) or another taxpayer who was directly involved in the same transaction or taxable event in the settled year.
- (d) An AIR agreement is a closing agreement under § 7121 of the Internal Revenue Code between the Service and a CEP taxpayer relating to one or more specific issues arising from an audit of a CEP taxpayer for a taxable period(s) ending prior to the date of agreement. See Rev. Proc. 68-16
- (e) The taxpayer or the IRS can opt out of the AIR program at any time, but any statements made in the written request will be effective notwithstanding the withdrawal.

4. Examination Early Referral Procedure.

- (a) Rev. Proc. 99-28 describes the method by which a taxpayer may request an early referral of one or more unresolved issues from the Examination or Collection Division to the Appeals Division.
- (b) This process was created to resolve cases more expeditiously through the District and Appeals working simultaneously.
- (c) A taxpayer may request early referral to Appeals of any developed, unagreed issue under the jurisdiction of the District Director arising from an audit. The District will continue to develop issues that have not been referred to Appeals.
- (d) Appropriate issues for early referral are limited to those that:

- (i) if resolved, can reasonably be expected to result in a quicker resolution of the entire case;
  - (ii) both the taxpayer and the District agree should be referred to Appeals early;
  - (iii) are fully developed; and
  - (iv) are part of a case where the remaining issues are not expected to be completed before Appeals could resolve the early referral issue. Industry Specialization Program (ISP) issues can also be referred to Appeals for early resolution under these early referral procedures.
- (e) Early referral does not include an issue:
- (i) with respect to which a 30-day letter has been issued. Thus, a qualified offer under § 7430(c), may not be made as part of the early referral process because such offers may only be made subsequent to the issuance of a 30-day letter;
  - (ii) that is not fully developed;
  - (iii) when the remaining issues in the case are expected to be completed before Appeals could resolve the early referral issue;
  - (iv) that is designated for litigation by the Office of Chief Counsel;
  - (v) for which the taxpayer has filed a request for Competent Authority assistance, or issues for which the taxpayer intends to seek Competent Authority assistance. Taxpayers are encouraged to request the simultaneous Appeals/Competent Authority procedure described in section 8 of Rev. Proc. 96-13, 1996-1 C.B. 616, or a subsequent revenue procedure. If a taxpayer enters into a settlement with Appeals (including an Appeals settlement through the early referral process), and then requests Competent Authority assistance, the U.S. competent authority will endeavor only to obtain a correlative adjustment with the treaty country and will not take any actions that would otherwise amend the settlement. See section 7.05 of Rev. Proc. 96-13; or

- (vi) that is part of a whipsaw transaction.
- (f) The taxpayer's early referral request must:
  - (i) identify the taxpayer (and, where applicable, all related persons involved in the issues) and the tax periods to which those issues relate;
  - (ii) state each issue for which early referral is requested;
  - (iii) describe the taxpayer's position with regard to the relevant early referral issues. This statement must contain a brief discussion of the material facts and an analysis of the facts and law as they apply to each early referral issue; and
  - (iv) contain a perjury statement as stated in Rev. Proc. 99-28.
- (g) If an agreement is reached with respect to an early referral issue generally, a Form 906, Closing Agreement on Final Determination Covering Specific Matters, is prepared.
- (h) If early referral negotiations are unsuccessful and an agreement is not reached with respect to an early referral issue:
  - (i) Taxpayers may then request mediation for the issue, provided the early referral issue meets the requirements for mediation. If mediation is not requested, Appeals will close the early referral file and return jurisdiction over the issue to the District.
  - (ii) Appeals will not reconsider an unagreed early referral issue if the entire case is later protested to Appeals, unless there has been a substantial change in the circumstances regarding the early referral issue.
- (i) Not very popular because most taxpayers see the reduction in issues as reducing the mutual-concession flexibility

5. Fast Track Settlement (FTS)
- (a) LB&I and Appeals Division jointly administer the FTS program to resolve cases within 120 days of entering the program. Rev. Proc. 2003-40.
  - (b) FTS does not eliminate or replace existing dispute resolution options, including the taxpayer's opportunity to request a hearing before Appeals or a conference with a manager. If the parties fail to resolve any issue in FTS, the taxpayer retains the option of requesting that the issue be heard through the traditional Appeals process.
  - (c) The taxpayer may withdraw from the FTS process at any time by notifying in writing the LB&I Team Manager and the FTS Appeals Official of the withdrawal. The FTS Appeals Official or the LB&I Team Manager also may terminate the LB&I Fast Track process, by notifying the taxpayer in writing, if either one determines that meaningful progress toward resolution of the issues has stopped. If any issues remain unresolved at the conclusion of the FTS process, the taxpayer retains all of its otherwise applicable appeal rights.
  - (d) Any recommended settlement by the FTS Appeals Official of an issue in FTS shall be subject to the procedures that would be applicable if the issue were being considered by Appeals, including procedures in the Internal Revenue Manual and existing published guidance. FTS therefore creates no special authority for settlement by the FTS Appeals Official- results are nonbinding, nonprecedential, and confidential.
  - (e) Either the taxpayer or the LB&I Team Manager may suggest participation in the FTS program. If the other party agrees, the parties may contact the LB&I or Appeals Fast Track Program Managers who will assist the parties in determining whether the issue is appropriate for the FTS program. If the parties determine that the issue is appropriate for FTS, the parties must apply to the program by completing and executing a LB&I Fast Track Agreement form. The parties must include the Notice of Proposed Adjustment (Form 5701) and the written response from the taxpayer with the LB&I Fast Track Agreement to complete the package.
  - (f) The parties should initiate FTS only after the Service issues the Form 5701 (Notice of Proposed Adjustment) and the

taxpayer provides a written response, but before the date on which the Service issues the first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review in the Office of Appeals (30-day letter).

- (g) FTS is generally available for all cases within LB&I Compliance jurisdiction. A small amount of cases are not eligible for inclusion into the program, including issues that are designated for litigation, whipsaw issues, and issues for which mediation would not be consistent with sound tax administration.
- (h) SBSE has started a FTS program as well.
- (i) The FTS Appeals Official will not perform in a traditional Appeals role, but will use dispute resolution techniques to facilitate settlement between the parties. During FTS, the taxpayer and LMSB representatives, including at least one representative with decision-making authority, from both LB&I and the taxpayer, will meet with the FTS Appeals Official.
- (j) During the session, the FTS Appeals Official may propose settlement terms for any or all issues. If the taxpayer accepts the FTS Appeals Official's settlement proposal, but the LB&I Team Manager rejects it, the LB&I Territory Manager must review the rejection and either concur in writing, or accept the settlement proposal on behalf of LB&I. If the LB&I Territory Manager concurs with the Team Manager's rejection of the settlement proposal, and an acceptable alternative settlement cannot be reached, the issue will be closed out of the FTS program as unagreed.
- (k) If the parties resolve any of the disputed issues at the conclusion of the session, the parties and the FTS Appeals Official shall sign the FTS Session Report acknowledging acceptance of the terms of settlement for purposes of preparing computations. The signature of the parties on the FTS Session Report does not constitute a final settlement, nor does it waive restrictions on assessment, terminate consents to extend periods of limitation, start the running of any periods of limitation, or constitute agreement to close the case.
- (l) The prohibition against ex parte communications between Appeals Officers and other Service employees provided by section 1001(a) of the Internal Revenue Service

Restructuring and Reform Act of 1998 *does not apply* to the communications arising in FTS because Appeals personnel, in facilitating an agreement between the taxpayer and LMSB, are not acting in their traditional Appeals settlement role.

**D. Settlement Documents**

1. Before negotiating a settlement with the IRS, it is important to consider the impact that the form of the settlement may have on subsequent years.
2. Form 870, “Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment”
  - (a) In nondocketed cases, the Appeals officer may use a standard 870-series form to document an agreed deficiency or overassessment, provided that there are no mutual concessions.
3. However, if mutual concessions are involved or the taxpayer or IRS seeks greater finality, the Appeals officer normally will use one of the special “AD” forms:
  - (a) Form 870-AD, “Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment”;
  - (b) Form 890-AD, “Estate Tax: Offer of Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment”;
  - (c) Form 2504-AD, “Excise and Employment Tax — Offer of Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment.”
4. The AD forms differ from standard waiver-type forms in several respects:
  - (a) they use terms of offer and acceptance;
  - (b) they contain mutual pledges:
    - (i) The IRS will not reopen the case unless there was fraud, malfeasance, concealment, or misrepresentation of a material fact; an important mistake in mathematical calculation; a deficiency or overassessment resulting from the application of the 1982 Tax Equity and Fiscal Responsibility Act

partnership rules; or an excessive tentative carryback refund; and

(ii) The taxpayer will not claim or sue for a refund, except for amounts attributable to carrybacks as provided by law;

(c) the standard forms are effective as a waiver of restrictions on assessment when received. The AD forms become effective only on acceptance on behalf of the commissioner; and

(d) the suspension of interest under section 6601(c) is controlled by the date the AD form becomes effective.

## 5. Closing agreements

(a) Unlike the other case-closing documents, a CA is a binding agreement, which explains why the IRS uses them sparingly

(b) 3 conditions must be satisfied before the IRS will enter into a closing agreement:

(i) the content of the agreement is satisfactorily agreed on;

(ii) the agreement does not intrude on the jurisdiction of any court to determine the tax liability; and

(iii) there appears to be an advantage to having the case permanently and conclusively closed, or good and sufficient reasons are shown by the taxpayer for desiring a closing agreement, and the IRS determines it will sustain no disadvantage by entering into such an agreement.

(c) Interpreted in accordance with contract law- must be a meeting of the minds

(i) Also, extrinsic evidence will not be considered if the terms of the CA are unambiguous

(ii) Unlike ordinary contract law, a CA will only be set aside for fraud, malfeasance, or a misrepresentation of a material fact.

6. Stipulated decision
  - (a) Document for a settled Tax Court case- signed by taxpayer and IRS counsel.
  - (b) Repudiation of stipulated decision is a formidable challenge.
    - (i) Must show that failure to allow modification might prejudice the party seeking modification
    - (ii) If the decision has been entered, repudiation is even harder: vacated only if it is shown that (1) fraud was perpetrated on the court or (2) the court never acquired subject matter jurisdiction in the first place.

**E. File Your Suit Where It Best Serves Your Interests.** At least conceptually, you can file your suit in any one of three trial courts. Consider, among others, the following factors:

1. Do you really have a choice – can your client afford to pay the asserted taxes, penalties, and interest required as a condition to filing suit in the Federal District Court or the Court of Federal Claims? If not, Tax Court, which has no such jurisdictional requirement, is generally the only alternative.
  - (a) While one district court has held that the payment of interest is not required as a jurisdictional prerequisite for a tax refund suit and the Claims Court has recently indicated that uncontested derivative penalties need not be paid to establish jurisdiction, the weight of authority is to the contrary. *Compare* Treas. Reg. § 301.6201-1(a) and *Arnold v. United States*, 50 AFTR 2d 82-6267 (N.D. Ohio 1982) with *Kell-Strom Tool Co. v. United States*, 205 F.Supp. 190 (D.Conn. 1967).
  - (b) Of course, relief is available where the tax is divisible. Consequently, one may contest an employer's withholding tax by paying the tax attributable to one employee, or may be able to contest a penalty asserted under Sections 6700 or 6701 by paying the penalty attributable to one investor or client. It should be noted that the Tax Court lacks subject matter jurisdiction to consider most divisible taxes and penalties in any event.
  - (c) In peculiar circumstances, the TEFRA Partnership Rules may provide an opportunity to get into District Court or the Court of Federal Claims.

2. Assuming that you really do have a choice, which forum contains the most favorable precedent for your case and what is the strength of that precedent? For example, a favorable factual finding in one decision may indicate a predisposition or slant in your favor but it is not controlling in your case. In theory, a Tax Court Memorandum opinion is not precedential (though it may be argued that a point of law in a TCM opinion is so well established as not to require a Tax Court opinion). On the other hand, a decision recently reviewed by the full court in either the Tax Court or Court of Federal Claims (*i.e.*, courts of national jurisdiction) will be very persuasive in those courts and often beyond. A Federal District Court judge is obviously not bound (but may be persuaded) by the decision of a judge in another district and, depending upon the local rules, he may not be bound by the decision of a judge in his same district.
3. Similarly, which of the two appellate courts available to you has the most favorable precedent? While it should come as no surprise that the precedent of the Court of Appeals for the Fourth Circuit is controlling upon the Federal District Courts in South Carolina, North Carolina, and Virginia, it is also controlling upon the Tax Court in a case involving an individual who resides or a corporation which maintains its principal place of business in this geographical area. *See Golsen v. Commissioner*, 54 T.C. 742, 756-758 (1970), *aff'd. on other grounds* 455 F.2d 885 (10th Cir. 1970). Adverse precedent from that Circuit Court can be escaped by filing suit in the Court of Federal Claims where appeals are taken to the Federal Circuit.
4. Do you need a national forum? If the trial involves either a formal test case or a decision that you wish to apply in other areas of the country, suit should generally be filed in either the Tax Court or the Court of Federal Claims. Moreover, if the taxpayers in the related cases will not be able to pay the tax, penalties, and (maybe) interest necessary to get into the Claims Court, then suit should normally be filed in the Tax Court. In the appropriate circumstances, the government may agree to be bound in the related cases by the result of a decision in the District Court or the Court of Federal Claims but the government's receptiveness is far from certain. By comparison, the government can almost always be persuaded (either by you or the court) to follow a test case in the Tax Court.
5. Do you need to consolidate your tax dispute with a non-tax dispute? In such situations, District Court is your only hope and even there, the government often resists the consolidation. Nonetheless, this factor may well be controlling where, for example, the taxpayer needs to interplead the promoter on a tax deficiency that is based upon the promoter's alleged misconduct. Consolidation should be appealing to the government where there is some question about the

taxpayer's ability to pay and the effect of the consolidation would be to add another deep pocket. Some ingenuity needs to be exercised to satisfy the *Flora* prepayment rule: consider small years, carryover years, gain years, etc.

6. Where can you find the most receptive audience for the peculiarities of your case?

(a) If your case turns upon application of a complex, technical point of law, serious consideration should be given to the Tax Court, where the judge acts as both finder of fact and arbiter of law, and that judge is a tax specialist. In contrast, trial in the Federal District Court may involve a jury that would be offended by technicalities. Where no jury is requested, the trial will be before the Federal District Court judge, typically a legal generalist, who is also likely to feel less bound by "technical tax niceties" but may be intimidated by non-precedential creatures like rulings. The Court of Federal Claims provides a middle ground where the trial is before a judge who likely spends some, but not all, of his time dealing with tax matters.

(b) If your case turns upon sympathetic facts, the analysis is more complex. The standard initial reaction is to take it to the Federal District Court and get a jury, particularly in light of the concept of "jury appeal." The population from which you would draw a jury may, however, bear a bias in favor of the government or against your client. For example, venue in your case may only lie in a large metropolitan area where the federal government is a major employer or it may lie in a place where the economic, social, or other bias is either against your client or your issues. In significant cases, serious consideration should be given to conducting a private survey and in all cases, the typical jury composition should be a matter of inquiry. On the other hand, you have no idea at the time you institute the suit which judge you will draw in either the Tax Court or the Claims Court while, in some cities, you will know which District Court judge will be assigned to your case. In all events, you must recognize that there is a broad range of attitudes and sensitivities among the individual members of each of these courts.

7. What are the statistical prospects for winning in each forum?

The statistics, published each year by the IRS need to be discounted by the following factors:

- (a) More than 60% of the cases filed in the Tax Court are *pro se* – *i.e.*, the taxpayer stands alone against the government attorneys. Very few District Courts and almost no Court of Federal Claims tax cases are handled *pro se* and those are generally tax protester cases.
  - (b) A disproportionate segment of the Tax Court's docket consists of "shoe box/failure to substantiate" cases. Indeed, the recent trend has been in the direction of Collection Due Process and Innocent Spouse cases and away from substantive disputes.
  - (c) Other than tax-advantaged investments (dubbed "shelters" by the IRS) Taxpayers have been winning more than 80% of the total amounts in the large cases (cases involving deficiencies of more than \$10 million) handled by the Tax Court.
  - (d) Many taxpayers are now taking "tax-advantaged investment" cases to the District Court or the Court of Federal Claims, rather than the Tax Court.
8. Which adversary would you prefer? While refund suits are going to be handled by the Trial Section of the Department of Justice, Tax Division assigned to that region or by the Court of Federal Claims Section of the Tax Division, a taxpayer can exercise some control (through his request for place of trial) on the particular IRS District Counsel office assigned to his Tax Court case. The government can move to change the place of trial but rarely does so absent a consolidation of cases or a conspicuous lack of any connection with the location requested. However, in cases involving substantial amounts or broad issues, the government may assign either a special trial attorney or the lawyer responsible for that special project.
9. Do you wish to seek or to avoid extensive discovery? Litigation in the District Courts and the Claim Courts is notorious for its extensive depositions, while depositions are rare in the Tax Court and formal discovery is the exception rather than the rule.
10. Does your case involve an unwieldy volume of documents? Trial in Tax Court is founded upon the stipulation process and both parties will be instructed to put all documents into evidence through a stipulation, save those reserved for impeachment purposes. Hence, one can often avoid the problems associated with separately authenticating every document at trial as is often required in refund litigation.

11. Does your case depend upon showing the asserted deficiency is erroneous rather than showing the actual tax due? At least in theory, the taxpayer only has the burden of proving in Tax Court that the Commissioner's assertion is erroneous (at which time, the burden shifts to the Commissioner to prove the correct tax). Moreover, the IRS may bear the burden of going forward with the evidence under Section 7491. In contrast, the taxpayer has traditionally borne the burden in refund litigation of proving not only the error of the Commissioner's ways but also the correct amount of tax. This distinction can be critical where affirmative evidence is unavailable (*e.g.*, the bank has destroyed the records, witnesses have passed away or are now claiming various testimonial privileges, etc.).
12. Will your case be benefited by the finder of fact possessing an awareness of local sites, conditions, and reputations? Where your client, or perhaps your expert witness, is well respected in the community for his integrity or your issues may be helped by the local economic conditions, serious consideration should be given to filing suit in District Court where, unlike Tax Court and Court of Federal Claims, the judge and the jury are residents of that vicinity.
13. Does your client wish to minimize local press coverage? District Court trials clearly draw more local coverage than trials in either Tax Court or Claims Court, where any coverage is extremely rare, and Washington, D.C. can always be requested as the place of trial. Beware, the free lance journalist who haunts the Tax Court beat.

### III. WAGING THE CONTEST IN TAX COURT.

#### A. Plead the Case Consistent with Your Overall Strategy.

1. Formulate your themes and theories early – subject to the wet cement principle.
2. The pleadings can be used as an instrument of persuasion.
  - (a) When most cases are set on a trial calendar, all the court will have had a chance to review is the Petition and the Answer. The Answer, except in fraud and certain other affirmative pleading cases, rarely contains any information other than general denials. Hence, when you are fairly confident of your trial strategy, you can start the persuasion process with the Petition without any serious competition.
  - (b) This choice, however, runs several risks:
    - (i) It may educate or excite your opponent.
    - (ii) If not properly drawn, it may reduce your flexibility in shifting theories.
    - (iii) If irresponsibly drawn, it may result in admission of facts that later prove to be detrimental or in loss of credibility when you attempt to retract those facts.
3. The pleadings may serve to narrow the issues. Because the IRS is obligated by Tax Court Rule 33 (counterpart to FED. R. CIV. P. R. 11) and Rule 36 (counterpart to FED. R. CIV. P. R. 8) to specifically admit or deny following a reasonable inquiry, the Respondent should admit those allegations set forth in the Petition which are not truly in dispute.
4. The pleading may serve as the foundation for motions and discovery. In the exceptional case where the taxpayer wants to pursue motions and discovery, the IRS pleadings practice of disregarding Tax Court Rules 33 and 36 can be pursued through a motion to strike under Rule 52 or a motion to dismiss (or impose lesser sanctions) under Rule 123. While the Tax Court currently questions its power to dismiss the government and is reticent to prejudice the Respondent's case on a procedural matter, these motions can provide both a point for appeal and the groundwork for a more persuasive argument when the Service makes the same general denial of your Request for Admissions.
5. Frequently, the better part of valor lies in maintaining a low visibility until trial time.

**B. Try to Pursue Discovery Through the Stipulation Process and, Failing that, Prepare for a Long and Expensive Process.**

1. While discovery and the stipulation process are both designed to narrow the issues through the exchange of information, discovery, when conducted by itself, has the effect of polarizing the parties.
2. Consequently, one should seek information and concessions from the government through the stipulation process. Normally, the parties will proceed on the principle of providing the information that would otherwise be available through discovery.
3. Note that the most recent version of the standard pre-trial order requires that all documents (save only those used exclusively for impeachment purposes) must be exchanged at least 15 days in advance of the trial calendar and should be stipulated.
4. If you feel your opponent has been less than forthright, you can always resort to formal discovery following an unsatisfactory response to informal/*Branerton* requests. Keep in mind, however, that all discovery must be completed 45 days before the trial calendar. Most Tax Court judges interpret this rule to mean that the motion to compel proper responses must be filed more than 45 days prior to the calendar call.
5. If you are unexpectedly served with objectionable discovery, service of thorough discovery requests upon your opponent often makes your opponent more receptive to mutual accommodations.
6. Typically, the most effective formal discovery narrows the issues through a Request for Admissions that itemizes the essential elements of those issues and is accompanied by a complimentary set of Interrogatories and Request for Production of Documents.
7. Each discovery request should contain an explicit set of instructions and definitions to minimize evasive responses and to strengthen your motion to compel.
8. The responses to discovery should be incorporated into the Stipulation of Facts as should all documents on which you intend to rely. While you may withhold those documents on which you intend to rely for impeachment purposes, there is a line of cases which suggests that impeachment is the only purpose for which you can use the withheld items – you cannot rely on them as affirmative proof of any fact.

9. In drafting the Stipulation of Facts, one must balance the value of having as many as possible of your facts undisputed (clearly, the most authoritative source for the factual findings you will request in your brief) against educating your opponent.

**C. Always Submit a Persuasive Trial Memorandum.**

1. The Standard Pre-Trial Order contemplates a skeletal Trial Memorandum. However, this is your best shot at persuasion so don't waste it.
2. In most cases, the tone should be clinical but tell the story your way.
3. The Trial Memorandum should include:
  - (a) The years, the type of tax, and the amounts involved;
  - (b) The number of witnesses expected to be called and the time projected for trial;
  - (c) A favorable statement of the issues;
  - (d) A clear but favorable description of the facts with charts of the transaction and parties, and a glossary of technical terms attached as an exhibit;
  - (e) A clear but favorable description of the law;
  - (f) An open-ended list of the witnesses you intend to call with a general description of their testimony;
  - (g) A brief discussion of any anticipated procedural or evidentiary problems; and
  - (h) A conclusion summarizing the essence of your case.
4. Let's be candid: your job is to impress the Court and intimidate your adversary with your preparation.
5. To the extent you submit the Trial Memorandum prior to the date required, you may request that a copy not be served upon your opponent until the date required.
6. The Trial Memorandum is your first real chance to capture the imagination and the favor of the judge. After reading a properly prepared Trial Memorandum, the judge should be acutely aware of your strengths and your opponent's weaknesses – an awareness that can make the trial far more enjoyable.

**D. Make Sure that Your Expert Prepares a Polished Report and that It is Timely Served at Least Thirty Days in Advance of the Trial Calendar.**

1. Expert witness reports are required by the Tax Court Rules and, absent their timely service, the Court typically will not allow the witness to take the stand.
2. Absent a specific order to the contrary, that report needs to be provided to the Court and your adversary 30 days in advance of the trial calendar.
3. Study the contents required by Tax Court Rule 143(c).
4. The report should contain a detailed description of the facts upon which the expert relies and the conclusions, but should be couched in terms of a summary.
5. Depending upon the Judge, the report may be deemed to be the totality of your (deer-in-the-headlights) expert's testimony. He or she needs their sea legs before the onslaught of cross-examination begins. Invoke the mantra of Rule 143(f) to open that door. ("Your honor, we seek leave of the Court under Rule 143(f) to ask this witness to clarify and emphasize certain aspects of her report and to comment on a few matters that have arisen since she tendered her report.")
6. Hence, you can put the witness on the stand and allow her to get comfortable through some form of elaboration on the report before she is turned over for cross-examination.
7. Keep in mind that an expert witness may rely upon documents and information that may not be otherwise admissible into evidence, so long as the documents and information are of a type normally relied upon by experts in that field.

**E. In Significant Cases, Conduct Two Mock Trials Before the Real Trial.**

1. A mock trial should be presided over by a tax lawyer with trial experience who has no prior exposure to the case.
2. He should be provided with the pleadings, the motions, the stipulations, and the trial memoranda of both parties.
3. In the role of the judge, he should be encouraged to grill your witnesses unmercifully.
4. One of the lawyers working on the case should spend whatever time is necessary to prepare the most aggressive, abusive version of the Service's case possible and should grill your witnesses unmercifully.
5. You should prepare your witnesses as if it were the real trial – explaining the issues, reviewing their testimony, and fortifying them for cross-examination. Every contact with a witness should be prefaced by a polite admonition to tell the truth and to share that admonition when asked. Every witness should also know what he needs to gut an aggressive cross-examination.
6. Filming of the mock trial so that the individual witness' demeanor can be critiqued is helpful, particularly when the witness comes across as arrogant, evasive, or hostile.
7. Remember that arrogance is the antithesis of credibility.
8. Test alternative trial strategies for effectiveness.
9. After all the adjustments have been made, run the dress rehearsal.

**F. Try the Case.**

1. Your opening statement should start with a theme and end with that same theme. At least in the beginning, it should be clinically stated. It should provide the Court with the road map of how and why the decision should be written in your favor. Any ridicule of the government's position should be gentle and understated. Above all else, the opening statement should contain a spark that distinguishes it from the tedium of most statements.
2. The practice of requiring a Trial Memorandum has diminished the perceived need for opening statements. Consider the Supreme Court numbered-points method for buying time.

3. Personalize your client: it is more difficult for the Court and the government lawyer to hurt Roland who was a postman when his father died and left him \$20,000 which Roland used to start this company that employs (and, if we win this case, will continue to employ) Charlie, Sue, Bill, and three hundred other people in this community.
4. Before the start of the trial, introduce yourself to the courtroom personnel, give the reporter a list of names and a glossary of the technical terms, and offer to help them in any way that you can. Good trial lawyers and people in Africa believe, as I do, in the spirit world. The court personnel contribute to the aura of emotion in the courtroom and are sometimes asked their reactions by the judge.
5. Witness sequence can be very important. The general rule is that you want to start strong and end strong. Equally important is remaining flexible. For instance, you may want to squeeze a witness in before lunch and you may want to end the first day's testimony with a particularly strong witness so that testimony will be the last statement on the judge's mind over the evening.
6. Demonstrative evidence is relatively rare in the Tax Court and, therefore, has a heightened impact upon the poor judge who is accustomed to listening to nothing but testimony all day. Consideration should be given to films, courtroom demonstrations, and the like. The most effective demonstration is one which appeals to the largest number of the senses – sight, hearing, touch, taste and smell – and gives the judge the feeling of participating in the event or transaction in the shoes of the taxpayer.
7. You must know the government's affirmative case better than your opponent does. You should have mapped out in advance not only the vulnerability of his witnesses but the evidentiary flaws in his proof.
8. Have a separate Memorandum of Authority on each one of those flaws (as well as on your evidentiary soft spots) and be prepared to argue each point aggressively. While many Tax Court judges are prone to let all information into evidence "for whatever it is worth," you will be earning credibility and shaking the Court's confidence in your opponent as well as in the vitality of whatever decision the court might consider entering in favor of your opponent.
9. Traditionally, the Tax Court has not encouraged closing statements, but with its shift to bench opinions one should be prepared with a closing statement and should request an opportunity to present it. You should request a daily transcript and read back to the court any promises your opponent may have made in his opening statement

and has not kept. Frequently, advantage can be gained over an unprepared opponent. The closing statement should follow the same rules of primacy and recency applicable to all stages of trial. This is your last chance to communicate with the judge face to face and to read his or her reactions. Moreover, the judge is likely to leave the trial favoring one side or the other and is likely to communicate that slant to the law clerk, who then summarizes the record, the briefs, and the law for decision.

**G. Prepare a Thorough Post-Trial Brief.** A thing of beauty is a joy forever.

1. The "Points Relied Upon" section is literally and figuratively the centerpiece of the brief – if one is not persuaded after reading this section, then either the section needs to be rewritten or settlement solicited.
2. Second in importance is the "Requested Findings of Fact." If they are written correctly from a properly tried case, the Argument section is all but superfluous. They should be viewed as the building one detailed brick at a time. They should be drawn from the record with very little poetic license and should always be followed by one or more record references.
3. The Argument section should be carefully structured, easy to follow, and precisely researched. It should provide the Court with the materials to draft a scholarly opinion in your favor. You should provide the Court with powerful quotes or literary allusions. Your citations must be precise: you should avoid citing memorandum opinions where regular opinions are available. Your arguments should always start with your affirmative contentions and leave the rebuttal material to the end or the reply brief. Form and neatness are all important. Careful thought should be given to how the argument appears on the page – are there visual breaks, critical elements broken into subsections and underscored, and the like? Tempo is also important – do your arguments start strong and end strong; do they blur and drag?
4. Your reply brief should be drawn only after you have outlined the structure of your opponent's argument. Your argument in rebuttal should then focus upon those critical points in your opponent's structure which, if broken, will cause the structure to fall. The remainder of your argument is simply designed to undermine the Court's confidence in your opponent.

#### **IV. ALWAYS WAGE YOUR WAR WITH A PEACEFUL EYE ON SETTLEMENT.**

##### **A. Settlement, if Pursued at the Right Moment and with the Right Strategy, Can Often Offer Results Unobtainable at Trial.**

1. Almost all successful settlements are the product of identifying, emphasizing, and sometimes creating the needs of your adversary.
2. Attractive settlements are rarely available unless the time is ripe. Interestingly, the phrase the Chinese use for negotiation is derived from their word for delay. In short, most cases settle on the courthouse steps because the parties can no longer avoid making a decision. The same is true any time one is operating within time limits.
3. Because the Service possesses restricted resources and a largely unrestricted flow of cases, a premium may be available where settlement is offered prior to the IRS attorney or conferee devoting a great deal of time to the case.
4. During the course of preparation, the strength of all cases ebbs and flows. You should settle (or, in the absence of settlement, try your case) on that tide that rises in the affairs of men which taken at the flood will lead to prosperity.
5. Recognize that the price of settlement discussions is educating your opponent and sometimes that price is too high.

##### **B. While There are Few, if any, Magic Formulas, Certain Truisms and Techniques Have Developed in the Realm of Tax Settlement Strategy.**

1. Negotiate from a position of strength or apparent strength – talk about most of your strengths and his weaknesses (but save some for trial).
2. Tactfully demonstrate a genuine interest and ability "to go to the mat" – to make the Service's worst litigation hazard a reality.
3. Emphasize the disparity in exposure: if the taxpayer loses, he loses only one case but, if the government loses, it loses this case and the thousands like it. In short, the government should exercise the good judgment to get rid of this case and find a litigating vehicle that has weaker facts and weaker representation for the taxpayer.
4. Always start out in a friendly but firm, non-adversarial appeal to reason. If that fails, consider strengthening tempo, strength, and emphasis.

5. Respect your opponent enough to allow him to acknowledge the weaknesses in his case and to note what he believes to be his strengths.
6. Don't make a frontal assault on his analysis: use the "but" technique (e.g., "I can easily understand how you may have drawn that conclusion but ..."). Good settlements can be obtained through vehement attacks but, more often than not, they simply entrench the parties.
7. Your explanation of why his contentions do not withstand analysis should be short and sweet to avoid escalating the importance of his contentions in his mind.
8. Subtly undermine confidence in the agent's conclusions or the government's witnesses. Be careful in dealing with evidentiary matters since most of these defects can be cured prior to trial.
9. Act as a lightning rod: personally accept blame where the Service's hostility would otherwise operate to the detriment of the client.
10. Secure undisputed concessions first.
11. When possible, concede to your advantage. The IRS attorney or appellate conferee is most concerned, if not exclusively concerned, with the tax years and issues assigned to him. You want to trade those issues that operate to your advantage in other years.
12. Aggressive, high-risk techniques:
  - (a) "Cheat the hangman": where personal hostility has arisen (such as sometimes results for you serving as a lightning rod), your opponent may settle the case to your client's advantage to keep you from earning a fee.
  - (b) Ogg and Grogg/Good guy, bad guy.
  - (c) Where the position of the Service is inconsistent with the policies of another government agency, pit one agency against the other.
  - (d) "If you're going to shoot at the king,..." Because of the importance of public image to the self assessment system, the IRS will, in rare cases involving outlandish agent or institutional conduct, get rid of the case. This is an explosive technique that must be handled very delicately, lest it backfire. You had better have hard evidence. For example, in *Payner v. United States*, a Supreme Court case, the IRS obtained certain offshore banking materials

through the services of a prostitute (query: tender entrapment?) and, despite its legal victory, later adopted a policy of conceding such cases. Note, however, that it is unethical to use the threat of criminal sanctions to obtain civil advantage. On the other hand, it is appropriate for the Service to consider the broader, civil consequence of a full trial on the merits.

## **V. CONCLUSION.**

Judgment and instinct dictate when and how to apply the principles discussed in this outline. Depending upon the circumstance, those principles should be used individually, or in tandem, or in a given sequence, or abandoned altogether. But above all else, the decision must be made with a view towards all the opportunities available over the life of a case.

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# **DANCING WITH A GRIZZLY BEAR: STRATEGIES IN DEALING WITH THE IRS**

**Presented by**

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# DEFENDING A CLIENT ON AUDIT

- **Your Pre-Audit Audit: Role of CPA and Attorney**
  - Pressure Test Return: “Audit Ready” File
  - IRM – Industry Audit Guidelines
  - IRS “Audit the taxpayer, not the return”
  - Public Records, Google, Large Transactions
  - Informant, Foreign Bank Accounts, Related Audits, *Etc.*,?
- **Game-On**
  - Quality Exam Process (QEP) – Request “Risk Analysis”
  - Rules of Engagement: Joint Audit Plan Process
  - Document Requests – IDRs and Summonses
  - Interview Requests and Section 7521(c)
  - Site Inspections
  - Limitations Extensions

# APPEALS

## Getting To The Right Answer

- Protest vs. Petition and Letter Brief: “With a Little Help From My Friends”
- “Sent Back to Exam”
- LB&I vs. SBSE Conferences
- Witness Affidavits and Declarations vs. Statements
- Rate of Sustaining Exam
- Special Considerations: New Issues, Ex Parte, Prior CID Referral
- When to Use Fast Track, Mediation, or Arbitration
- Proving “Hazards of Litigation”: Power Point, Video, Trial Graphics

## Offer

- Who Makes Opening Offer?
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# LITIGATION: BUILDING A PERSUASIVE STORY

- Choice of Forum: Tax Court, District Court, or Court of Federal Claims
- FOIA – When to File and What to Request
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- Answer – Generally, General Denial
- Burden of Proof: Excessive and Erroneous vs. Section 7491
- *Greenberg's Express*: “Looking Behind the Notice”
- Trial vs. Settlement (19 Out of 20): “Hazards of Litigation”
- Discovery Changes
- Experts
- Trial Memorandum: Evidentiary Motions
- Trial: “Cry Havoc and Let Slip the Dogs of War”
  - Opening, Direct and Cross Examination
  - Witness Challenges: Credibility vs. Arrogance, Nerves, Prep for Cross
- Briefing: “A Thing of Beauty is a Joy Forever”
- Appeal – Questions of Law vs. Questions of Fact

# **Who Me? Tax Collections from Non-Taxpayers**

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## Who Me? Tax Collections from Non-Taxpayers

### **I. The Trust Fund Recovery Penalty**

#### **A. What is the Trust Fund Recovery Penalty?**

1. The Code requires persons other than taxpayers to function as withholding agents for certain taxes:
  - a. Employers must collect and withhold income and Social Security (FICA) taxes from employees
  - b. Sellers of certain types of property must withhold excise taxes
  - c. Payors must withhold income tax on certain income items paid to nonresident aliens
2. § 6672<sup>1</sup> provides an enforcement mechanism for collection of taxes withheld but not remitted to the government
  - a. Any responsible person who has a duty “to collect, truthfully account for, and pay over any tax imposed by the [Code], [that] willfully fails to collect such tax, or truthfully account and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof,” is personally liable for a penalty equal to the total amount of the tax evaded, or not collected or not accounted for and paid over
  - b. Known as the 100% penalty or the trust fund recovery penalty (“TFRP”)
  - c. Applies to the taxes listed above but is most commonly assessed with respect to employment taxes
3. General Observations
  - a. TFRP does not fully compensate the government – it only applies to the employee portion of employment taxes (the portion withheld from employees)
  - b. Liability for the TFRP and the employer’s liability are separate and distinct but related
  - c. When a business is conducted as a sole proprietorship or partnership the individual owners or general partners are liable for the debts of the business
  - d. Penalty is not limited to one person – the Internal Revenue Service (“IRS”) will assess against anyone they can place in the zone of responsibility
  - e. No negligence or fraud penalty may be assessed against a responsible person who is assessed the TFRP- the TFRP is the only civil penalty imposed for failure to collect and pay over trust fund taxes
  - f. Liability for the TFRP may also be asserted against persons who supplied financing or funds to an employer

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<sup>1</sup> All references to Sections (§) herein refer to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

4. Liability under Section 3505
  - a. Imposes personal liability on lenders or other non-employers who pay wages directly to employees or lend money to the employer for the purpose of paying wages
  - b. A lender's natural inclination is to loan the bare minimum to a strapped debtor in order to keep the debtor afloat in hopes of collecting the balance of their loan at a later date
  - c. Liability is limited to 25% of the amount supplied to the employer (in cases where wages were not directly paid to employees)
  - d. Lenders and sureties must have actual notice or knowledge that the employer does not intend to or will not pay the payroll taxes

**B. Who is required to withhold employment taxes?**

1. Status of the payor as the employer of an employee establishes the requirement to withhold
  - a. Designation of an employee/independent contractor by the employer does not matter
  - b. Statutory employees – certain workers designated by federal law as employees
  - c. Common law employees – 20 factor employment test centered around the amount of control the employer has over the employee
2. Employment tax procedures:
  - a. Requirement to file quarterly payroll tax returns (Forms 941) and make federal tax deposits
  - b. Amount of tax withheld from employees is held to be a special trust fund for the United States
  - c. Employers are also required to report and pay their own portion of FICA taxes as well as unemployment tax (FUTA)
  - d. Employees receive credit for withholdings even if the employer fails to remit the taxes
  - e. In the event employment taxes are not remitted to the government, the IRS may send a notice under § 7512 requiring the employer to create a special bank account to hold payroll taxes until they are paid to the government

**C. Responsible Person – Two Requirements Under § 6672**

1. § 6672 imposes the TFRP on any person who (1) was required “to collect, truthfully account for and pay over” employment taxes, and (2) willfully failed to do so
2. **Responsibility requirement**
  - a. Responsible persons may include:
    - i. Officer or director of the employer (a special rule exempts certain non-profit board members)
    - ii. Shareholder, member or partner of employer
    - iii. Employee of the employer

- iv. Other persons considered to have the duty to perform the required statutory acts, such as a prospective purchaser, surety, creditor, lender, trustee or other fiduciary or an attorney
- b. Not limited to persons with a formal corporate office – the key to liability has been variously stated as follows:
  - i. Whether the person had the final word as to what bills should or should not be paid and when
  - ii. Whether the person controlled the employer’s finances
  - iii. Whether the person exercised full authority over the financial affairs of the employer
- c. IRS will assert the TFRP against all potentially liable persons and make those persons come forward with a defense
- d. Generally excluded from responsible persons are:
  - i. Employees who merely perform the mechanical functions of collection and payment and who don’t exercise independent judgment
  - ii. Officers who have been stripped of significant authority
- e. Responsibility cannot be delegated but a delegation of financial authority regarding the employer may bear on willfulness
- g. Lenders / other creditors – the more information the lender has and the more control the lender has over the disbursement of loan funds the more likely the lender will be found to be responsible

**3. Willful requirement**

- a. Willful acts often denote an act which is intentional, or knowing, or voluntary – as distinguished from an accident
- b. In the criminal context willful means a voluntary and intentional violation of a known legal duty
- c. Courts have generally refused to examine the responsible person’s state of mind to determine whether the actions taken were subjectively reasonable under the circumstances
- d. If the employer has sufficient funds to pay a trust fund liability at the time the responsible person learns of the past due liability, the responsible person is under a duty to use the funds to satisfy the liability and acts willfully if he fails to do so
- e. IRS position – willfulness exists when money withheld from employees was knowingly and intentionally used to pay the operating expenses of the business or for other purposes
- f. Evidence to negate willfulness:
  - i. Advice by counsel
  - ii. Assurance of others
  - iii. Lack of knowledge of the failure to pay over the taxes

- 4. Collectibility – the unspoken third consideration**
  - a. Revenue officers consider the collectability of the responsible person prior to making the assessment (the Internal Revenue Manual requires this to be considered)
  - b. Revenue officers may consider:
    - i. The individual's current financial condition
    - ii. Any involvement in a bankruptcy proceeding
    - iii. The individual's income history / potential
    - iv. Asset potential (current and potential asset equity)
    - v. Existence of prior TFRPs
    - vi. Existence of prior "currently not collectible" cases

**D. Responsible Person – Factor Tests**

1. IRS Factors:
  - a. Identity of the person as an officer, director, or shareholder of the corporation
  - b. Duties of the officer as set forth in the corporate bylaws
  - c. Ability of the person to sign checks, regardless of whether the individual actually did so
  - d. Identity of the persons in control of the financial affairs of the business
  - e. Identity of persons who hired and fired employees
  - f. Identity of persons who had the authority to determine which creditors to pay and those persons who exercised that authority
  - g. Identity of persons who signed and filed Forms 941
  - h. Identity of persons who controlled payroll disbursements
  - i. Identity of persons who had control of the corporation's voting stock
  - j. Identity of persons who made the federal tax deposit
2. Additional IRS factors when employers utilize payroll service providers
  - a. Whether the responsible person had knowledge of a pattern of noncompliance by the provider
  - b. Whether the provider used fraud or deception to conceal the noncompliance
  - c. Whether the client received notices from the IRS indicating non-payment
  - d. Length of time of the delinquency
  - e. Whether the client turned a blind eye to the non-compliance
  - f. Actions the client took to meet its obligations after learning of the delinquency
3. Factors for the U.S. Court of Appeals for the Fourth Circuit (*Plett v. U.S.*, 185 F.3d 216 (4th Cir. 1999))
  - a. Whether the person served as an officer of the company or as a member of its board of directors;
  - b. Whether the person controlled the company's payroll;
  - c. Whether the person determined which creditors to pay and when to pay them;

- d. Whether the person participated in the day-to-day management of the corporation;
  - e. Whether the person possessed the power to write checks; and
  - f. Whether the person had the ability to hire and fire employees,
4. Other Cases in the U.S. Court of Appeals for the Fourth Circuit
- a. *O'Connor v. U.S.*, 956 F.2d 48 (4th Cir. 1992)
    - i. Factors favoring the IRS - Taxpayer was designated as a vice president, director and 50% shareholder of the company, had authority to write checks, and received periodic financial reports regarding the corporation
    - ii. Factors favoring the taxpayer - Taxpayer had no control regarding payroll or which bills were paid, did not participate in day-to-day management, did not exercise the authority the status of director or vice president may have bestowed on him, and did not perform duties an officer might perform
    - iii. Court conclusion - “a party cannot be presumed to be a responsible party merely from titular authority...[t]he substance of the circumstances must be such that an officer exercises and uses his authority over financial affairs or general management, or is under a duty to do so, before that officer can be deemed to be a responsible person.”
    - iv. The Court ruled the taxpayer in this case neither possessed nor exercised authority over the financial affairs or general management of the Corporation or Priority
  - b. *In re: Frank H. Barnett, Jr.*, 101 AFTR 2d 2008-2003 (387 B.R. 698) (Bankr. W.D. Va. 2008)
    - i. Bankruptcy case appealable to the Fourth Circuit
    - ii. Factors favoring the IRS - Taxpayer was a 50% shareholder of the company, had authority to write checks, and signed checks at the direction of the person controlling day-to-day operations
    - iii. Revenue Officer claimed the taxpayer explained during an interview that he “helped with business decisions...was involved in hiring and firing, managing, paying bills, dealing with suppliers, negotiating loans, opening the corporate banking accounts, signing checks, making bank deposits, and authorizing payroll checks.”
    - iii. Factor favoring the taxpayer - Taxpayer had no control regarding payroll or which bills were paid
    - iv. The Court ruled the taxpayer in this case neither possessed nor exercised authority over the financial affairs or day-to-day affairs of the company

**E. Procedure of a TFRP Case**

**1. Examination and Assessment**

- a. Revenue officer is assigned to the case and proceeds to examine the following items:

- i. Articles of incorporation
- ii. Minute books and bylaws
- iii. Cancelled checks and bank statements
- iv. Payroll records and tax returns
- v. Bank records of the business
- vi. Records of any loan applications and financial statements
- b. Revenue officer will interview potential responsible persons and recommend to the IRS Collection Division whether to assess the TFRP
- c. Collections Division then sends a proposed assessment notice to the responsible person, following which the person has 60 days to file a protest with the Appeals Division
- d. As a general rule – revenue officers will assess the TFRP against anyone they have any evidence against
  - i. This policy leaves the taxpayer holding the bag as the burden of defense is on the taxpayer
  - ii. If the person has no authority over the financial affairs of the corporation, an employment agreement, corporate resolution or other official document should clearly state this fact
  - iii. IRS’ official policy states that “non-owner employees of the business entity, who act solely under the dominion and control of others, and who are not in a position to make independent decisions on behalf of the business entity, will not be asserted the trust fund recovery penalty,” (Internal Revenue Manual 1.2.14.1.3.6, Policy Statements for Collecting Process Activities – Policy Statement 5-14 (June 9, 2003)).

## **2. Appeal**

- a. Appeals officers are generally more knowledgeable and well trained than auditors
- b. Appeals officers are supposed to be independent – they may weigh the risks of litigation in addition to looking at liability for the penalty
- c. Some practitioners believe Appeals Division is unfruitful for the following reasons:
  - i. Several different TFRP assessments against different responsible persons reduces doubt as to the group’s liability and increases the likelihood of collection
  - ii. There is practically no litigating risk for the IRS – the government can sit back and let the various responsible persons implicate each other (in addition to the IRS friendly litigation procedures discussed below)
  - iii. The IRS has suffered losses when administrative accommodations have been made

## **3. Litigation**

- a. There is no prepayment forum – the U.S. Tax Court has no jurisdiction with respect to TFRP cases

- b. Stopping administrative and judicial collection of the TFRP
  - i. § 6672(c) prohibits continued collections activity if the responsible person does the following within 30 days following the assessment of the TFRP:
    - (a) Pays a divisible portion of the assessment (discussed in more detail below);
    - (b) Files a claim for refund of the amount paid; and
    - (c) Furnishes a bond in an amount that is 1½ times the amount of the assessment
  - ii. Responsible person must then file a refund lawsuit within 30 days following the denial of the refund claim
  - iii. The cost of the bond makes this option prohibitive for some clients
  - iv. Bankruptcy may also protect the corporate entity from collections but it generally doesn't stop the IRS from collecting against responsible persons
- c. Procedure for filing lawsuit
  - i. Pay the penalty for one employee for each quarter assessed
  - ii. Within 2 years of payment file a refund claim for the amount paid and a claim for abatement of the remainder of the TFRP
  - iii. When the claim is denied (or after 6 months if no action is taken by the IRS) – file suit in the U.S. District Court or Court of Federal Claims
- d. Trial issues
  - i. Burden of proof is on the responsible person to prove by a preponderance of the evidence that either responsibility or willfulness is not present
  - ii. When brought in District Court jury trials are available
  - iii. The IRS is barred during the trial from collecting via levy
  - iv. Contribution claims
    - (a) § 6672(d) provides for a right of contribution from other responsible persons for the excess of the amount paid by a person over that person's proportionate share of the penalty
    - (b) Claims for contribution may not be added to the refund lawsuit challenging responsibility for the TFRP
  - iv. Defenses
    - (a) Statute of limitations
    - (b) Installment agreement entered into by corporation
    - (c) Reasonable cause
    - (d) Spreading the blame
    - (e) Designation of payments (voluntary payments by employer)

#### **4. Collections**

- a. Voluntary payment
  - 1. Some taxpayers find voluntary payment to be the best option

2. Taxpayers may designate which portion of the tax (employer or employee) the payment is being made against
  3. This designation is not permitted by the IRS for involuntary payments via levies or garnishments, which will be applied to the employer portion of the taxes first
- b. Options for dealing with collections
1. Installment agreement
  2. Offer in compromise
  3. Uncollectible status
  4. Bankruptcy
    - (a) Pursuant to 11 U.S.C. Sections 507(a)(8)(C) and 523(a)(1)(A), the TFRP is not dischargeable in bankruptcy
    - (b) This option may allow the taxpayer to challenge the assessment of the TFRP, otherwise it only serves to slow down the IRS

## 5. Statute of limitations

1. General rule - IRS has 3 years from the date of filing of the return to assess the TFRP
2. Timely-filed payroll returns (4/30, 7/31, 10/31, 1/31) are deemed filed on the following April 15
3. The 3 year statute of limitations doesn't apply if no return is filed
4. There is no statute of limitations for fraudulent returns

## II. Transferee Liability

### A. What is transferee liability?

1. Transferee liability under federal tax jurisprudence typically refers to a set of procedures governing the manner in which the IRS may proceed against a person who receives property from a taxpayer with a deficiency
2. § 6901 was enacted to streamline enforcement of preexisting, substantive state and federal creditor laws

### B. Who is a transferee?

1. Legal definitions
  - a. § 6324(a)(2) – any “donee, heir, legatee, devisee, and distribute, and with respect to estate taxes, also includes any person who...is personally liable for any part of such tax”
  - b. Treas. Reg. § 301.6901-1(b) – “distributee of an estate of a deceased person, the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in § 368, and all other classes of distributees”
  - c. Courts – one who takes or receives property of another without full, fair and adequate consideration to the prejudice of creditors

2. Corporations may be transferees of the shareholder-transferors upon incorporation
3. Shareholders receiving corporate distributions (liquidating or otherwise)
4. Joint tenants are generally held not to be transferees unless the elements of transferee liability are present at the creation of the joint tenancy

**C. Typical elements of transferee liability:**

1. Alleged transferee received property of the transferor
  - a. Transfers may be deemed to have occurred in some situations, including entity liquidations and stock redemptions
  - b. Entity loans to related parties may be attacked as transfers – courts look at the accounting treatment of the loan, the debtor’s intention to repay, the lack of a relationship between the loan amount and the percentage of the entity owned by the debtor, and the absence of earnings and profits from which to pay dividends
2. Transfer was made without consideration or for less than adequate consideration
3. Transfer was made during or after the period for which the tax liability of the transferor accrued
  - a. Several courts have held tax liabilities are deemed due at the close of the taxable year
  - b. Some courts have held transferees liable for transfers which occurred in the year the liability accrued, including transfers which occurred prior to the assessment of the tax
  - c. Payment of the liability by the transferor releases the transferee’s liability even though the transferor may later file a refund claim, but payment by a transferee followed by a refund claim does not extinguish the liability of other transferees because the payment of the tax is not final
4. Transferor was insolvent prior to or because of the transfer
  - a. Burden of proof is on the IRS
  - b. Bankruptcy test is generally used to determine insolvency - excess of liabilities over assets
  - c. Transferor’s tax liability includes penalties and interest for purposes of the insolvency test
  - d. Tax liability for the year of the transfer is included in the amount of the deficiency for purposes of the insolvency test (even if not yet fully known)
  - e. Assets immune from legal process are ignored
  - f. Insolvency is measured as of the time of the transfer
  - g. Insolvency need not be shown in cases involving fraudulent transfers
5. All reasonable efforts to collect from the transferor were made and further efforts would be futile
6. Proof of value of the transferred property - the transferee’s liability is limited to the value of property received

#### **D. Transferee liability theories**

1. Transferee liability in equity
  - a. Elements are typically contained in state's fraudulent conveyance law
  - b. S.C. Code § 27-23-10 - transfers made to delay, hinder, or defraud creditors and others are deemed to be clearly and utterly void
  - c. Inadequate consideration is not an element of South Carolina's fraudulent conveyance law
2. Transferee liability at law
  - a. Liability under state statutes typically arises in statutes concerning gifts and estates, merger and consolidation laws when a successor assumes liabilities, bulk sales statutes under the U.C.C. and laws providing creditors a right in life insurance benefits
  - b. S.C. Code § 38-63-40 protects life insurance benefits payable to a beneficiary other than the debtor's estate from creditors if the proceeds are expressed to be for the primary benefit of the insured's spouse, children or dependents (statute contains some limited exceptions)
  - c. § 6324(a) – liability for estate taxes
    - i. Gross estate is burdened by a ten year tax lien
    - ii. §§ 2206-2207A provide proportionate liability rules for estate taxes to be collected from (a) recipients of life insurance, (b) transferees of property due to powers of appointment, and (c) property passing under the marital deduction
    - iii. Liability for estate taxes may also be asserted against trustees and surviving tenants
    - iv. This liability derives at law (not equity) and therefore no insolvency test is required
  - d. § 6324(b) – donees may be personally liable for any unpaid gift taxes up to the value of the gift
  - e. 31 U.S.C. § 3713 – fiduciary liability (see Section III below)
3. Contractual transferee liability - parties may stipulate that one party will be responsible for the other's tax liability

#### **E. Limitations on amount of transferee's liability**

1. Liability is limited to the value of assets received by the transferee
2. At law – liability may be limited by statute
3. Contractual – liability may be limited by the contract
4. Return of the property - Tax Court has reduced liability for the value of property returned to the transferor prior to the issuance of a notice of transferee liability

#### **F. Procedural issues (§ 6901)**

1. Statute of limitations on assessment against a transferee:
  - a. Assessment must be made within one year after the limitations period against the transferor expires (including any extensions thereof)

- b. Subsequent transferees – assessment may be made within one year after the statute runs against the prior transferee, but the assessment period may not exceed three years after the period expired against the original transferor
- c. Assessments against fiduciaries must be made no later than one year after expiration of the statute of limitations for the tax giving rise to fiduciary liability or the statute of limitations on collection of that tax (whichever is later)
- 2. Transferee liability procedure:
  - a. IRS first sends Notice of Liability (similar to Notice of Deficiency) to the fiduciary
  - b. Fiduciary may contest in Tax Court or sue for a refund in District Court or the Court of Federal Claims
- 3. Burden of proof regarding transferee's liability is on the IRS and transferee bears the burden to prove the original taxpayer was not liable for the taxes
- 4. Interest and penalties - transferee's liability includes interest and penalties (but may be limited by the amount of property received by the transferee)
- 5. Transferee liability is joint and several when several transferees are involved

### **III. Fiduciary Liability (31 U.S.C. § 3713)**

#### **A. When does liability under 31 U.S.C. § 3713 arise?**

- 1. 31 U.S.C. § 3713(a) provides priority to debts due the United States when (1) the estate of a decedent is insufficient to pay all creditors, or (2) an insolvent debtor transfers property in a creditor proceeding which does not result in bankruptcy
- 2. Fiduciary who makes a distribution in violation of this priority is subject to personal liability under § 3713(b)
- 3. Priority does not depend on the secured status of a tax claim (no tax lien is needed)
- 4. Three conditions:
  - a. Must be a debt due the U.S.
  - b. Living taxpayer or the estate of a deceased taxpayer must be insolvent
  - c. Living taxpayer must have manifested insolvency by one of three triggers (discussed in Section III.D below)

#### **B. What is a debt due the United States?**

- 1. Tax need not be assessed to constitute a debt - if the facts creating the tax have occurred and the amount is readily determinable it will be considered a debt for purposes of § 3713
- 2. Debt includes interest and penalties

3. Where the U.S. acquires the claim a taxpayer had against an insolvent debtor, the debt of the insolvent debtor becomes a § 3713 debt
  - a. E.g. – a government levy on the assets of distressed corporation A results in the assignment of A's receivables will create the possibility for personal liability under § 3713 for the officers, directors and shareholders of the debtors of A
  - b. This is true even though the original debt (receivables due A from A's debtors) was not a tax debt

**C. When is a taxpayer insolvent?**

1. Several tests for insolvency in various areas of creditor law:
  - a. Balance sheet test – debtor is insolvent if debts exceed the book value of assets
  - b. Equity test – debtor is insolvent when he is unable to pay debts as they become due in the ordinary course of business
2. § 3713 uses the balance sheet test
3. In an estate context, only the value of the probate estate is considered

**D. When is the priority created?**

1. Priority is created at the time property of an insolvent living taxpayer has passed to a third party in a non-bankruptcy proceeding – three triggers:
  - a. An “act of bankruptcy” committed by the debtor;
  - b. A voluntary assignment of property by an insolvent debtor; or
  - c. The property of an insolvent debtor is attached while the debtor is absent
2. Mere insolvency is enough to create priority in an estate situation (without the necessity of a transfer to a third party)
3. “Act of bankruptcy”
  - a. Involuntary petitions in bankruptcy may be filed by creditors when a debtor (1) isn't paying debts as they come due, or (2) has made an assignment or permitted the appointment of a receiver of less than substantially all of his property for the benefit of creditors within 120 days prior to the filing of a petition
  - b. § 3713 applies if one of these acts is committed but no bankruptcy petition is filed
4. “Voluntary assignment”
  - a. Any transfer by a debtor of his property without legal compulsion
  - b. Examples - general assignments for the benefit of creditors, equity receiverships, bankruptcy reorganizations and liquidations of insolvent corporations

**E. Proceedings typically involved in § 3713 claims**

1. § 3713 contemplates collective creditor proceedings – a substantial divestiture of the debtor's property is required in a legal proceeding which is instituted to liquidate the insolvent debtor's estate and pay the debtor's debts

2. Probate proceedings
  - a. The U.S. government is not subject to the probate claim statute of limitations contained in S.C. Code § 62-3-802
  - b. It has sometimes been held that the government has submitted to the jurisdiction of a probate court if it files a creditor's claim
  - c. If a proof of claim is not filed, the IRS will notify the fiduciary of the liability so that he can be held liable
  - d. Discharge of the personal representative of an insolvent estate, approval of an accounting or final distribution of estate assets will not relieve the personal representative of liability under § 3713
  - e. Liability of the personal representative accrues at the time of distribution and not on the date of death
3. Assignment for the benefit of creditors
  - a. Debtor may transfer property to a person in trust to apply the property to the payment of his debts
  - b. After the transfer the debtor has no legal claim to the property unless the property (or proceeds from the property) exceed the debt
  - c. If a general assignment is made prior to the assessment of taxes a tax lien can't attach to the assets because the taxpayer no longer has the property
  - d. Priority accrues at the date of execution of the assignment but personal liability does not attach until a distribution to a third party is made
4. Receiverships
  - a. Receivers may be appointed to preserve, protect and administer property involved in litigation or to prevent fraud - not merely in situations involving insolvency as defined by § 3713
  - b. Once the receiver has taken over by court order, normal collections efforts of the IRS must be suspended against the assets subject to the jurisdiction of the court
  - c. Tax claims allowed but unpaid in receiverships are not discharged – the IRS may continue collections against other property of the taxpayer
  - d. Property subject to a tax lien which comes under the control of a receivership continues to be subject to the tax, but § 3713 is the government's main collection device for taxes which are unassessed or unliened at the institution of the receivership
  - e. Priority accrues on the date the receiver takes over by court order and personal liability attached at the time of an inappropriate distribution

**F. Exceptions to the § 3713 Priorities**

1. Costs of administering the estate of a deceased or living debtor, including court costs and reasonable compensation for the fiduciary and attorney
2. Funeral expenses, expenses of decedent's last illness and widow's allowances
  - a. Widow's allowances are viewed as charges against the estate

- b. Taxes assessed before death which are subject to a federal tax lien are also charges against the estate and are entitled to priority over the widow's allowance
- 3. Prior mortgages and security interests
  - a. On its face, § 3713 provides no exemption for secured creditors prior in time to the government
  - b. Official IRS position
    - i. Priority will not ordinarily be asserted over a mortgage on real estate or a prior fully perfected security interest even if the debtor was not divested of either title or possession prior to the priority date under § 3713
    - ii. Preexisting lien must be choate (must be sufficiently specific and perfected) to overcome the priority of the government
  - c. No other liens are given priority over the government in § 3713 situations, including judgment liens, state tax liens, wage claims and landlord's liens
  - d. Supreme Court has not definitively answered the question whether the U.S. can subordinate a preexisting first lien mortgage, but several appeals court rulings have sided with the mortgage holder
- 4. Statute of limitations - six years from the date of assessment of the taxes unless the tax liability was reduced to judgment prior to the expiration of the statute of limitations on collection

**G. Personal Liability of the Fiduciary**

- 1. Any person who has possession or control of the debtor's assets is made liable – these facts and not the title given to the fiduciary control the analysis
- 2. 3 conditions for fiduciary liability:
  - a. The conditions for priority under § 3713(a) must have occurred
  - b. Liability is limited to debts actually paid before the government
  - c. Fiduciary must know or have reason to know of the government's claim
- 3. Fiduciary knowledge
  - a. This condition is not in the statute – it was created judicially
  - b. Requires actual knowledge or notice of facts that would put a reasonably prudent person on inquiry of the existence of a liability
  - c. Fiduciary is not under a duty to inquire of the IRS whether a liability exists unless there are suspicious circumstances that might prompt a prudent person to do so
- 4. Notice to the IRS
  - a. § 6903 requires a fiduciary to give the IRS notice of the fiduciary relationship (IRS Form 56)
  - b. If notice is not given, a statutory notice of deficiency will be valid if sent to the taxpayer's last known address even where the fiduciary never receives notice
  - c. Written notice to the IRS is also required upon termination of the fiduciary relationship

- d. Failure to give notice only subjects the estate to the liabilities – the fiduciary must still distribute assets in violation of § 3713 to become personally liable
- 5. Liability in the corporate context
  - a. § 3713 has been applied to corporate officers, directors and shareholders who participate in actions designed to avoid the federal tax liability of a legal entity
  - b. Example:
    - i. Distributions to shareholders at the dissolution of an entity could trigger this liability
    - ii. Escrow agent was held liable for corporate taxes where the agent received proceeds from asset sale and applied the proceeds to state and local taxes prior to federal taxes
    - iii. Executor was held liable for taxes of dissolved solvent corporation where corporate assets were distributed to beneficiaries of the estate
- 6. Fiduciaries are required to object to court ordered distributions that violate § 3713 in order to escape liability under § 3713(b)
- 7. Prudent fiduciaries should
  - a. Apply for a discharge under § 6905 (income and gift taxes) or § 2204 (estate taxes)
  - b. Request prompt assessment of income, gift and estate tax liabilities under § 6501(d)
  - c. Give prompt written notice of the fiduciary relationship and the termination thereof to the IRS pursuant to § 6903

#### **H. Enforcement Procedures**

- 1. Government enforces § 3713 in two ways:
  - a. Actions in District Court
  - b. Transferee liability procedures of § 6901
- 2. Transferee liability procedure:
  - a. IRS first sends Notice of Liability (similar to Notice of Deficiency) to the fiduciary
  - b. Fiduciary may contest in Tax Court or sue for a refund in District Court or the Court of Federal Claims
  - c. Government may also assert transferee liability for estate taxes under § 6324(a)(2) or any creditor remedy provided by state law

#### **IV. Nominee Liens/Levies and Alter Ego**

##### **A. What is a nominee lien or levy?**

- 1. Lien or levy put in place by the IRS because legal title to a taxpayer's property is put in the name of a third party while actual beneficial ownership remains in the transferor
- 2. Effect of nominee lien is to provide public notice that the property is being held by the record owner for the benefit of the taxpayer and that a tax lien has attached to the property

3. The levy equivalent of a nominee lien is the nominee levy
4. No direct statutory authority exists for nominee liens, but courts have sanctioned their use (including the U.S. Supreme Court)

**B. Factors:**

1. No consideration or inadequate consideration for the transfer
2. Property placed in the name of the nominee in anticipation of liabilities but with the transferor continuing to exercise control
3. Close relationship between the taxpayer and nominee
4. Failure to record the conveyance
5. Retention of possession by the taxpayer
6. Exercise of dominion or control by the taxpayer
7. State property taxes paid or assessed in the taxpayer's name
8. Other expenses of property paid by the taxpayer

**C. Effects of a nominee lien**

1. Nominee may experience impairment of credit
2. Lien could trigger default on loan agreements or leases
3. Nominee's first notice of the liability is frequently the filing of the lien

**D. Remedies**

1. Nominees do not have many effective remedies or rights
2. Deficiency procedures are not available to nominees
3. Collection Due Process hearings are not available to nominees
4. Options:
  - a. Nominee may bring a quiet title action under 28 U.S.C. § 2410 to challenge the lien
  - b. Collection Appeals Program hearing (disadvantage - these hearings are final and not appealable)

**E. Alter Ego**

1. Similar to a corporate veil-piercing argument
2. IRS elements of alter ego:
  - a. Unity of ownership and interest (such that the separateness of the corporation has ceased to exist)
  - b. Fraud or inequity would result from the failure to disregard the corporate entity
3. Factors
  - a. Absence of corporate formalities
  - b. Commingling of corporate and personal funds/expenses
  - c. Family relationship between corporate officers and the taxpayer
  - d. Taxpayer controls entity to shield himself from personal liability
4. Reverse piercing is available to the IRS in alter ego situations – entity held liable for personal liabilities

## Mission Impossible: Tax Planning for 2013 and Beyond

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2013 South Carolina Bar Convention  
Tax Section Seminar  
January 26, 2013

**CHARLESTON**  
SCHOOL OF LAW

### Overview of 2013 Changes

- Patient Protection and Affordable Care Act of 2010.
- American Taxpayer Relief Act of 2012.
- What's next?

## Tax Planning for 2013 and Beyond

### Individual Tax Changes

### Income Tax Rates

- Permanently extends the lower tax rate brackets:
  - 10% bracket permanently extended.
  - 25% (28%), 28% (31%), 33% (36%) permanently reduced.
  - 35% (39.6%) permanently reduced BUT only for taxable incomes up to:
    - \$225,000 for married filing separate.
    - \$400,000 for single filers.
    - \$425,000 for head of household filers.
    - \$450,000 for married couples filing jointly.
  - 39.6% rate for income greater than the above thresholds.
    - Note – 39.6% rate begin at \$11,950 for trusts with taxable income that is not distributed.
- Indexed for inflation beginning in 2014.

## 2013 Income Tax Rates

2013 Federal Tax Rates	Single	Married Filing Jointly & Surviving Spouses	Married Filing Separate Returns	Heads of Households
Personal Exemption	\$3,900			
Std Deduction	\$6,100	\$12,200	\$6,100	\$6,100
10%	\$0 - \$8,925	\$0 - \$17,850	\$0 - \$8,925	\$0 - \$12,750
15%	\$8,925 - \$36,250	\$17,900 - \$72,500	\$8,925 - \$36,250	\$12,750 - \$48,600
25%	\$36,250 - \$87,850	\$72,500 - \$146,400	\$36,250 - \$73,200	\$48,600 - \$125,450
28%	\$87,850 - \$183,250	\$146,400 - \$293,050	\$73,200 - \$146,400	\$125,450 - \$203,350
33%	\$183,250 - \$398,350	\$293,050 - \$450,000	\$146,400 - \$293,050	\$203,350 - \$398,350
35%	\$398,350 - \$400,000	\$450,000 - \$450,000	\$293,050 - \$293,050	\$398,350 - \$425,000
39.6%	over \$400,000	over \$450,000	over \$293,050	over \$425,000

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## 0.9% Medicare Tax

- Beginning in 2013, an additional 0.9% Medicare Tax is imposed on income from wages (includes individual's wages, compensation, and self-employment income) that exceeds the threshold amount based on the taxpayer's filing status as follows:
  - \$125,000 married filing separate.
  - \$250,000 married filing jointly.
  - \$200,000 single and head of household ("in all other cases").
- All wages that are currently subject to Medicare Tax are subject to the additional 0.9% Medicare Tax if they are paid in excess of the applicable threshold for a taxpayer's filing status.
- Applies only to employees, not employers.
- Employer Withholding Obligation.* Must withhold the additional tax from employees it pays wages or compensation in excess of \$200,000 in a calendar year.

## Capital Gains & Dividends

- Permanently extends capital gain rates to qualified dividends.
- Permanently extends the 0% and 15% tax rates.
- The top rate will permanently increase to 20% for filers with **taxable incomes** above:
  - \$225,000 for married filing separate.
  - \$400,000 for single filers.
  - \$425,000 for head of household filers.
  - \$450,000 for married couples filing jointly.
- 25% and 28% for unrecaptured 1250 gain and collectibles remains unchanged.

## 3.8% Net Investment Income Tax

- The NIIT applies at a rate of 3.8% to certain net investment income of individuals, estates, and trusts that have income above the statutory threshold amounts.
- Subject to the estimate tax provisions.

## 3.8% Net Investment Income Tax

- Who Owes NIIT?

- Estates and Trusts are subject to the NIIT if they have undistributed NII and an AGI over the dollar amount at which the highest tax bracket for an estate or trust begins for such taxable year.
- There are special computational rules for certain types of trusts, such a Charitable Remainder Trusts and Electing Small Business Trusts, which can be found in the proposed regulations.

## 3.8% Net Investment Income Tax

- Who Owes NIIT?

- The following trusts are not subject to the Net Investment Income Tax:
  - Trusts that are exempt from income taxes (e.g., charitable trusts and qualified retirement plan trusts exempt from tax under IRC §501, and Charitable Remainder Trusts exempt from tax under IRC § 664).
  - A trust in which all of the unexpired interests are devoted to one or more of the purposes described in § 170(c)(2)(B).
  - Trusts that are classified as “grantor trusts” under IRC §§ 671-679.
  - Trusts that are not classified as “trusts” for federal income tax purposes (e.g., Real Estate Investment Trusts and Common Trust Funds).

## 3.8% Net Investment Income Tax

- **Who Owes NIIT?**
  - Nonresident Aliens (NRA) are not subject to NIIT.
    - Special rules are provided in the proposed regulation for a NRA that is married to a U.S. citizen or resident and has made, or is planning to make, an election under § 6013(g) to be treated as a resident alien for purposes of filing married filing jointly.
  - The tax will affect taxpayers with a modified adjusted gross income that exceeds the threshold amount based on the taxpayer's filing status as follows:
    - \$125,000 married filing separate.
    - \$250,000 married filing jointly/surviving spouse.
    - \$200,000 single and head of household ("any other case").
  - Not indexed to inflation (for individuals).

## 3.8% Net Investment Income Tax

- **What is Included in NII?**
  - $NII = \text{Investment Income} - \text{Investment Expenses}$
  - Investment Income:
    - Includes (but is not limited to):
      - Interest,
      - Dividends,
      - Capital gains (regardless of ST or LT),
      - Rental and royalty income,
      - Non-qualified annuities,
      - Income from businesses involved in trading of financial instruments or commodities, and
      - Businesses that are passive activities to the taxpayer.

## 3.8% Net Investment Income Tax

- What is Included in NII?
  - Investment Income (Continued):
    - To the extent that gains are not otherwise offset by capital losses, the following gains are common examples of items taken into account in computing NII:
      - Gains from the sale of stocks, bonds, and mutual funds.
      - Capital gain distributions from mutual funds.
      - Gain from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence).
      - Gains from the sale of interests in partnerships and S corporations (to the extent you were a passive owner).

## 3.8% Net Investment Income Tax

- What is Included in NII?
  - Investment Expense:
    - Deductions that are properly allocable to items of Investment Income.
    - Examples include:
      - Investment interest expense,
      - Investment advisory and brokerage fees,
      - Expenses related to rental and royalty income, and
      - State and local income taxes properly allocable to items included in NII.

## 3.8% Net Investment Income Tax

- How calculated?

- The surtax will be based, on the lesser of:
  - (1) The taxpayer's NII - or -
  - (2) The amount the modified AGI (which includes investment income) exceeds the threshold amounts.

## 3.8% Net Investment Income Tax

- How calculated?

- For example (assuming no above the line deductions or investment deductions):
  - H & W earn a salary of \$400,000 and \$100,000 from investment income. **Surtax = \$3,800.**
    - Lesser of: (1) \$100,000 or (2) \$250,000  $[(400,000 + 100,000) - 250,000 \text{ Threshold}]$ .
  - H & W earn a salary of \$200,000 and \$200,000 from investment income. **Surtax = \$5,700.**
    - Lesser of: (1) \$200,000 or (2) \$150,000  $[(200,000 + 200,000) - 250,000 \text{ Threshold}]$ .

## PEPS and Pease

- Permanently reinstates: (1) the phase-out of personal exemptions (PEPs) and (2) the limitation on itemized deductions (Pease).
- But raises the AGI threshold at which they begin to take effect to:
  - \$150,000 for married filing separate.
  - \$250,000 for single filers.
  - \$275,000 for head of household filers.
  - \$300,000 for married couples filing jointly.
- Thresholds adjusted for inflation.

## 2013 Thresholds:

	Income Tax 39.6% (Taxable Income)	Medicare Surcharge 0.9% (Wages in Excess)	Capital Gains 20% (Taxable Income)	NIE 3.8% (Modified AGI)	PEASE & PEPS (AGI)
Married Filing Jointly	\$450,000	\$250,000	\$450,000	\$250,000	\$300,000
Single	\$425,000	\$200,000	\$425,000	\$200,000	\$250,000
Married Filing Separate	\$225,000	\$125,000	\$225,000	\$125,000	\$150,000
Head of Household	\$400,000	\$200,000	\$400,000	\$200,000	\$275,000

## Payroll Tax

- Restores the employee Social Security payroll tax contribution to 6.2% on income up to \$113,700 in 2013.
- This payroll tax contribution had been temporarily reduced to 4.2%.
- Thus, every working taxpayer has a 2% tax increase.

## AMT

- Permanently extends the AMT patch with annual inflation adjustments.
- Permanently made nonrefundable personal credits to the full amount of the individual's regular tax and AMT.

## Conservation Easements

- Extends through 2013.
- Raises the deduction a landowner can take for donating a built-in capital gain property for conservation purposes from 30 percent of their adjusted gross income to 50 percent.
- Qualifying farmers and ranchers can deduct up to 100 percent of their adjusted gross income.
  - Qualified farmer or rancher → a taxpayer whose gross income from the trade or business of farming is greater than 50 percent of the taxpayer's gross income for the taxable year.
- The law also increases the number of years over which a landowner can take those deductions from 5 to 15 years.

## Retirement Savings

- Allows participants in 401(k) plans with in-plan Roth conversion features to make transfers to a Roth account at anytime.
- Taxed on the total value of the amount converted at the time of the conversion.
- But, avoids any penalty for an early distribution.
- After the conversion, the new Roth account grows tax-free and no tax will be due on distributions made from Roth account.

## Retirement Savings

- For 2012 and 2013, Congress restored the provision for those age 70.5 or over to transfer up to \$100,000 from their IRA to a charity.
  - Taxpayers who make qualified charitable rollover distributions in January 2013 can count the rollover as if it were made in 2012.
  - Taxpayers who took a distribution in December 2012 can contribute that amount to a charity (before February 1, 2013) and count it as an eligible charitable rollover.
  - The transfer will count as the taxpayer's required minimum distribution.
  - Taxpayers will:
    - Avoid all taxes on this withdrawal.
    - But, will not get a deduction for the charitable contribution.

## Educational Incentives

- **American Opportunity Tax Credit.** Extends through 2017.
- **Deduction for Qualified Tuition.** Extends through 2013.
- **Student Loan Interest Deduction.**
  - Repeals the 60-month limit on deducting student loan interest.
  - Permanently expands the AGI range for phase-out of the deduction.
  - Repeals the restriction that makes voluntary payments of interest not deductible.

## Educational Incentives

- **Coverdell Education Savings Accounts.** Makes permanent enhancements to the Coverdell ESAs, including a \$2,000 max. contribution amount and treatment of K-12 and post-secondary school expenses as qualified expenses.
- **Employer-Provided Education Assistance.** Makes permanent the exclusion from income and employment taxes of employer provided education assistance up to \$5,250.
- **Teacher's Classroom Expense Deduction.** Extends through 2013.

## Energy Incentives for Individuals

- **Credit for Energy-Efficient Existing Homes.** Extends through 2013.
  - Individuals can make energy efficiency improvements to their existing residence and take up to the lifetime credit limit of \$500 (\$200 for windows and skylights).
- **Credit for Alternative Fuel Vehicle Refueling Property.** Extends through 2013.
  - For personal use, the credit is limited to up to \$1,000.
- **Credit for 2- or 3- wheeled Plug-In Electric Vehicles.** Reforms and extends credit of up to \$2,500 credit for 2012 and 2013.

## Other Changes

- **State and Local Tax Deduction.** Extends through 2013.
- **QPRI (IRC § 108(a)(1)(E)).** Extends through 2013.
- **Unreimbursed Medical Expenses.**
  - Must exceed 10% of AGI before you can deduct.
  - For taxpayers 65 and older, the threshold is 7.5% through 2016.
- **Transit Benefits.** Extends parity through 2013.
- **Mortgage Insurance Premiums.** Extends deduction through 2013.

## Other Changes

- **Child Tax Credit.** Makes permanent the \$1,000 child tax credit (not indexed for inflation).
- **Adoption Credit.** Makes permanent the exclusion from income of up to \$10,000 (indexed for inflation) for employer-paid or reimbursed adoption expenses.
- **Child and Dependent Care Credit.** Makes the current 35% credit rate permanent. Also, the \$3,000 cap on expenses for one qualifying individual and the \$6,000 cap on expenses for two or more qualifying individuals is made permanent.

## Tax Planning for 2013 and Beyond

### Business Tax Changes

### Section 179

- Extends through 2013.
- For 2012 and 2013: \$500,000 annual limit and \$2 million investment limit.
  - For 2014 scheduled to return to: \$25,000 annual limit and \$200,000 investment limit (adjusted for inflation).
- **Qualified property.** New or used tangible personal property used in business. Examples include:
  - Equipment purchased for business use,
  - Computers,
  - Computer off-the shelf software,
  - Office Furniture,
  - Office Equipment, and
  - Property attached to your building that is not a structural component of the building

## Section 179

- Extends the eligibility of off-the-shelf software expensing.
  - To qualify, the software must be:
    - Readily available for purchase by the general public,
    - Subject to a nonexclusive license, and
    - Cannot have been substantially modified.
  - If the core software is standardized, a small amount of customization is alright.
- Extends expensing of up to \$250,000 for qualifying leasehold improvements, restaurant property, and retail improvement property.

## Section 179

- The property must be used for business purposes more than 50% of the time to be eligible for § 179 expensing.
  - Multiply the cost of the property by the percentage of business-use to arrive at the monetary amount eligible for § 179.
- Consider using a lease or finance agreement.

## Bonus Depreciation

- Extends through 2013 the 50% bonus depreciation (through 2014, for property having a longer production period and certain aircraft).
- **Qualified Property.** Must meet all of the following requirements:
  1. Be property having a tax recovery period of 20 years or less;
  2. The “Original Use” of the property must commence with the taxpayer;
  3. Be acquired by the taxpayer before January 1, 2014 or pursuant to a “Written Binding Contract” entered before January 1, 2014; and
  4. Be placed in service by the taxpayer before January 1, 2014, or before January 1, 2015 for aircraft qualifying under the rules for “Certain Aircraft” and aircraft qualifying under the rules for “Property Having Longer Production Periods”.

## Bonus Depreciation

- Applies to self-constructed property.
  - IRS regulations provide that “property that is manufactured, constructed or produced for the taxpayer by another person under a written binding contract . . . that is entered into prior to the manufacture, construction or production of the property for use by the taxpayer in its trade or business (or for its production of income) is considered manufactured, constructed or produced by the taxpayer.”
- Deductibility of the remaining basis.
  - A taxpayer’s remaining basis, if any, after deducting the Bonus Depreciation allowance is depreciated under standard depreciation principles.

## Section 179 & Bonus Depreciation Calculation

5-Year Equipment Purchase	\$ 600,000
First Year § 179 Write-Off	\$ 500,000
50% Bonus First Year Depreciation	\$50,000
Normal First Year Depreciation	\$10,000
Total First Year Deduction	\$560,000
Tax Saving (30% effective tax rate)	\$168,000
Cost of Equipment after First Year Savings	\$432,000

## Research Tax Credit

- Retroactively reinstated and prospectively extended through 2013.
- Includes both in-house and contract research expenses.

## Research Tax Credit

- **Modifies and simplifies rules for taxpayers under common control.** The new rule provides that the credit allowable to each member of a controlled group of corporations (or each business under common control) will now be allocated to the members based on the member's proportionate share of QREs

## Research Tax Credit

- **Modifies rules for computing the credit when a portion of the T/B exchanges hands.**
  - In the computation of the R&D credit for the year of acquisition, the new rule provides that when a business is acquired, the acquiring entity includes only a proportionate share of QREs for the acquired business, reflecting the period after the acquisition.
  - In the base years, corresponding adjustments to QREs and gross receipts will also be prorated based on the number of days the acquired business was owned by the acquirer during the year of acquisition.
  - For years after the acquisition, the full prior year QREs and gross receipts amounts for the acquired business would be included in the acquirer's base amount computations.
  - Mirror image rules were enacted for the disposing entity.

## Depreciation – Asset Life

- Property placed in service through 2013:
  - **Qualifying leasehold improvements, restaurant property, and retail improvement property.** 15-year straight-line cost recovery period.
  - **Motorsports entertainment complexes.** 7-year recovery period.

## Employment Tax Credits

- Extends through 2013:
  - **Work Opportunity Tax Credit.** Provides a credit generally equal to 40% of first-year wages up to \$6,000 for hiring an individual within a target group.
  - **Heroes Act of 2011.** Provides a credit up to \$9,600 for hiring a qualified veteran.
  - **Employer Wage Credit for Activated Military Reservists.** Provides qualified small business employers with a credit equal to 20% of the sum of the differential wage payments to activated military reservists.

## Employer Provided Benefits

- **Makes Permanent:**
  - **Employer-Provided Child Care Credit.** Employers may qualify for a credit of up to \$150,000 for acquiring, constructing, rehabilitating, or expanding property which used for a child care facility.
  - **Employer-Provided Education Assistance.** Employers may deduct up to \$5,240 annually for qualified education expenses paid on behalf of an employee.

## S Corporation

- **Extends through 2013:**
  - **Reduced recognition period for S corporation built-in gains tax.** Extends the reduced 5-year recognition period for sales occurring in 2012 and 2013. [§ 1374(d)].
    - “If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.”
  - **Basis adjustment to stock of S Corporations making charitable donations of property.** Provides that the decrease in basis in stock of the S Corporation by reason of a charitable contribution of property shall be the amount equal to the shareholder’s pro rata share of the adjusted basis of such property. [§ 1367(a)(2)(D)].

## Carried Interests

- No changes at this time.
- But, definitely a focus of many.
- However, 3.8% Net Investment Income Tax may now apply.

## Qualified Small Business Stock

- 100% exclusion for gain on sale of qualified small business stock. [§1202].
- Qualified small business stock must meet the following requirements:
  - Acquired by issuance, not cross purchase;
  - Issued by a C corporation with cash and other assets totaling \$50 million or less, based on adjusted basis, at all times from August 10, 1993 to immediately after the stock is issued.
  - Meets an active business requirement—at least 80% of the value of the corporation's assets are used in a qualified trade or business during substantially all of the taxpayer's holding period for such stock and the corporation is an eligible corporation.
- Must hold the stock for 5 years to benefit from §1202.
- *Limit.* Greater of (1) \$10 million (\$5 million for married taxpayers filing separately), minus any amount excluded with respect to that corporation's stock in prior years, or (2) ten times the aggregate basis of stock of the qualified corporation sold during the year.

## Additional Extenders - Through 2013

- *International Tax:*
  - Subpart F exceptions for active financing income.
  - Look through rule for related controlled foreign corporation payments.
  
- *Empowerment Zones:*
  - Tax incentives for empowerment zones.
  - Qualified zone academy bonds.
  
- *Indian Cultural Incentives:*
  - Indian employment credits.
  - Accelerated depreciation for business property on Indian reservations.
  
- *Mining:*
  - Mine rescue team training credit.
  - Election to expense advanced mine safety equipment.

## Additional Extenders - Through 2013

- *RICS:*
  - Treatment of dividends of regulated investment companies (RICs).
  - Treatments of RICs as qualified investment entities.
  
- *Misc:*
  - Railroad track maintenance credit.
  - Enhanced Deduction for charitable contributions of food inventory.
  - Low-income tax credits for non-federal subsidized new buildings.
  - Low-income housing credit treatment of military housing allowances.
  - Special expensing rules for qualified film and television productions.

## Additional Extenders - Through 2013

- *Energy Incentives:*
  - Extension and modification of cellulosic biofuel producer credit.
  - Extension of incentives for biodiesel and renewable diesel.
  - Extension of production credit for Indian coal facilities placed in service before 2009.
  - Extension and modification of credits with respect to facilities producing energy from certain renewable resources.
  - Extension of credit for energy-efficient new homes.
  - Extension of credit for energy-efficient appliances.
  - Extension and modification of special allowance for cellulosic biofuel plant property.
  - Extension of alternative fuels excise tax credits.

## Tax Planning for 2013 and Beyond

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Estate and Gift Tax Changes

## Estate and Gift Tax

- Permanently extends the lifetime estate and gift tax exemption of \$5 million (with annual inflation adjustments - \$5.12 million for 2012).
- Increases the top tax rate from 35% to 40%.
- Provisions for spousal portability and reunification of the estate and gift tax are also permanently extended.
- Extends the deduction for state estate taxes paid.
- Repeals the 5% surtax on estates larger than \$10 million.

## Tax Planning for 2013 and Beyond

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If you have any further questions,  
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