

Tax Practice and Administration: Sanctions, Agreements, and Disclosures

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- Understand the application of the statutes of limitations, and taxpayer-government agreements that may be made with respect thereto.

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THE ADVERSARIAL NATURE OF the Federal tax system has become apparent throughout this text, especially in Chapter 13. The revenue system is based on the notion of self-assessment, but the failure of the taxpayer to comply in detail with the requirements of the structure can lead to painful negotiations with the Internal Revenue Service (IRS) and prolonged litigation.

Yet, the Treasury need not wait for a resolution of the disputed tax issues alone to collect revenues. Penalties and interest play an ever-increasing role in the makeup of the Federal tax system—in many cases, the accumulated penalties and interest assessed by the IRS equal 50 percent of the disputed tax or more.

Interest charges are made by the Treasury so that the taxpayer gains no advantage or disadvantage with respect to the time value of money in deciding how to handle a tax dispute—to the extent that interest rates are developed to parallel those of the rest of the financial market, both parties are indifferent as to cash flow issues, and the negotiations can center on the tax issues alone. In Chapter 12, we discussed the role of present values in assisting taxpayers to make these decisions in an economically prudent manner.

Penalties have become more prominent in the Federal tax system for several reasons. The tax professional must incorporate into the research model the penalty-based “costs” of being too aggressive in taking a tax return or litigation position, and convey the computations of those costs to the client.

- In an environment where nominal tax increases are politically unpopular, penalty increases can supplement revenues in a manner that is acceptable to the public.
- Politics aside, penalties increase the tax cost of negotiating with the Treasury and may discourage challenges to tax precedents that are not founded in sound tax law.
- Penalties can bolster the self-assessment process by discouraging taxpayers from behaviors that the Treasury wishes to repress, such as working with tax shelters and ignoring filing deadlines and requirements.
- As professional tax preparers and advisers play a more important role in the development of tax return positions, the behavior of such third parties also must be controlled, both in keeping a free flow of information between the government and the taxpayer and in interpreting the tax law in an objective manner.

We conclude this chapter with a review of alternatives and strategies available to taxpayers in making various compromises and other agreements with the IRS as a result of the examination process. In today’s tax practice, the professional must have a full working knowledge of the details of the tax administration process, so as best to serve clients and the fisc.

TAXPAYER PENALTIES

To promote and enforce taxpayer compliance with the U.S. voluntary self-assessment system of taxation, Congress has enacted a comprehensive array of penalties. Tax penalties may involve both criminal and civil offenses. Criminal tax penalties are imposed only after the usual criminal process of law is carried out, in which the taxpayer is entitled to the same constitutional guarantees that are given to nontax criminal defendants. Normally, a criminal penalty provides for imprisonment. Civil tax penalties are collected in the same manner as other taxes, and they usually provide only for monetary fines. Criminal and civil penalties are not mutually exclusive; therefore, a taxpayer may be liable under both types of sanctions.

Civil Penalties

The Code imposes two types of **civil penalties**. *Ad valorem penalties* are additions to tax that are based on a percentage of the delinquent tax. Unlike assessable penalties, ad valorem penalties are subject to the same deficiency procedures that apply to the underlying taxes. *Assessable penalties* typically are expressed as a flat dollar amount. Because of the lack of jurisdiction by the Tax Court or a specific statutory exemption, assessable penalties are not subject to review by the Tax Court. The Code characterizes tax penalties as additions to tax; thus, they cannot subsequently be deducted by the taxpayer.¹

Civil penalties are imposed when the tax statutes are violated (1) without **reasonable cause**, (2) as the result of **negligence** or intentional disregard of pertinent rules, or (3) through a willful disobedience or outright **fraud**. The most important civil penalties include the following.

- Failure to file a tax return
- Failure to pay tax
- Failure to pay estimated income taxes
- Negligence, fraud, or substantial understatement of income tax
- Substantial understatement of the tax liability
- Failure to make deposits of taxes or overstatement of such deposits
- Giving false information with respect to withholding
- Filing a frivolous return

Failure to File a Tax Return When a taxpayer fails to file a required tax return, a penalty is imposed unless it is shown that the failure is due to some reasonable cause and not to the taxpayer's willful neglect. The penalty is 5 percent of the amount of the tax, less any prior payments and credits, for each month (or fraction thereof) that the return is not filed. The maximum penalty that may be imposed is 25 percent (or five months' cumulative penalty). A fraudulent failure to file is subject to a 15 percent monthly penalty, to a 75 percent maximum.²

If the taxpayer's failure to file is due to willful neglect, there is a minimum penalty for a failure to file an income tax return within sixty days of the due date, including extensions. This minimum penalty is the lesser of \$100 or the full amount of taxes that are required to be shown on the return. The penalty does not

¹§6665(a)(1).

²§§6651(a)(1) and (f).

apply if the failure is due to reasonable cause.³ This penalty is applied in lieu of, rather than in addition to, some other penalty.

No statutory or administrative definition exists for the term “reasonable cause.” However, some courts define it to include such action as would prompt an ordinary, intelligent person to act in the same manner as did the taxpayer, under similar circumstances. One of the most commonly encountered examples of reasonable cause is the reliance on the advice of competent tax counsel.⁴ Other examples of reasonable cause that the *Internal Revenue Manual* describes include the following.

- A timely mailed return that is returned for insufficient postage.
- Death or serious illness of the taxpayer or his or her immediate family.
- Destruction of the taxpayer’s residence, place of business, or records by fire or other casualty.
- Proper forms that were not furnished by the IRS.
- Erroneous information obtained from IRS personnel.
- A timely mailed return sent to the wrong IRS address.
- An unavoidable absence by the taxpayer.
- An unavoidable inability to obtain records necessary to compute the tax.
- Some other inability to obtain assistance from IRS personnel.

However, the penalty will not be excused for any of the following reasons.

- The taxpayer lacks the necessary funds with which to pay the tax.⁵
- The taxpayer was hospitalized and suffered from an illness that was not incapacitating.⁶
- The taxpayer was incarcerated.⁷
- The taxpayer allegedly was ignorant of the laws.⁸

To avoid the penalty, the taxpayer must meet the burden of proof that the failure to file (or to pay) was due to reasonable cause. In these situations, the IRS’s determination of the penalty is presumed to be correct.



SPOTLIGHT ON TAXATION

When Is a Return Filed?

To avoid the §6651 penalty, a return must be “filed.” Some taxpayers think that sending in a blank form, or neglecting to sign the return, is enough to avoid this penalty, but the tax law says otherwise. The taxpayer

continued

³§6651(a)(3).

⁴See, for example, Chamberlin, TC Memo 2000-50.

⁵Langston, 36 T.C.M. 1703 (1977).

⁶Hernandez, 72 T.C. 1234 (1979).

⁷Jones, 55 T.C.M. 1556 (1988).

⁸*Lammerts Estate v. Comm.*, 456 F.2d 681 (CA-2, 1972).

continued

information must be included in a readable format, almost always on the correct IRS form, mailed by the due date, and signed by the appropriate parties. There must be enough information on the return so as to compute the correct amount of tax; thus, leaving lines or check-boxes empty will void the filing and the penalty will be assessed.

As electronic filing requirements are imposed on various taxpayers, both to speed up the system, and to eliminate the possibility of errors, IRS software will not accept an incomplete or frivolous return. This is also a way to verify tax identification numbers, so as immediately to identify those with other delinquent accounts, or with inadequate filing credentials.

Failure to Pay Tax If a taxpayer fails to pay either a tax that is shown on his or her return or an assessed deficiency within ten days of an IRS notice and demand, a penalty is imposed. The ten-day period becomes twenty-one days when the tax due is less than \$100,000.⁹ The penalty is 0.5 percent of the required liability, after adjusting for any prior payments and credits, for each month (or fraction thereof) that the tax is not paid—but it increases to 1 percent of the underpaid tax per month after notice and demand is issued by the IRS.¹⁰ The maximum penalty that may be imposed is 25 percent of the outstanding tax. This penalty does not apply if the failure to pay is attributable to a reasonable cause, or to the failure to pay an estimated tax for which there is a different penalty.

For this purpose, reasonable cause is defined in a manner that is identical to that discussed in conjunction with the failure-to-file penalty, except that, if an individual is granted an automatic filing extension, reasonable cause is presumed to exist, provided that the balance due does not exceed 10 percent of the total tax.¹¹

The failure-to-file penalty is reduced by the 0.5 percent failure-to-pay penalty for any month in which both apply. Thus, no more than a 5 percent total (non-fraud) penalty typically can be assessed against a taxpayer for any month. Nonetheless, after rendering sufficient notice to the taxpayer, the IRS can assess both the failure-to-pay and the failure-to-file penalties.

A taxpayer can avoid the failure-to-file penalty if an extension of the return's due date is granted by the IRS. However, with the two exceptions that we just discussed, the failure-to-pay penalty is imposed when the total amount of the tax is not paid by the unextended due date of the return.

Example 14-1 John Gray, a calendar-year taxpayer, filed his 2008 income tax return on October 20, 2009, paying an amount due of \$1,000. On April 1, 2009, John had obtained a six-month extension of time in which to file his return. However, he could not assert a reasonable cause for failing to file the return by October 15, 2009 (the extended due date), nor did he show any reasonable cause for failing to pay the tax that was due on April 15, 2009. Gray's failure to file was not fraudulent. As a result, Gray is subject to a \$35 failure-to-pay penalty and a \$45 failure-to-file penalty, determined as follows.

⁹§6651(a)(3).

¹⁰§§6651(a)(2) and (d)(1). The monthly penalty rate is cut in half for taxpayers paying delinquent taxes under an installment agreement. §6651(h).

¹¹§6654(d)(1)(B)(i).

Failure to pay	
Underpayment	\$1,000
Penalty percentage	<u>× .005</u>
Penalty per month outstanding	\$ 5
Months (or fractions thereof) for which required payment was not made	<u>× 7</u>
Failure-to-pay penalty	<u>\$ 35</u>
Failure to file	
Underpayment	\$1,000
Penalty percentage	<u>× .05</u>
Penalty per month outstanding (before reduction)	\$ 50
Months (or fractions thereof) for which return was not filed	<u>× 1</u>
Unreduced penalty	\$ 50
Less: concomitant failure-to-pay penalty (portion of October) [1 month × (.005 × \$1,000)]	<u>- 5</u>
Failure-to-file penalty	<u>\$ 45</u>

Accuracy-Related Penalty Major penalties relating to the accuracy of the return data, including the existing negligence penalty and the penalty for substantial understatement of income tax liability, are combined in a single Code section. This consolidation of related penalties into a single levy eliminates the possibility of the stacking of multiple penalties when more than one type of penalty applies to a single understatement of tax.

The **accuracy-related penalty** amounts to 20 percent of the portion of the tax underpayment that is attributable to one or more of the following.

- Negligence or disregard of applicable Federal tax rules and Regulations
- Substantial understatement of income tax
- Substantial valuation overstatement
- Substantial overstatement of pension liabilities
- Substantial understatement of estate and gift tax valuation

The penalty applies only where the taxpayer fails to show either a reasonable cause for the underpayment or a good-faith effort to comply with the tax law.¹² When the accuracy-related penalty applies, interest on the penalty accrues from the due date of the return, rather than merely from the date on which the penalty was imposed.

Occasionally, a valuation overstatement penalty is encountered. This 20 percent penalty applies when an asset value has been overstated on a return, for example, to substantiate a charitable contribution deduction. It is assessed when the valuation used is 150 percent or more of the actual value, resulting in an underpayment of over \$5,000 (\$10,000 for C corporations).

Similarly, a 20 percent transfer tax valuation understatement penalty is assessed where the claimed value is 65 percent or less than the asset's actual value, resulting in an underpayment of over \$5,000. The rate of both penalties is 40 percent

¹²§6662.

if a gross valuation misstatement is made, that is, the income tax valuation was at least 200 percent of actual value, or the transfer tax value was 40 percent or less of actual value.¹³

The practitioner is likely to encounter two of the elements of this penalty most frequently: (1) negligence or disregard of rules and (2) substantial understatement of tax. In the first penalty, “negligence” includes any failure to make a reasonable attempt to comply with the provisions of the Code.¹⁴ This might occur when the taxpayer fails to report gross income, overstates deductions, or fails to keep adequate records with which to comply with the law. “Disregard” includes any careless, reckless, or intentional disregard of the elements of the tax law.

The negligence component of the penalty is waived where the taxpayer has made a good-faith attempt to comply with the law, as indicated by a full disclosure of the nonfrivolous position that may be contrary to that of the IRS. Such disclosure is made by completing Form 8275, reproduced as Exhibit 14-1, and attaching it to the return. If the return position is contrary to the language of a Regulation, Form 8275-R is used.

The second commonly encountered penalty, substantial understatement of income tax, occurs if the determined understatement exceeds the greater of (1) 10 percent of the proper tax liability or (2) \$5,000. The understatement must exceed the lesser of the following for a corporation other than an S corporation or a personal holding company.¹⁵

- ▶ • 10 percent of the proper tax liability, or
- \$10,000, if greater

OR

- ▶ \$10,000,000.

The amount that is subject to this penalty is reduced if the taxpayer either has substantial authority for the position that was taken in the return, or makes a full disclosure of a position taken in the return where there is a reasonable basis for the position, on Form 8275 or 8275-R.¹⁶ More specifically, the taxpayer is not subject to this penalty where there is **substantial authority** for his or her position that supports a one-in-three likelihood of defeating contrary positions.¹⁷

For this purpose, “substantial authority” includes the Code, Regulations (proposed and temporary), court decisions, administrative pronouncements, tax treaties, IRS information and press releases, IRS Notices and Announcements, Letter Rulings, Technical Advice Memoranda, General Counsel Memoranda, Committee Reports, and “Blue Book” explanations of tax legislation.¹⁸ Substantial authority does not include conclusions reached in tax treatises, legal periodicals, and opinions rendered by tax professionals.¹⁹

Clearly, greater weight is placed on the Code and temporary Regulations than will be assigned to Letter Rulings and IRS Notices, but the derivation of a weighted average among all of the competing positions with respect to a given tax question is not likely to be easily obtained.

¹³§6662 (e) through (h).

¹⁴§6662(c).

¹⁵§6662(d)(1).

¹⁶§6662(d)(2)(B). Tax shelters cannot use this provision.

¹⁷§6662(d)(2)(B).

¹⁸Reg. §1.6662-4(d)(iii).

¹⁹Notice 90-20, 1990-1 CB 328.

Exhibit 14-1: Disclosure Statement

Form **8275**
(Rev. May 2001)

Disclosure Statement

Do not use this form to disclose items or positions that are contrary to Treasury regulations. Instead, use Form 8275-R, Regulation Disclosure Statement. See separate instructions.

OMB No. 1545-0889

Department of the Treasury
Internal Revenue Service

▶ **Attach to your tax return.**

Attachment
Sequence No. **92**

Name(s) shown on return

Identifying number shown on return

Part I General Information (see instructions)

(a) Rev. Rul., Rev. Proc., etc.	(b) Item or Group of Items	(c) Detailed Description of Items	(d) Form or Schedule	(e) Line No.	(f) Amount
1					
2					
3					

Part II Detailed Explanation (see instructions)

1

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2

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3

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Part III Information About Pass-Through Entity. To be completed by partners, shareholders, beneficiaries, or residual interest holders.

Complete this part only if you are making adequate disclosure for a pass-through item.

Note: A pass-through entity is a partnership, S corporation, estate, trust, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC).

1 Name, address, and ZIP code of pass-through entity	2 Identifying number of pass-through entity
	3 Tax year of pass-through entity / / to / /
	4 Internal Revenue Service Center where the pass-through entity filed its return

Civil Fraud If any part of an underpayment of tax is attributable to fraud, a substantial civil penalty is imposed. In addition, the taxpayer may be liable for a criminal penalty, which we will discuss later in this chapter. The civil fraud penalty is 75 percent of the underpayment that is attributable to the fraud.²⁰

The burden of proof in a fraud case is on the IRS—it must show a fraudulent intent for the underpayment. This usually entails more than mere negligence, but a plan to defraud the government, often including a series of actions over time to evade the tax.



SPOTLIGHT ON TAXATION

Proving Fraud

The courts factor in the education and experience of the taxpayer in determining whether fraud has occurred. Is the taxpayer “smart” enough, say in terms of business and accounting training, to construct a plan to defraud, and then to carry it out? In cases of a complicated tax law or tax-reduction device, the taxpayer might successfully plead ignorance and avoid the fraud charge.

Under an all-or-nothing rule, if the IRS establishes that any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud, and the penalty applies to the entire amount due. But if the taxpayer shows that any part of an underpayment is not attributable to fraud, the fraud penalty is not imposed with respect to that amount.²¹ Neither the failure-to-file, nor the failure-to-pay penalty, nor the civil accuracy-related penalty, is assessed in these circumstances. However, the penalty for underpayment of estimated tax (discussed later) may still be assessed, and interest is assessed from the (extended) due date of the return.

Fraud is not defined in either the Code or the Regulations. One long-standing judicial definition of fraud describes it as “... actual, intentional wrongdoing ... the intent required is the specific purpose to evade a tax believed to be owing.”²² This definition has been expanded to include acts that are done without a “bad or evil purpose.” In *U.S. v. Pomponio*, the Supreme Court held that “willfulness,” which is a crucial element of fraud, is present when the taxpayer’s actions constitute “... a voluntary, intentional violation of a known legal duty.”²³ Consequently, the taxpayer’s deceptive or misleading conduct distinguishes fraud from mere negligence, or from other actions that are taken to avoid taxation, and not the presence of some (inherent or documented) evil purpose.

If a taxpayer is convicted of criminal fraud, he or she cannot contest a civil fraud determination. However, a charge that the taxpayer is guilty of criminal fraud may be contested when a civil fraud determination has been upheld. In a criminal fraud case, the IRS must prove “beyond a shadow of any reasonable doubt” that the taxpayer’s actions were fraudulent. In a civil fraud case, there must be “clear and convincing evidence” that the taxpayer committed fraud.

²⁰ §§6663(a) and (b).

²¹ §6663(b).

²² *Mitchell v. Comm.*, 118 F.2d 308, 310 (CA-5, 1941).

²³ 429 U.S. 10, 97 S.Ct. 22 (1976).

Ordinarily, the evidence that indicates that a taxpayer's conduct was fraudulent is circumstantial. Thus, the court must infer the taxpayer's state of mind from the evidence. Examples of fraud include the following.

- Keeping two sets of books, one in English and one in Japanese.²⁴
- Making false accounting entries.²⁵
- Destroying books or records.²⁶
- Concealing assets or sources of income.²⁷
- Consistently understating income or overstating deductions.²⁸
- Purposely avoiding the making of business records and receipts.²⁹

Failure to Make Estimated Payments A penalty is imposed on both individuals and corporations who fail to pay quarterly estimated income taxes. This penalty is based on the amount and duration of the underpayment, and the rate of interest that currently is established by the Code. This rate, for instance, was 7 percent early in 2008. Unlike the similar interest computation, however, this penalty is computed without any daily compounding and is not deductible.

The penalty is calculated separately for each quarterly installment. Each penalty period begins on the date on which the installment was required, and it runs through the earlier of either the date that the amount is paid or the due date for filing the return. Any overpayment is first applied to prior underpayments and the excess is credited to later installments.³⁰ In this regard, the taxpayer must balance cash flow concerns with the payment requirements of the Code.

Example 14-2 The taxpayer is required to have \$100 paid in as estimates for the year. Payment schedule A would likely incur an underpayment penalty, while schedule B would not.

Quarter	Schedule A	Schedule B
1	\$ 10	\$ 40
2	40	10
3	10	40
4	40	10
Total	\$100	\$100

Individuals An individual's underpayment of estimated tax is computed as the difference between the amounts that were paid by the quarterly due dates, and the least of the following.

- 90 percent of the tax that is shown on the current year's return;
- 100 percent of the prior year's tax, if a return was filed for that tax year of twelve months;

²⁴*Noro v. U.S.*, 148 F.2d 696 (CA-5, 1945).

²⁵*U.S. v. Lange*, 161 F.2d 699 (CA-7, 1947).

²⁶*U.S. v. Ragen*, 314 U.S. 513, 62 S.Ct. 374 (1942).

²⁷*Gendelman v. U.S.*, 191 F.2d 993 (CA-9, 1952).

²⁸*Holland v. U.S.*, 348 U.S. 121, 75 S.Ct. 127 (1954) and *Ragen*, op.cit.

²⁹*Garispy v. U.S.*, 220 F.2d 252 (CA-6, 1955).

³⁰§§6654(b) and 6655(b).

- 90 percent of the tax that would be figured by annualizing the income that was earned during the year, up to the month in which the quarterly payment is due.³¹

For this purpose, unless the taxpayer can prove otherwise, taxes that are withheld are considered to have been remitted to the IRS in equal quarterly installments.³²

The underpayment penalty will not apply if less than \$1,000 in underwithheld tax is due. Thus, an individual can avoid the estimated tax underpayment penalty if (1) the preceding taxable year included twelve months, (2) the individual did not have any tax liability for the preceding year, and (3) he or she was a citizen or resident of the United States throughout the preceding taxable year.³³

The IRS can waive the estimated tax underpayment penalty (but not the penalty that is based on the outstanding interest attributable thereto) (1) if the failure to make the payment was due to a casualty, disaster, or other unusual circumstance where it would be inequitable to impose the penalty, or (2) if the failure was due to reasonable cause rather than willful neglect during the first two years after the taxpayer retires after reaching age sixty-two, or becomes disabled.³⁴ The fourth installment penalty is waived if the corresponding tax return is filed with full tax payment by the end of the first month after the tax year-end (January 31 for calendar-year taxpayers).

Corporations An underpayment on the part of a corporation is defined as the difference between the amount of the installment that would be required to be paid if the estimated tax was equal to 100 percent of the tax that is shown on the return (or, if no return was filed, 100 percent of the actual tax that is due), and the amount that was actually paid on or before the prescribed payment date.³⁵

The underpayment penalty will not apply if less than \$500 in tax is due, or if the total payments that are made by the applicable installment date are equal to the least of the following.

1. 100 percent of the nonzero amount of tax that is shown on the corporation's tax return for the preceding year, provided that the preceding year contained twelve months;
2. 100 percent of the current-year tax liability; or
3. 100 percent of the tax that is due using a seasonal installment method, or annualizing the current year's income received for (1) the first two or three months, relative to the installment that is due in the fourth month of the tax year, (2) the first three, four, or five months, for the installment that is due in the sixth month, (3) the first six, seven, or eight months, for the installment that is due in the ninth month, or (4) the first nine, ten, or eleven months, for the installment that is due in the twelfth month as elected.³⁶

Exception 1 does not apply to a "large corporation," that is, one that had a taxable income of \$1 million or more in any of its three immediately preceding taxable years. To avoid an underpayment penalty, a large corporation must remit quarterly

³¹§6654(d). The rule is 110 percent of the prior-year tax if that year's AGI > \$150,000.

³²§6654(g).

³³§§6654(e)(1) and (2).

³⁴§6654(e)(3).

³⁵§6655(b)(1).

³⁶§§6655(d), (e), and (f).

estimated tax payments that are equal to its current year's tax liability, or it must meet Exception 3, as discussed.³⁷

Failure to Make Deposits of Taxes or Overstatements of Deposits The Code requires employers to collect and withhold income and Social Security taxes from their employees. Amounts that are withheld are considered to be held in a special trust fund for the United States, and they must be deposited in a government depository on or before certain dates prescribed by the statute and Regulations. An employer who does not have either the inclination or sufficient funds with which to meet its deposit obligations may be tempted to postpone the making of these deposits, that is, to “borrow” from the government the cash provided by employees. Consequently, the Code imposes heavy civil and criminal penalties on those who are responsible for the failure to make a timely deposit of the withheld funds.³⁸ A responsible party may be an officer or board member of a corporation rather than the corporation itself, even for charities and other exempt entities.

If an employer fails to deposit on a timely basis taxes that were withheld from employees, a penalty equal to a percentage of the underpayment is imposed. This rate varies from 2 to 15 percent, depending on when the failure is corrected.³⁹ The penalty may be avoided where the taxpayer can show that his or her actions were due to reasonable cause and not to willful neglect.

If any person who is required to collect, truthfully account for, and remit employment taxes willfully fails to do so, a penalty equal to 100 percent of the tax is imposed.⁴⁰ Therefore, when a corporate employer willfully does not pay to the government employment taxes that it withheld from an employee, the IRS effectively may collect the tax from those who are responsible for the corporate actions, such as the corporate directors, president, or treasurer.⁴¹

In addition to the civil penalties that have been discussed, criminal penalties may be imposed in an aggravated case of nonpayment.

Giving False Information with Respect to Withholding All employees are required to give their employer a completed Form W-4, Employee Withholding Allowance Certificate. This form notifies the employer of the number of withholding exemptions that the employee is entitled to claim. The employer then calculates the amount of tax that must be withheld from each employee. A civil penalty of \$500 is imposed on any person who gives to his or her employer false information with respect to withholding status or the number of exemptions to which he or she is entitled. This penalty is not imposed where there was a reasonable basis for the taxpayer's statement. Moreover, the IRS may waive all or part of the penalty if the actual income taxes that are imposed are not greater than the sum of the allowable credits and estimated tax payments.⁴²

Employers who receive a Form W-4 from an employee, on which he or she claims more than ten exemptions, must submit a copy of the form to the IRS.⁴³

³⁷ §§6654(d)(2) and (g)(2). The prior-year exception can be used in making the first-quarter installment, however. §6654(d)(2)(B).

³⁸ §6656.

³⁹ §6656(b)(1).

⁴⁰ §6672(a).

⁴¹ §§6671(b), 7809(a).

⁴² §6682.

⁴³ Reg. §31.3402(f)(2)-1(g).

Filing a Frivolous Return A separate \$5,000 civil penalty is assessed when the taxpayer is found to have filed a frivolous return.⁴⁴ Returns of this sort have been used to assert that the taxpayer's Fifth Amendment rights are violated by tax return disclosures,⁴⁵ that the taxpayer objects to the use of his or her tax receipts for defense or other uses,⁴⁶ that the government can collect taxes only in gold-based coins and certificates (which no longer circulate freely in the United States), or some other argument. Specifically, the penalty applies when the return

- does not contain information by which to judge the completeness of the taxpayer's self-assessment (e.g., if the return is blank);
- contains information or statements that on their face indicate that the self-assessment requirement has not been met (e.g., a "tax protestor" statement is attached); or
- otherwise takes positions that are frivolous or are meant to impede the administration of the tax law; for example, it takes a return position contrary to a decision of the U.S. Supreme Court, or it is not presented in a readable format.



SPOTLIGHT ON TAXATION

Frivolous Returns

The \$5,000 penalty will not be assessed in the course of a typical dispute over the amount of tax due, for example, on an audit where both sides have defensible positions concerning the law. The penalty also is not applied in the case of a mathematical/clerical error. But the penalty relates to the original return as filed, that is, the penalty is not waived if the taxpayer "fixes" the problem by filing an amended return.

The frivolous return penalty applies even if the taxpayer legitimately owes a zero tax, and if the taxpayer was not required to file a return (e.g., due to low taxable income) but did so anyway.

Other Civil Penalties A variety of other civil penalties may be imposed on taxpayers who fail to comply with the Code. Most of these penalties involve a specialized area of the tax law and ordinarily are not encountered by taxpayers. Consequently, one should be aware of the existence of such sanctions and refer to the Code and Regulations when working in such a specialized field to identify the events that might trigger such penalties.

Reliance on Written Advice of the IRS The secretary of the Treasury must abate any civil penalty or addition to tax that is attributable to the taxpayer's reliance on erroneous written advice furnished by an IRS officer or employee. This abatement is available only with respect to advice given in response to a specific request by the taxpayer, and it is negated if the IRS error was made due to a lack of information provided by the taxpayer.⁴⁷

⁴⁴§6702.

⁴⁵*Welch v. U.S.*, 750 F.2d 1101 (CA-1, 1985).

⁴⁶*Fuller v. U.S.*, 786 F.2d 1437 (CA-9, 1986).

⁴⁷§6404(f).

Criminal Penalties

In addition to the civil penalties that we have discussed so far, the Code prescribes a number of **criminal penalties** for certain acts of taxpayer noncompliance. The criminal penalties are intended “to prohibit and punish fraud occurring in the assessment and collection of taxes.”⁴⁸ They are imposed only after the implementation of the constitutional criminal process, under which the taxpayer is entitled to the same rights and privileges as other criminal defendants.



SPOTLIGHT ON TAXATION

Tax Criminals

With Enron and other accounting scandals still destabilizing the economy, the question should be asked: What are the tax implications of these infractions? Are indictments of tax fraud and other tax-related criminal activities still to come?

Without knowing the workplan of the Treasury and Justice Departments, this question may not be answerable. But trends of the past decade or so would speak to a lack of interest by the Federal government in pursuing corporate tax crimes. Criminal tax investigations tend to involve both departments, mentioned above, of the President’s cabinet, and they reflect the existence of convincing evidence of a serious tax infraction, not just a “fishing expedition.” Civil penalties, audits, and appeals in the normal administration of the tax law are put on hold when a taxpayer is under a criminal tax investigation.

Are corporate taxpayers more compliant with the tax laws than they were in the past? Are the investigations less aggressive than they have been in the past? Why?

How else to explain the change in the work patterns of the criminal tax investigators? Today they tend to concentrate on smaller, mundane cases, not the high-profile violations of the Al Capones and Spiro Agnews of the past. And the investigations have declined in absolute terms as well, according to a think tank at Syracuse University. Estimates for the 2002 work year are for about 360 criminal tax prosecutions.

	2002	1992 or 1993
Criminal tax investigations initiated	2,500	4,000
Prosecutions for tax crimes	500	1,000
Corporate civil fraud penalties assessed	159	555
Corporate negligence penalties assessed	22	2,376

The IRS was not part of President George W. Bush’s post-Enron Corporate Fraud Task Force, leading some to conclude that the government is not currently interested in pursuing tax criminals. And, even though there are 12 percent more corporate tax returns than there were a decade ago, the number of revenue agents employed by the agency to follow these returns has fallen by a quarter.

Previous comments by IRS personnel have admitted that the agency pursues only 20–30 percent of the known tax criminal cases, and that about \$280 billion per year escapes collection because of this limited enforcement. Another report estimates that there are about 7,500 known “tax protestors” whom the government does not pursue.

⁴⁸*U.S. v. White*, 417 F.2d 89, 93 (CA-2).

Prosecutions for tax crimes have brought down some highly visible individuals, including political and entertainment figures, but the penalties can be used against any taxpayer. Currently penalties are in public favor as part of “white collar” crime investigations. They can entail felony or misdemeanor infractions and are meant to punish the offender for evading the tax.

Nature of Criminal Penalties Criminal and civil penalties are not mutually exclusive. Consequently, a taxpayer may be acquitted of a criminal tax offense, but still be liable for a corresponding civil tax penalty.

The IRS bears a greater burden of proof with respect to a criminal case. Moreover, the taxpayer holds the right to refuse to answer inquiries that are made by the IRS in a criminal setting if he or she would suffer a loss of some constitutional right by answering.

Ordinarily, criminal prosecutions are limited to flagrant offenses for which the IRS believes it is virtually certain to obtain a conviction. As a result, the IRS usually limits its charges to the civil penalty provisions. In the typical context, according to Section 100 of the *IRS Law Enforcement Manual IX*, criminal prosecutions are limited to cases in which (1) the additional tax that will be generated from a successful prosecution is substantial, (2) the crime appears to have been committed in three consecutive years, or (3) the taxpayer’s flagrant or repetitive conduct was so egregious that the IRS believes that it is virtually certain to obtain a conviction. As a result, the IRS usually will not engage in a criminal prosecution when the taxpayer’s noncompliance can be corrected by imposing civil penalties.

Criminal Tax Offenses The principal criminal offenses that are addressed by the Code include the following.

- Willful attempt to evade or defeat a tax (i.e., tax evasion)—a felony offense that is punishable by a fine that is not to exceed \$100,000 (\$500,000 for corporations), reimbursement of the government’s cost of prosecution, and/or imprisonment for a period that is not to exceed five years.⁴⁹
- Willful failure to collect, account for, and remit any tax, by any person who is required to do so—a felony offense that is punishable by a fine that is not to exceed \$10,000, reimbursement of the government’s cost of prosecution, and/or imprisonment for a period that is not to exceed five years.⁵⁰
- Willful failure to file a return, supply information, or pay tax or estimated tax—a misdemeanor offense that is punishable by a fine that is not to exceed \$25,000 (\$100,000 for corporations), reimbursement of the government’s cost of prosecution, and/or imprisonment for a period that is not to exceed one year (five years and felony status for returns relative to money laundering rules, that is, large amounts of cash received by a business).⁵¹
- Willful making, subscribing, or aiding or assisting in the making of a return or other document that is verified by a declaration under the penalties of perjury, and that the person does not believe to be true and correct as to every material matter—a felony offense that is punishable by a fine not to exceed \$100,000 (\$500,000 for corporations), reimbursement of the government’s cost of prosecution, and/or imprisonment for a period that is not to exceed three years.⁵²

⁴⁹§7201.

⁵⁰§7202.

⁵¹§§7203 and 6050I.

⁵²§7206.

- Willful filing of any known-to-be-false or fraudulent document—a misdemeanor offense that is punishable by a fine that is not to exceed \$10,000 (\$50,000 for corporations) and/or imprisonment for a period not to exceed one year.⁵³
- Disclosure or use of any information that is furnished to a person who is engaged in the business of preparing tax returns, or providing services in connection with the preparation of tax returns, for purposes other than the preparation of the return—a misdemeanor offense that is punishable by a fine not to exceed \$1,000 and/or imprisonment for a period not to exceed one year.⁵⁴

In addition to the penalties just described, the Code prescribes a number of other criminal penalties that ordinarily are not encountered on a regular basis. Most of these penalties involve a specialized area of the tax law. Consequently, one should be aware of the existence of such sanctions and refer to the Code and Regulations when working in such a specialized field to identify them.

Defenses to Criminal Penalties The standard for conviction in a criminal case is establishment of guilt beyond a reasonable doubt. With respect to criminal tax cases, taxpayers have had some success in presenting one or more of the following defenses—that is, to establish some doubt in the minds of the court or the jury.

- Unreported income was offset fully by unreported deductions.⁵⁵
- Unreported income was in reality a gift or some other excludible receipt.⁵⁶
- The taxpayer was confused or ignorant as to the applicable law—one cannot intend to violate the tax law if he or she does not know what that law is.⁵⁷
- The taxpayer relied on the erroneous advice of a competent tax adviser.⁵⁸
- The taxpayer has a mental disease or defect, so could not have acted willfully to violate the tax law.⁵⁹
- The statute of limitations (discussed later in this chapter) has expired.
- The taxpayer enters a plea bargain and accepts conviction on a lesser offense.

PENALTIES ON RETURN PREPARERS

Individuals who prepare income tax returns or refund claims for compensation are subject to a number of disclosure requirements and penalties for improper conduct in the preparation of those documents. These provisions were added to the Code after Congress found that about one-half of all taxpayers utilized some form of professional assistance in preparing their income tax returns. Moreover, a significant percentage of returns that were prepared by return preparers indicated some fraud potential.

⁵³§7207.

⁵⁴§7216.

⁵⁵*Koontz v. U.S.*, 277 F.2d 53 (CA-5, 1960).

⁵⁶*DiZenzo v. Comm.*, 348 F.2d 122 (CA-2, 1965).

⁵⁷*U.S. v. Critzer*, 498 F.2d 1160 (CA-4, 1974). This is not a mere disagreement with the law, which is not an acceptable defense. *U.S. v. Schiff*, 801 F.2d 108 (CA-2, 1986), cert. den.

⁵⁸*U.S. v. Phillips*, 217 F.2d 435 (CA-7, 1954).

⁵⁹*U.S. v. Erickson*, 676 F.2d 408 (CA-10, 1982).

The return preparer penalties apply to all Federal tax returns. Most of them are mild, ranging from \$50 for the failure to furnish an identification number to \$1,000 for the aiding and abetting of an understatement of a tax liability. However, as these sanctions may be applied cumulatively, their magnitude can become more substantial. In addition, the criminal penalties that may be imposed on the return preparer provide for substantial monetary fines and jail terms.

We discussed some of these rules in Chapters 1 and 2. For both taxpayer and tax preparer, the penalty system “encourages” a lawful application of the tax rules by all, by raising the cost of the tax when specific requirements are violated.

Definition of Return Preparer

A **tax return preparer** (TRP) is any person who prepares for compensation, or employs one or more persons to prepare for compensation, all or a substantial portion of a tax return or claim for income tax refund.⁶⁰ A TRP can be an employer, employee, or a self-employed person. This distinction is important because certain penalties are imposed only on a selected type of preparer. For instance, only an employee preparer is subject to a negligence or fraud penalty, unless the employer participated in the wrongdoing. To determine whether the employer or employee return preparer (or both) is liable for a certain penalty, the Regulations that relate to that penalty must be consulted.

A person must prepare a tax return for compensation if he or she is to be subject to the return preparer sanctions. If a return is prepared gratuitously, the preparer is not a TRP. The preparer also must prepare all or a substantial portion of a return if the TRP sanctions are to apply. In determining whether the work that has been performed by the party is substantial, a comparison must be made between the length and complexity of the prepared schedule, entry, or other item and the total liability or refund claim.

The Regulations adopt two objective safe harbors in determining the Constitution of a substantial portion of a return or claim. If a schedule, entry, or other item involves amounts that are (1) less than \$2,000 or (2) less than \$100,000 and also less than 20 percent of the gross income (or adjusted gross income, where the taxpayer is an individual) that is shown on the return, then the item is not substantial.⁶¹

Definition of Return Preparation

In constructing a definition of the TRP, one first must define the domain of *return preparation*. Return preparation includes activities other than the mere physical completion of a return. The IRS asserts that tax advisers, planners, software designers, and consultants are all tax preparers, even though they may only review the return or give the taxpayer instructions on its completion. According to the Regulations, one who furnishes a taxpayer or other preparer with “sufficient information and advice so that completion of the return or claim for refund is largely a mechanical matter” is a TRP.⁶² However, an adviser is not a TRP when the advice is given with respect to completed transactions or for other than tax return filing purposes.

⁶⁰§7701(a)(36)(A).

⁶¹Reg. §301.7701-15(b)(2).

⁶²Reg. §301.7701-15(a)(1).

A person is not a TRP merely because he or she:⁶³

- furnishes typing, reproducing, or other clerical assistance;
- prepares a return or refund claim of his or her regular employer or of an officer or employee of the employer;
- prepares as a fiduciary a return or claim for refund;
- prepares a claim for refund during the course of an audit or appeal;
- provides general tax advice to a taxpayer;
- is an employee or official of the IRS, while performing job-related duties;
- prepares the return for no compensation; or
- works for IRS-sponsored programs such as Volunteer Income Tax Assistance, Tax Counseling for the Elderly, or a Low-Income Tax Clinic.

Being classified as a TRP is not directly based on the attainment of a certificate or degree, or the completion of continuing education requirements, but on the substantial completion of a tax return for compensation.

Preparer Disclosure Penalties

Five key **preparer penalties** may be imposed on those who do not comply with certain disclosure requirements.⁶⁴

- A penalty of \$50 for each return may be imposed on a TRP if the taxpayer is not given a complete copy of the return when it is presented to him or her for signature.
- A penalty of \$50 for each return may be imposed on a TRP if he or she fails to sign the return.
- A penalty of \$50 for each return is imposed on a TRP if the preparer's identification number or that of his or her employer, or both, is not listed on each completed return.
- A penalty of \$50 for each failure is imposed on a TRP if he or she does not retain a copy of all returns that he or she prepared. Alternatively, he or she may retain a list of all of the taxpayers and their identification numbers for whom returns were prepared for the previous three years.
- A penalty of \$50 for each failure to retain, and \$50 for each item that is omitted, is imposed on a TRP who does not retain records that indicate the name, identification number, and place of work of each preparer who is employed during the twelve-month period that begins on July 1 of each year.

In each instance, the maximum penalty for any calendar year is \$25,000.

Preparer Conduct Penalties

The Code contains a number of civil and criminal penalties that may be imposed on return preparers relative to their misconduct. The civil penalties were added to the Code because Congress found that a significant number of return preparers were engaging in improper practices, such as guaranteeing refunds or having tax-

⁶³§7701(a)(36)(B) and Reg. §§301.7701-5(a)(2) through (7).

⁶⁴§6695.

payers sign blank returns. However, except for the criminal penalty of aiding and assisting in the preparation of a false return, there were no lesser sanctions that could be applied to return preparers who were guilty of misconduct.

Civil penalties that may be imposed on preparers relate to:

- endorsing or negotiating a refund check;
- negligent understatement or intentional disregard of rules and Regulations;
- willful understatement of tax liability;
- failing to be diligent in applying eligibility rules for the earned income tax credit;
- organizing, or assisting in organizing, or promoting and making or furnishing statements with respect to an abusive tax shelter;
- aiding and abetting the understatement of a tax liability; and
- disclosure or use of return information for other than return preparation.

Return preparers always have been subject to criminal prosecution for willful misconduct. The two principal criminal preparer penalties involve those who:

- aid or assist in the preparation or presentation of a false return, affidavit, claim, or other document,⁶⁵ or
- disclose or use information for other than return preparation purposes.⁶⁶

Endorsing or Negotiating a Refund Check A TRP may not endorse or otherwise negotiate an income tax refund check that is issued to another person. A preparer who violates this rule is subject to a \$500 penalty.⁶⁷

Understatements Due to Unreasonable Positions A tax preparer incurs a penalty for each occurrence of an understatement of tax due to the taking of an unreasonable position in the return. Where there is not a reasonable belief that the return position is more likely than not to be upheld on its merits upon a review, the penalty applies.⁶⁸ The penalty is waived if the return includes a disclosure of the preparer's nonfrivolous position, or if the preparer has acted in good faith in preparing the return.

The penalty applies to a tax return position that is taken on a Federal tax return or a claim for refund. The amount of the penalty does not relate to the amount of understated tax, the manner of computing most tax penalties. Rather, the unreasonable-position penalty is computed as the greater of \$1,000 or one-half of the return preparer's fees derived from the engagement.⁶⁹

The penalty is applied where the tax preparer knew or should have known of the disputed tax return position, and there was no **reasonable basis** for the position (likely a one-in-four chance that the position would be sustained on its merits), or a disclosure was not made on Form 8275 or 8275-R.

Example 14-3 Josie prepares a tax return that includes the claiming of a deduction that is contrary to an extant Revenue Ruling. Because of a new court decision in another circuit that is favorable to the deduction, Josie believes that

⁶⁵§7206(2).

⁶⁶§7213(a)(3).

⁶⁷§6695(f).

⁶⁸§6694(a)(2).

⁶⁹§6694(a)(1).

there is a 70 percent chance that the position would be sustained in a suit relative to the deduction. No unreasonable-position penalty applies to Josie, whether the client wins or loses in court, and she need not disclose in any way her variance from the government position on her return.

Example 14-4 Continue with the facts of Example 14-3, except that Josie believes the following probabilities exist with respect to a court's treatment of her deduction, as supported by substantial authority.

Full support for her position	40%
Partial deduction allowed	35%
No deduction allowed	25%

No unreasonable-position penalty applies to Josie, whether the client wins or loses in court, and she need not disclose in any way her variance from the government position on her return. The return position is more likely than not to prevail.

Example 14-5 Return to the facts of Example 14-3, except that Josie believes that the position has a 30 percent probability of success in a court hearing. To avoid any unreasonable-position penalty, Josie must attach a Form 8275 to the return, revealing where and how she has deviated from the government's position relative to the deduction. There is a reasonable basis for the disclosed position.

Example 14-6 Return to the facts of Example 14-3, except that Josie believes that the deduction has a 5 percent probability of prevailing in court. Josie cannot take this filing position on any tax return. This is a frivolous position and would trigger an unreasonable-position penalty.

Willful Understatement A preparer is subject to a penalty if any part of an understatement of a taxpayer's liability is attributable to the preparer's willful attempt in any manner to understate the liability, or to the reckless or intentional disregard of IRS rules or Regulations.⁷⁰ A preparer is considered to have willfully attempted to understate the tax in this manner if he or she disregards information that has been supplied by the taxpayer, or by any other person, in an attempt wrongfully to reduce the taxpayer's levy.

The penalty is computed as the greater of \$5,000 or one-half of the return preparer's related fees.

Organizing Abusive Tax Shelters A civil penalty may be imposed on any person who organizes or assists in organizing, or (even indirectly) participates in the sale of any interest in, a tax shelter, and who makes or furnishes a statement regarding an expected tax benefit that the person knows or has reason to know is either false or fraudulent, or contains a gross valuation understatement on a material matter.⁷¹

For this purpose, a gross valuation understatement is a statement of the value of any property or service that exceeds 200 percent of the amount that is determined to be its correct value, if the value of the property or service is directly

⁷⁰§6694(b).

⁷¹§6700.

related to the amount of any allowable deduction or credit.⁷² Accordingly, there does not need to be an understatement of tax before this penalty can be applied. The penalty, equal to one-half of the party's related fees from the engagement, can be triggered without an IRS audit, and it can be based only on the shelter's offering materials.

The amount of a valuation overstatement penalty is the lesser of \$1,000 or 100 percent of the gross income that is derived from the activity, or is to be derived, by the taxpayer from the project. The IRS may waive all or a portion of the penalty that is attributable to a gross valuation understatement if there was a reasonable basis for the valuation, and it was made in good faith.⁷³

Although the penalty is not aimed specifically at tax preparers, but rather at the tax shelter industry itself, professional tax advisers may be subject to the penalty because they often assist in organizing tax shelter projects.

Aiding and Abetting Understatement The Code imposes a civil penalty on any person who aids or assists, or procures or advises, in the preparation or presentation of any portion of a return or other tax-related document, if he or she knows or has reason to believe that the return or other document will be used in connection with any material tax matter, and that this use will result in the understatement of another person's tax liability.⁷⁴ This penalty may also be imposed on a person who acts in violation of the statute through a subordinate (e.g., an employee or agent) by either ordering or causing the subordinate to act, or knowing of and not attempting to prevent the subordinate from acting, wrongfully.⁷⁵

The amount of the penalty is \$1,000 (\$10,000 for corporations) for each understating taxpayer. This penalty may be imposed only once per year for each understating taxpayer who is serviced by the TRP. However, it may be imposed in addition to other penalties. Thus, the preparer may also be prosecuted under the criminal statutes.⁷⁶

Aiding or Assisting in the Preparation of a False Return A criminal penalty may be imposed on any person who willfully aids or assists in the preparation of a return or other document that is false as to any material matter. This penalty is the criminal equivalent to the civil penalty for aiding and abetting the understatement of any tax liability.

A person who is convicted of violating this statute is guilty of a felony and is subject to imprisonment for up to three years and/or may be fined an amount that cannot exceed \$100,000 (\$500,000 for corporations). This is one of the most severe tax preparer penalties under the Code.⁷⁷

The persons who are prosecuted under this statute usually are accountants or other return preparers. However, a person who supplies false information that is used in the preparation of a return may also be subject to this penalty. The penalty can be assessed when it is merely a false tax-related document (like a Form 1099 or W-4), and not a tax return, that is prepared.

Disclosure or Use of Information by Return Preparers The Code imposes a civil penalty on any return preparer who discloses or uses any tax return information for other than the purpose of preparing a tax return. This penalty amounts to \$250 per

⁷²§6700(b)(1).

⁷³§§6700(a)(2) and (b)(2).

⁷⁴§6701(a).

⁷⁵§6701(c).

⁷⁶§6701(b).

⁷⁷§7206(2).

improper use; a preparer's maximum penalty for any calendar year is \$10,000. The Code also imposes a criminal penalty on any return preparer who knowingly or recklessly discloses or uses any tax return information for other than the specific purpose of preparing a tax return. One who is convicted of violating this statute is guilty of a misdemeanor and is subject to imprisonment for not more than one year and/or may be fined an amount that cannot exceed \$1,000.⁷⁸

The definition of a TRP for purposes of this criminal penalty is broader than that under the civil preparer statutes. For instance, a clerical assistant who types or otherwise works on returns that are completed by the preparer is a TRP for purposes of this provision; however, he or she would not be considered a TRP for purposes of the civil preparer penalty statutes.

Exhibit 14-2: Summary of Tax-Related Penalties

Criminal and civil penalties are not mutually exclusive, so a taxpayer or a preparer may be liable for both. Unlike civil penalties, which are collected in the same manner as would be true for the regular tax, criminal penalties are imposed only after the completion of the normal criminal process, in which the defendant is entitled to a number of constitutional guarantees and other rights, that is, he or she is deemed to be innocent until proven guilty.

IRC Section	Type of Infraction	Penalty
Civil Penalties		
6694(a)	Understatement due to unreasonable position	\$1,000 or one-half of income derived, per return
6694(b)	Willful understatement of liability	\$5,000 or one-half of income derived, per return
6695(a)	Failure to furnish copy to taxpayer	\$50 per failure
6695(b)	Failure to inform taxpayer of certain record-keeping requirements or to sign return	\$50 per failure
6695(c)	Failure to furnish identifying number	\$50 per failure*
6695(d)	Failure to retain copy or list	\$50 per failure*
6695(e)	Failure to file correct information return	\$50 per failure to file; \$50 per omitted item*
6695(f)	Negotiation or endorsement of refund checks	\$500 per check
6695(g)	Failure to be diligent in applying eligibility rules for earned income tax credit	\$100 per failure
6700	Organizing (or assisting in doing so) or promoting and making or furnishing statements with respect to abusive tax shelters	Greater of \$1,000 or 100% of gross income derived by preparer from the project

⁷⁸ §§6713 and 7216(a).

IRC Section	Type of Infraction	Penalty
6701	Aiding and abetting an understatement of tax liability	\$1,000 per return; \$10,000 per return if taxpayer is a corporation
6713	Improper disclosure or use of return data	\$250 per improper use; annual maximum \$10,000
Criminal Penalties		
7201	Attempt to evade or defeat tax	Felony; fine of not more than \$100,000 (\$500,000 if a corporation) and/or imprisonment for not more than five years
7202	Willful failure to collect or pay over a tax	Felony; fine of not more than \$10,000 and/or imprisonment for not more than five years, plus costs of prosecution
7203	Willful failure to file return, supply information, or pay tax	Misdemeanor; fine of not more than \$25,000 (\$100,000 if a corporation) and/or imprisonment for not more than one year (five years and felony relative to willful violation of cash receipts rules)
7204	Fraudulent statement or failure to make statement to employees	Fine of not more than \$1,000 and/or imprisonment for not more than one year
7205	Fraudulent withholding exemption certificate or failure to supply information	Fine of not more than \$1,000 and/or imprisonment for not more than one year
7206	Fraud and false statements; concealing or removing property	Felony; fine of not more than \$100,000 (\$500,000 if a corporation) and/or imprisonment for not more than three years
7206(2)	Aid or assistance in the preparation or presentation of a false return, claim, or other document	Felony; fine of not more than \$100,000 (\$500,000 if a corporation) and/or imprisonment for not more than three years
7207	Fraudulent returns, statements, or other documents	Fine of not more than \$10,000 (\$50,000 if a corporation) and/or imprisonment for not more than one year
7210	Failure to obey summons in tax matter	Fine of not more than \$1,000 and/or imprisonment for not more than one year
7212	Attempts to interfere with administration of internal revenue laws, corruption, threats of force	Fine of not more than \$5,000 and/or imprisonment for not more than three years
7216	Disclosure or use of information by preparer of return	Misdemeanor; fine of not more than \$1,000 and/or imprisonment for not more than one year

*Annual maximum penalty = \$25,000.

The preparer, as here defined, may disclose information that is obtained from the taxpayer without being subject to the civil or criminal penalty if such disclosure is pursuant to any other provisions of the Code, or to a court order.

See Exhibit 14-2 for a summary of the most important of the civil and criminal penalties that may apply to taxpayers, preparers, and shelter distributors.

INJUNCTIONS

The IRS is empowered to seek **injunctions** against two classes of persons of interest to our discussion: (1) TRPs and (2) promoters of abusive tax shelters. An injunction is a judicial order that prohibits the named person from engaging in certain specified activities. The courts have broad authority to structure any injunctive relief that is granted to fit the circumstances of the case as appropriate.

Action to Enjoin TRPs

The IRS may seek an injunction against a TRP who is guilty of certain misconduct to prohibit him or her from engaging in such misconduct or from practicing as a return preparer.

Before such an injunction can be issued, however, the preparer must have:

- violated a preparer penalty or a criminal provision of the Code,
- misrepresented his or her eligibility to practice before the IRS,
- guaranteed the payment of any tax refund or the allowance of a credit, or
- engaged in other fraudulent or deceptive conduct that substantially interferes with the administration of the tax laws.

In addition, it must be shown that the injunctive relief is appropriate to prevent the conduct from recurring. An injunction to prohibit the person from acting as a TRP may be obtained if the court finds that the preparer continually or repeatedly has engaged in misconduct, and that an injunction prohibiting such specific misconduct would be effective.⁷⁹

Action to Enjoin Promoters of Abusive Tax Shelters

The IRS may obtain an injunction against a person who is guilty of promoting abusive tax shelters, or of aiding and abetting an understatement of the tax liability, to prohibit him or her from engaging in such conduct or activities. Before such an injunction is issued, a court must find that injunctive relief is appropriate to prevent this conduct from recurring.⁸⁰

INTEREST

The Code provides for the payment of interest on underpayments and overpayments of tax, at an adjustable rate, compounded daily. The objective of these provisions is to compensate offended parties for the use of their funds. Moreover, the interest charge eliminates the benefits that taxpayers (or the government) could obtain by adopting aggressive positions in the creation or processing of tax returns in order to postpone or avoid the payment of their taxes.

Interest-Computation Conventions

Interest on underpayments is payable at a federally specified rate, from the last date that is prescribed for the payment of the tax to the date on which the tax is actually

⁷⁹§7407.

⁸⁰§7408.

paid. The last date that is prescribed for payment of the tax is usually the unextended due date of the return that reports the amount of tax that is due.⁸¹

Interest is compounded on a daily basis.⁸² Thus, given an interest rate that equals or exceeds about 15 percent, the obligation of the taxpayer or government could double in five years. The IRS has published interest-factor tables that automatically calculate the daily compounding for various rates of interest.⁸³

The rate of interest that is used for underpayments and overpayments is adjusted quarterly to reflect the Federal short-term interest rate for the first day of the quarter.⁸⁴ The new prevailing rate is published in a timely fashion, typically in a Revenue Ruling. Exhibit 14-3 documents the various IRS rates of interest that applied to over- and underpayments occurring through early 2008.

Where the taxpayer is subject to both underpayment and overpayment computations for the same time period, whether the prior disputes involve income, transfer, or employment taxes, the amounts due and payable to the government are netted and a zero interest rate applies to those amounts.

Example 14-7 Mary Brown, a calendar-year taxpayer, filed her 2006 tax return and showed a balance due of \$1,000. The return was filed on June 30, 2007, pursuant to a properly executed extension of time to file, and the tax was paid in full with the return. The prevailing IRS interest rate that applies to Brown's underpayment was 7 percent. She must pay about \$15 of interest with her return, determined as follows.

Total tax outstanding	\$ 1,000
Factor from Rev. Proc. 95-17, for 7 percent interest and seventy-six days' late payment	$\times .014680663$
Interest assessed	\$ 14.68

If Brown does not remit the interest that she owes when she files the return, interest will continue to accrue, on both the tax and the \$15 of interest itself, until the obligation is paid in full. If this amount is paid within ten days of the receipt of an IRS notice and demand for payment, however, no further interest accrues.

Interest accrues on the full amount of the tax liability that is appropriate under the Code, regardless of the amount of tax that is entered on the return. Moreover, interest is imposed on an assessable penalty, additional amount, or addition to the tax if these amounts are not paid within twenty-one calendar days of the date on which the IRS requests its payment. Interest on penalties generally is imposed only from the date of this IRS notice and demand, and not from the due date of the return. However, the fraud, accuracy-related, and failure-to-file penalties run from the (extended) due date of the return.⁸⁵

No interest is charged on criminal penalties or delinquent estimated tax payments. However, recall that a nondeductible penalty is imposed in lieu of interest with respect to delinquent estimated tax payments. This penalty is computed in the same manner as would be the required interest, except that daily compounding of the penalty is not required.

⁸¹ §§6601(a) and (b).

⁸² §6622(a).

⁸³ Rev. Proc. 95-17, 1995-1 CB 556.

⁸⁴ §6621.

⁸⁵ §6601(e)(2). Interest begins to run after ten business days for amounts exceeding \$100,000.

Exhibit 14-3: IRS Overpayment and Underpayment Interest Rates

Period	Rate
Prior to July 1975	6%
July 1, 1975–January 31, 1976	9
February 1, 1976–January 31, 1978	7
February 1, 1978–January 31, 1980	6
February 1, 1980–January 31, 1982	12
February 1, 1982–December 31, 1982	20
January 1, 1983–June 30, 1983	16*
July 1, 1983–December 31, 1984	11*
January 1, 1985–June 30, 1985	13*
July 1, 1985–December 31, 1985	11*
January 1, 1986–June 30, 1986	10*
July 1, 1986–December 31, 1986	9*

Period	Over-payment Rate*†	Under-payment Rate*†	Large Corporation Under-payment Rate*	Rate for Corporation Over-payments >\$10,000*
January 1, 1987–September 30, 1987	8%	9%		
October 1, 1987–December 31, 1987	9	10		
January 1, 1988–March 31, 1988	10	11		
April 1, 1988–September 30, 1988	9	10		
October 1, 1988–March 31, 1989	10	11		
April 1, 1989–September 30, 1989	11	12		
October 1, 1989–March 31, 1991	10	11		
April 1, 1991–December 31, 1991	9	10	12%	
January 1, 1992–March 31, 1992	8	9	11	
April 1, 1992–September 30, 1992	7	8	10	
October 1, 1992–June 30, 1994	6	7	9	
July 1, 1994–September 30, 1994	7	8	10	
October 1, 1994–December 31, 1994	8	9	11	
January 1, 1995–March 31, 1995	8	9	11	6.5
April 1, 1995–June 30, 1995	9	10	12	7.5
July 1, 1995–March 31, 1996	8	9	11	6.5
April 1, 1996–June 30, 1996	7	8	10	5.5
July 1, 1996–April 15, 1998	8	9	11	6.5
April 16, 1998–December 31, 1998	7	8	10	5.5
January 1, 1999–April 15, 1999	6	7	9	4.5
April 16, 1999–April 15, 2000	7	8	10	5.5
April 16, 2000–April 15, 2001	8	9	11	6.5
April 16, 2001–June 30, 2001	7	8	10	5.5
July 1, 2001–December 31, 2001	6	7	9	4.5
January 1, 2002–December 31, 2002	5	6	8	3.5
January 1, 2003–September 30, 2003	4	5	7	2.5

Period	Over-payment Rate*	Under-payment Rate*†	Large Corporation Under-payment Rate*	Rate for Corporation Over-payments >\$10,000*
October 1, 2003–March 31, 2004	3	4	6	1.5
April 1, 2004–June 30, 2004	4	5	7	2.5
July 1, 2004–September 30, 2004	3	4	6	1.5
October 1, 2004–March 31, 2005	4	5	7	2.5
April 1, 2005–September 30, 2005	5	6	8	3.5
October 1, 2005–June 30, 2006	6	7	9	4.5
July 1, 2006–December 31, 2007	7	8	10	5.5
January 1, 2008–March 31, 2008	6	7	9	4.5
July 1, 2006–December 31, 2007	7	8	10	5.5

*Daily compounding required.

†After 1998, noncorporate taxpayers use the second column for both under- and overpayments. Corporations still receive one percentage point less with respect to their smaller overpayments; that is, the first column applies.

In general, the IRS has no authority to forgive the payment of interest. Consequently, a taxpayer is required to pay the total amount of interest assessed on any underpayment, even though the delinquency was attributable to a reasonable cause, including an IRS loss of records and the illness, transfer, or leave of a pertinent IRS employee. However, the IRS can abate such interest where it is attributable to an unreasonable error or delay caused by an employee or officer of the IRS in response to the taxpayer's filing a claim on Form 843. Such a delay cannot be traceable to an interpretation of the tax law, but rather must relate to nondiscretionary, administrative, or managerial duties of procedure or return processing, including an IRS loss of records and the illness, transfer, or leave of a pertinent IRS employee.⁸⁶

The government is required to pay interest at the applicable Federal rate to any taxpayer who has made an overpayment of tax. Interest on an overpayment runs from the date of the overpayment to the date on which the overpayment is credited against another tax liability, or, in the case of a refund, to a date that is not more than thirty days before the date of the refund check.

However, the IRS is allowed a specific period in which it may refund an overpayment without incurring interest. This interest-free period runs for forty-five days after the unextended due date of the return or, if the return is filed after its due date, for forty-five days after it is actually filed. If the refund is not made within this forty-five-day period, interest begins to accrue from the later of (1) the due date of the return or (2) the date on which the return was actually filed.⁸⁷

Example 14-8 Joan Jeffries, a calendar-year taxpayer, filed her 2005 Federal income tax return on October 1, 2008. Her return showed an overpayment of \$2,500, for which Jeffries requested a full refund. If the IRS refunds the \$2,500 overpayment on or before November 14, 2008, no interest is due from the government. However, if the refund is paid after November 14, 2008, interest accrues from October 1, 2008, through a date that is not more than thirty days before the date of the refund check. (In any event, interest does not accrue as of April 16, 2008, for Joan.)

⁸⁶§6404(e); *Dormer*, TC Memo 2004-167; TD 8789 (1998).

⁸⁷§6611(e).

The date that is stated on the government's refund check determines whether the overpayment is refunded within the forty-five-day interest-free period. The date on which the refund is actually received does not control for this purpose. Thus, an interest-free refund may be paid, even though it is not received by the taxpayer until the forty-five-day period has expired.



SPOTLIGHT ON TAXATION

Prepaying Interest

If interest rates are relatively high, some taxpayers consider prepaying the amount of tax in dispute, so as to stop the running of interest charges that will be due if the issue is found in favor of the government. A deposit of the tax (and perhaps of related penalty and interest charges) is set up with the Treasury. Such a prepayment might make sense because:

- The prepayment can trigger an immediate interest deduction.
- If the taxpayer prevails in the dispute, interest is payable back from the government on the full deposit amount.

Applicable Interest Rate

Different rates are used with respect to IRS overpayments and underpayments, as is evident in Exhibit 14-3. The overpayment rate (paid by the IRS) is two percentage points greater than the Federal short-term interest rate, compounded daily, and the underpayment rate (paid to the IRS) is three percentage points greater than the same Federal rate.

Large corporations pay interest at two percentage points higher than the usual underpayment rate. Corporations receive interest on overpayments at 1 1/2 percentage points lower than the usual overpayment rate, where the overpayment exceeds \$10,000. Under- and overpayment rates are determined for the beginning of each calendar quarter, using the Federal rates in effect for the first month of that quarter.

STATUTES OF LIMITATIONS

The Code establishes a specific period of time, commonly referred to as a **statute of limitation**, within which all taxes must be assessed and collected, and all refund claims must be made. After the pertinent statute of limitations expires, certain actions may not be taken, because the expiration establishes an absolute defense for the party against whom legal action is brought. In other words, a taxpayer cannot be required to pay taxes that he or she rightfully owes if these taxes are not assessed and collected within the time periods that the Code has established.

Nature of Statutes of Limitations

Although the statute of limitations appears to be a legal loophole that rewards delinquent taxpayers who avoid detection, Congress believes that, at some point, the right to be free of stale claims must prevail over the government's right to pursue them. If the statutes permitted the lapse of an extended period of time between the initiation of a claim and its pursuit, the defense could be jeopardized because witnesses might have died or disappeared, memories might have faded, and records or

other evidence might have been lost. Moreover, some statutes of limitations are designed solely to protect the government (e.g., the statute of limitations on credits or refunds). A number of such statutes limit the time period within which assessment, collection, and claim for refund or credit activities must be conducted.⁸⁸

Assessment

Assessment of an internal revenue tax generally must be made within three years of the later of the date that the return was actually filed or the unextended due date of the return. A return that is filed prior to its due date, for this purpose, is deemed to be filed on its due date. The assessment period for a return that is filed after the due date starts on the day that follows the actual filing date, regardless of whether the return is delinquent or the due date was extended properly.

The period in which a tax may be assessed is extended to six years if the taxpayer omits from his or her reported gross income an amount that is greater than 25 percent of the reported gross income.⁸⁹ For this purpose, §61 gross income is used in the 25 percent computation, with two exceptions. First, the gross income of a business is *not* reduced by cost of sales. Second, income that is omitted from the return is ignored for purposes of constructing the base for the 25 percent test, if the omission is disclosed in the return or in an attached document.⁹⁰

Although the limitations period is extended for a substantial omission of income, it (surprisingly) is not extended where the taxpayer has overstated the amount of his or her deductions, regardless of the amount of the overstatement.

Irregular Returns A tax may be assessed at any time when a taxpayer files a false or fraudulent return with the intent to evade tax liability.⁹¹ Once the fraudulent return is filed, the limitations period remains open indefinitely. A later filing of a nonfraudulent amended return will not start the running of the three- (or six-) year limitation period.⁹²

When a taxpayer fails to file a return, the tax may be assessed at any time. For this purpose, one's failure to file need not be willful. A taxpayer who innocently or negligently fails to file still is subject to an unlimited period of assessment for the tax.⁹³

Acceleration, Extension, and Carryback Effects Generally, the filing of an amended return does not affect the length of the limitations period. However, the limitations period is extended by sixty days if the IRS receives, within sixty days of the expiration of the applicable statute of limitations, an amended return that shows the taxpayer owes an additional tax.⁹⁴ This provision was enacted to discourage taxpayers from waiting until the limitations period on an assessment was about to expire before submitting an erroneous amended return. Prior to the enactment of this provision, it was beneficial for the taxpayer to wait to file an amended return this way, because the IRS would not have enough time to assess more tax if an examination of the original return uncovered additional unreported errors or omissions.

⁸⁸§6501.

⁸⁹§6501(e)(1)(A).

⁹⁰§§6501(e)(1)(A)(i) and (ii).

⁹¹§6501(e)(1).

⁹²*Badaracco v. Comm.*, 464 U.S. 386, 104 S.Ct. 756 (1984).

⁹³§6501(e)(3).

⁹⁴§6501(e)(7).

The usual three-year assessment period can be reduced to eighteen months if a request for a prompt assessment is filed with the IRS.⁹⁵ This request usually is made for an income tax return of a decedent or an estate, or for a corporation that is in the midst of a dissolution. Generally, a prompt assessment is requested when all of the involved parties wish to accelerate the final determination of the tax liability.

A deficiency for a carryback year that is attributable to the carryback of a net operating loss, capital loss, or unused research or general business credit can be assessed at any time before the expiration of the limitations period for the year in which the loss occurred or the credit originated. This extension in the period of assessment for the carryback year is necessary to ensure that there is adequate time to process the refund claim and to allow the IRS to examine the return that gave rise to the carryback item.⁹⁶

The period for assessment is not extended when a net operating loss, capital loss, or unused credit is carried forward.

IRS-Requested Extensions An extension of the period of limitations typically is requested by the IRS when an audit or an appellate review cannot be completed until after the statute of limitations expires. The taxpayer is not bound to agree with such a request, but such a refusal may prompt the IRS to stop negotiations prematurely and assess a deficiency against the taxpayer. Although the issuance of a statutory notice of deficiency does not preclude the taxpayer from obtaining a negotiated settlement with the IRS, he or she will be required to undertake a more costly procedure and file a petition with the U.S. Tax Court or pay the assessment and file a claim for refund. Consequently, a taxpayer normally should not refuse to sign a waiver of the statute of limitations, as requested by the IRS, unless the agent has completed the examination and there exist one or more unagreed-upon issues that the taxpayer is ready to litigate.

Collection

All taxes must be collected within ten years after a timely assessment has been made.⁹⁷ **Collection** can be made either by IRS levy or by the agency's commencement of an action in court. If the tax is not collected administratively by levy within the ten-year period, the IRS must commence an action in court to reduce the assessment to a judgment before the statute of limitation expires. Once a judgment for the assessed tax is awarded, the tax may be collected at any time after the normal period of collections has expired. Thus, collection is not barred after the ten-year period expires, provided that the IRS has obtained a timely judgment against the taxpayer.

The taxpayer and the IRS may agree to an extension of the normal collection period. The IRS will request such an extension whenever the taxpayer has agreed to extend the period of limitations for assessment of the tax. In addition, the taxpayer may request an extension to allow additional time in which to (raise and) submit any delinquent taxes. If the taxpayer agrees to extend the period of limitation on collections, the IRS may agree not to seize and sell the taxpayer's property to satisfy the tax liability.

The ten-year period of limitations begins only after an assessment is made. If an assessment can be made at any time, for example, because the taxpayer failed to

⁹⁵§6501(d).

⁹⁶§§6501(h) through (k).

⁹⁷§6502(a)(1).

file a return or filed a fraudulent return, the tax may be collected within ten years of the date of assessment, regardless of when it eventually is made.

Claim for Refund or Credit

A taxpayer must file a timely and valid claim at the service center for the district in which the tax was paid to receive a refund or credit of an overpayment of tax. The claim should be made by individuals on Form 1040X, Individual Amended Income Tax Return, and by corporations on Form 1120X, Corporation Amended Income Tax Return.

Generally, an overpayment can be refunded or credited only to the person who was subject to the original tax. However, the IRS can apply overpayments to delinquent support obligations and certain certified nontax debts that are owed to the Federal government. Refunds in excess of \$2,000,000 may not be made until they have been reviewed by the Joint Committee on Taxation.⁹⁸

A taxpayer who reports a net operating loss, capital loss, or credit carryback can accelerate the processing of the refund by filing an Application for Tentative Carryback Adjustment on Form 1045 (for individuals) or Form 1139 (for corporations). The IRS has ninety days from the later of the date on which the application was filed or the last day of the month in which the return for the loss is due to examine the application and accept or deny the claim.⁹⁹ However, if the application is denied, the taxpayer cannot bring a suit for recovery of the overpayment, because the IRS's determination is only tentative. Instead, the taxpayer must file a refund claim on the appropriate form and wait for six months from the date on which the claim was filed, or until the IRS denies the refund claim, before legal action can be started.

Before a refund or credit can be issued, the IRS must review the taxpayer's claim. Even if the Commissioner agrees that the taxpayer has overpaid a tax, he or she has no authority to refund or credit the overpayment unless the taxpayer files the claim within the allowable period. Any refund of an overpayment that is made after the period for filing a timely claim is considered erroneous and a credit is considered void.

Limitations Period A taxpayer who has filed a return must file a claim for credit or refund within three years of the date on which the return was filed or two years of the date on which the tax was paid, whichever is later. If the taxpayer did not file a return (e.g., because taxes were withheld from the taxpayer's wages, but the taxpayer did not file a return because his or her taxable income did not exceed the applicable exemptions and standard deduction), the claim for credit or refund must be made within two years of the date on which the tax was paid.¹⁰⁰

The period within which a claim for credit or refund may be filed is extended when the taxpayer and the IRS agree to extend the statute of limitations on assessments. A claim can be filed within six months after the expiration of the extended assessment period.¹⁰¹

Other Extensions The limitations period also can be extended where an overpayment results from a business bad debt or from a discovery of worthless securities.¹⁰² A claim for refund or credit that is attributable to losses sustained from

⁹⁸§6405(a).

⁹⁹§6411(b) and Reg. §1.6411-1(b).

¹⁰⁰§6511(a).

¹⁰¹§6511(c)(2).

¹⁰²§6511(d).

worthless securities or business bad debts may be filed within seven years from the date that the return was due, without regard to any extension for filing the return. This period is extended further if the debt or loss increases a net operating loss carryback, since the taxpayer is entitled to three additional years for the filing of a claim that is based on the carryback.¹⁰³

This provision was enacted because the determination of the date on which a debt or share of stock becomes worthless is a question of fact that may not be determined until after the year in which the loss actually occurred. If taxpayers were not allowed additional time in which to file refund claims for these items, they could incur substantial losses without the receipt of any tax benefits, because the deductions must be taken in the taxable year of the loss, not in a later year.

The period for filing a claim for refund is extended when the claimed overpayment results from the carryback of a net operating loss, capital loss, or certain credits. If a claim for credit or refund is attributable to the carryback of a net operating loss, net capital loss, or business credit, it can be filed within three years of the extended due date of the return for the year in which the losses occurred or the credits originated, rather than within three years of the due date of the return for the carryback year. Again, this provision was enacted because the existence and amount of these items might not be known until after the expiration of the usual three-year period for filing the claim.

Amount of the Credit or Refund If a claim for refund or credit is filed in a timely fashion, the amount of the taxpayer's refund or credit is limited to the portion of the tax that was paid during the three immediately preceding years, plus the period of any extension for filing the return.¹⁰⁴ The amount of tax that is subject to the claim may include amounts that were withheld and estimated payments that were made more than three years before the date on which the claim was filed, because these amounts are all deemed to have been paid on the due date of the return.

If a claim is filed after the three-year period, the amount of any refund or credit is limited to the portion of the tax that was paid during the two years that immediately precede the filing of the claim. This two-year period also is effective if a claim is filed for a year in which a return was not filed. Because this claim relates only to a two-year period, it may not protect payments that were made with the original return.

Suspension of Period of Assessment and Collection

Usually, a tax must be assessed within three years after the filing of a tax return, and it must be collected within six years of the assessment. However, under certain circumstances, the running of the statutes of limitations on assessment or collection is suspended.

When the IRS mails a statutory notice of deficiency (i.e., a ninety-day letter) to the taxpayer, the assessment and collection period is suspended for 150 days (210 days if the letter is addressed to a person who is outside the United States).¹⁰⁵ The statutes of limitations on assessment and collection also are suspended when a case is pending before the U.S. Tax Court. This suspension period begins when the taxpayer files a petition in the Tax Court contesting the deficiency, and it continues until sixty days after the decision of the Tax Court becomes final.

¹⁰³ §6511(d)(2)(A).

¹⁰⁴ §6511(b)(2)(A).

¹⁰⁵ §6503(a)(1).

When a taxpayer submits an offer in compromise for consideration by the IRS, the statute of limitations on assessment is suspended. This suspension period begins when the offer is submitted, and it continues until one year after the offer is terminated, withdrawn, or formally rejected.¹⁰⁶

In addition to the circumstances just discussed, the statute of limitations also can be suspended when:¹⁰⁷

- the taxpayer's assets are in the custody of the court;
- the taxpayer is outside the United States for six or more consecutive months;
- the taxpayer's assets are wrongfully seized;
- a fiduciary or receiver is appointed in a bankruptcy case;
- the IRS is prohibited under bankruptcy law from any assessment or collection of a tax; or
- the collection of excise or termination taxes on certain retirement plans or private foundations is suspended.

Mitigation of Statute of Limitations

Generally, the IRS cannot make an assessment and a taxpayer cannot obtain a refund after the statute of limitations has expired. However, §§1311 through 1314 of the Code include a complex set of rules designed to prevent the taxpayer or the IRS from taking advantage of an oncoming expiration of the period of limitations on assessment, collection, or refunds.

When an error has been made in the inclusion of an item of income, allowance, or disallowance of a deduction or other tax treatment of a transaction that affects the basis of property, the mitigation provisions will allow a submission of the error to be corrected, even though the normal period of limitations has expired for that year.

STATUTORY AGREEMENTS

The Code provides for two types of agreements that may be used to resolve tax disputes, namely, closing agreements and offers in compromise.

Closing Agreements

A **closing agreement** is a formal, written agreement that is made between a taxpayer and the IRS. It is the only agreement that the Code recognizes as being binding. Once it is approved, a closing agreement is final and conclusive on the part of both the government and the taxpayer, unless there is a showing of fraud, malfeasance, or a misrepresentation of a material fact, by either party.¹⁰⁸

The purpose of a closing agreement is either (1) to enable the taxpayer and the IRS to resolve, finally and completely, a tax controversy for any period prior to the date of the agreement and to protect the taxpayer against the reopening of the matter at a later date; or (2) to determine a matter in a tax year that arises after the date of the agreement.

¹⁰⁶Reg. §301.7122-1(f).

¹⁰⁷§§6503(b) through (f). That section also contains other, less frequently encountered suspension possibilities.

¹⁰⁸§7121(b).

The IRS is authorized to enter into a closing agreement in any case where there appears to be a benefit to the government in closing the case permanently and conclusively, or if the taxpayer demonstrates a need to close the case and the government's interests are not harmed. Typically, a closing agreement is used in cases where the IRS and the taxpayer have made mutual concessions relative to the case, and it is necessary or desirable to bar further actions by either party. Such an agreement also may be used when a corporation is winding up its business affairs or when a taxpayer needs some authentic evidence of his or her tax liability, say, to satisfy creditors.

As a matter of practice, the IRS discourages the use of closing agreements because of their finality. Moreover, the IRS would have a difficult time processing a large number of requests for these agreements. Consequently, it prefers to use a number of informal agreements that may not resolve conclusively the tax dispute that is under examination, or that may not provide for the same degree of finality as would a closing agreement.

Offers in Compromise

The Commissioner can make an **offer in compromise** for any civil or criminal case that does not involve sales of illegal drugs, prior to the time that the case is referred to the Justice Department for prosecution or defense. Once the case is referred to the Justice Department, however, the U.S. Attorney General has the final authority to compromise the case.¹⁰⁹ Compromise proposals entailing more than \$50,000 in tax also must be supported by an opinion of the Chief Counsel.

In this context, the government will compromise a case only if there is doubt as to the liability or collectibility of the assessed tax. The IRS will not enter into a compromise with the taxpayer if the liability has been established by a valid judgment, and if there is no doubt as to the ability of the IRS to collect the amounts that are due.

A compromise agreement may cover the principal amount of tax, plus any corresponding interest or penalties. Ordinarily, the IRS will not compromise a criminal tax case unless it involves a violation of a regulatory provision of the Code or of a related statute that was not deliberately violated with an intent to defraud.

A compromise agreement relates to the entire liability of the taxpayer, and it conclusively settles all of the issues for which an agreement is to be made. It is a legally enforceable promise that cannot be rescinded unless there has been a misrepresentation of the assets of the taxpayer by falsification or concealment, or a mutual mistake relative to a material fact. Consequently, a taxpayer cannot decide later to bring a suit for refund with respect to any item that is so compromised. Moreover, if a taxpayer defaults on a compromise agreement, the IRS may collect the original tax liability, less any payments that were actually made, or sue to enforce the agreement.

An offer in compromise typically is made via Form 656, Offer in Compromise, and it must be accompanied by a comprehensive set of the taxpayer's financial statements. The offer may be revoked or withdrawn at any time prior to its acceptance. Form 656 is reproduced in Exhibit 14-4.

An offer in compromise is perhaps most appropriate in the following circumstances.

- There is doubt as to the taxpayer's liability for the tax (i.e., disputed issues still exist).

¹⁰⁹§7122(a).

Exhibit 14-4: Offer in Compromise

Form **656**
(February 2007)

Department of the Treasury — Internal Revenue Service

Offer in Compromise

Attach Application Fee and Payment (check or money order) here.		IRS RECEIVED DATE
Section I Taxpayer Contact Information		
Taxpayer's First Name and Middle Initial	Last Name	
If a joint offer, spouse's First Name and Middle Initial	Last Name	
Business Name		
Taxpayer's Address (Home or Business) (number, street, and room or suite no., city, state, ZIP code)		DATE RETURNED
Mailing Address (if different from above) (number, street, and room or suite no., city, state, ZIP code)		
Social Security Number (SSN) <i>(Primary)</i>	Employer Identification Number (EIN) <i>(EIN included in offer)</i>	
- -	- -	-

Section II To: Commissioner of Internal Revenue Service

I/We (includes all types of taxpayers) submit this offer to compromise the tax liabilities plus any interest, penalties, additions to tax, and additional amounts required by law (tax liability) for the tax type and period marked below: (Please mark an "X" in the box for the correct description and fill-in the correct tax period(s), adding additional periods if needed).

- 1040/1120 Income Tax — Year(s) _____
- 941 Employer's Quarterly Federal Tax Return — Quarterly period(s) _____
- 940 Employer's Annual Federal Unemployment (FUTA) Tax Return — Year(s) _____
- Trust Fund Recovery Penalty as a responsible person of (enter corporation name) _____, for failure to pay withholding and Federal Insurance Contributions Act taxes (Social Security taxes), for period(s) ending _____
- Other Federal Tax(es) [specify type(s) and period(s)] _____

Note: If you need more space, use a separate sheet of paper and title it "Attachment to Form 656 Dated _____." Sign and date the attachment following the listing of the tax periods.

Section III Reason for Offer in Compromise

I/We submit this offer for the reason(s) checked below:

- Doubt as to Collectibility — "I have insufficient assets and income to pay the full amount." You must include a complete Collection Information Statement, Form 433-A and/or Form 433-B.
- Effective Tax Administration — "I owe this amount and have sufficient assets to pay the full amount, but due to my exceptional circumstances, requiring full payment would cause an economic hardship or would be unfair and inequitable." You must include a complete Collection Information Statement, Form 433-A and/or Form 433-B and complete Section VI.

Section IV Offer in Compromise Terms

I/We offer to pay \$ _____ (must be more than zero). Complete Section VII to explain where you will obtain the funds to make this offer.

Check **only** one of the following:

- Lump sum cash offer** — 20% of the amount of the offer \$ _____ must be sent with Form 656. Upon written acceptance of the offer, the balance must be paid in 5 or fewer installments.
 \$ _____ payable within _____ months after acceptance
 \$ _____ payable within _____ months after acceptance
 \$ _____ payable within _____ months after acceptance
 \$ _____ payable within _____ months after acceptance
 \$ _____ payable within _____ months after acceptance
- Short Term Periodic Payment Offer** — Offer amount is paid within 24 months from the date IRS received your offer. The first payment **must** be submitted with your Form 656. You **must** make regular payments during your offer investigation. Complete the following:
 \$ _____ will be submitted with the Form 656. Beginning in the month after the offer is submitted (insert month _____), on the _____ day of each month, \$ _____ will be sent in for a total of _____ months. (Cannot extend more than 24 months from the date the offer was submitted.)

- There is doubt as to the collectibility of the tax (i.e., the taxpayer's net worth and earnings capacity are low).
- Payment of the disputed amount would constitute an economic hardship for the taxpayer. For instance, the taxpayer is incapable of earning a living because of a long-term illness or disability, or liquidation of the taxpayer's assets to pay the amount due would leave the taxpayer unable to meet basic living expenses.

The IRS investigates the offer by evaluating the taxpayer's financial ability to pay the tax. In some instances, the compromise settlement includes an agreement for final settlement of the tax through payments of a specified percentage of the taxpayer's future earnings. This settlement procedure usually entails lengthy negotiations with the IRS, but the presumption is that the agency will find terms upon which to enter into a compromise with the taxpayer. The IRS is charged to use a "liberal acceptance policy" in compromising with taxpayers and to increase educational efforts so that taxpayer rights and obligations are better known.

The IRS has statutory authority to enter into a written agreement allowing taxes to be paid on an installment basis if that arrangement facilitates the tax collection.¹¹⁰ The agency encourages its employees to use installment plans, and an individual is guaranteed the right to use an installment agreement when the amount in dispute does not exceed \$10,000. The taxpayer uses Form 9465 to initiate the installment plan.

The IRS provides an annual statement accounting for the status of the agreement. The agreement may later be modified or terminated because of (1) inadequate information, (2) subsequent change in financial condition, or (3) failure to pay an installment when due or to provide requested information.

SUMMARY

In dealing with tax underpayments, the stakes include more than just the disputed tax. Interest charges accrue, and both the taxpayer and tax adviser can be subjected to significant amounts of civil and criminal penalties. Restrictions on the actions of the taxpayer and practitioner are expressed using such ambiguously defined terms as *reasonable cause* and *substantial authority*, such that the lay taxpayer is

expected to project accurately the final holding of a judicial forum. Such is the condition of a tax system under which tax rates virtually cannot be raised, yet revenue needs continue to escalate. The tax professional must include these sanctions in the research process, communicating their effects to the client as needed.

TAX TUTOR

Reinforce the tax research information covered in this chapter by completing the online tutorials located at the *Federal Tax Research* web site: <http://academic.cengage.com/taxation/raabe>

¹¹⁰§6159.

KEY WORDS

By the time you complete this chapter, you should be comfortable discussing each of the following terms. If you need additional review of any of these items, return to the appropriate material in the chapter or consult the glossary to this text.

Accuracy-related penalty
Assessment
Civil penalties
Closing agreement
Collection
Criminal penalties
Fraud
Injunctions

Negligence
Offer in compromise
Preparer penalties
Reasonable basis
Reasonable cause
Return preparer
Statute of limitation
Substantial authority

DISCUSSION QUESTIONS

1. When should prevailing interest rates bear on tax decision making?
 - a. The taxpayer is contemplating litigation in either the Tax Court or the Court of Federal Claims.
 - b. An understatement of estimated tax payments is discovered late in the tax year.
2. What is the role of the statute of limitations in the Federal income tax system?
3. Indicate whether the following statements are true or false.
 - a. The government never pays a taxpayer interest on an overpayment of tax.
 - b. Penalties may be included as an itemized deduction on an individual's tax return.
 - c. An extension of time for filing a return results in an automatic extension of the time in which the tax may be paid.
 - d. The IRS can compromise on the amount of tax liability if there is doubt as to the taxpayer's ability to pay.
 - e. The statute of limitations for assessment of taxes never extends beyond three years from the filing of a return.
 - f. There is no statute of limitations relative to a taxpayer's claim for a refund.
4. Indicate whether, after both parties sign a closing agreement, the following result(s) occur. More than one answer may be correct.
 - a. The taxpayer still may appeal to a higher level of the IRS.
 - b. The interest on the assessment stops accruing immediately.
 - c. The agreement is binding on both the taxpayer and the IRS.
 - d. The tax must be paid, but a suit for refund can be filed in the District Court or U.S. Court of Federal Claims.
5. Ace filed her 2003 income tax return on January 25, 2004. There was no material understatement of income on her return, and the return was properly signed and filed. The statute of limitations for Ace's 2003 return expires on:
 - a. January 25, 2007
 - b. April 15, 2007

- c. January 25, 2010
 - d. April 15, 2010
6. Blanche filed her 1998 income tax return on April 4, 2004. On December 14, 2004, she learned that 100 shares of stock that she owned had become worthless in 2003. Since she did not deduct this loss on the 2003 return, Blanche intends to file a claim for refund. This claim must be filed by no later than April 15,
 - a. 2005
 - b. 2008
 - c. 2010
 - d. 2011
 - e. There is no expiration date for the statute of limitations in this context.
 7. Carl purposely omitted from his 2003 tax return \$40,000 of the gross receipts that he collected as the owner of a saloon. His 2003 return indicated collective gross receipts of \$25,000. The IRS no longer can pursue Carl with the threat of a collection of the related tax, interest, and penalties, as of April 15,
 - a. 2005
 - b. 2008
 - c. 2010
 - d. 2011
 - e. There is no expiration date for the statute of limitations in this context.
 8. Diane accidentally omitted from her 2003 tax return \$40,000 of the gross receipts that she collected as the owner of a saloon. Her 2003 return indicated collective gross receipts of \$25,000. The IRS no longer can pursue Diane with the threat of a collection of the related tax, interest, and penalties, as of April 15,
 - a. 2005
 - b. 2008
 - c. 2010
 - d. 2011
 - e. There is no expiration date for the statute of limitations in this context.
 9. Describe the civil fraud penalties, the definition of fraud, and the all or nothing rule for civil fraud. What are the differences in individual and corporate penalties for failure to make adequate estimated payments? What is a frivolous return?
 10. Explain the imposition of criminal penalties. What is the relationship between criminal and civil penalties? What are the defenses against criminal penalties?
 11. Discuss the penalties imposed on TRPs. Who is a preparer and what is defined as a tax return preparation and what is not preparation?
 12. What is an injunction and when may the IRS seek an injunction?
 13. What are the statutes of limitations for the IRS and taxpayers and why did Congress create them? When can they be shortened, extended, or suspended?
 14. How has Congress used tax penalties to discourage the development of certain tax shelters?

15. Define and illustrate the following terms or concepts.
 - a. Fraud
 - b. Negligence
 - c. Reasonable cause
 - d. Lack of reasonable cause
 - e. Civil penalty conviction
 - f. Criminal penalty conviction

EXERCISES

16. Construct a scenario in which the tax adviser should recommend that the client terminate the challenge of the IRS with the following.
 - a. Lawsuit
 - b. Offer in compromise
 - c. Closing agreement
 - d. Appeals conference
 - e. Office audit
 - f. Correspondence audit

17. The client's return is found by the U.S. Tax Court to have included improper business deductions. The court agreed that the taxpayer's position had some statutory and judicial merit, but it held for the government nonetheless. Which of the following could the IRS charge with a preparer penalty?
 - a. Taxpayer
 - b. Partner of the accounting firm that prepared the return
 - c. Employee of the client, who provided the accounting firm with the deduction data
 - d. Staff member of the accounting firm, who used the deduction data to prepare the return
 - e. Secretary of the accounting firm, who made copies of the return

18. Discuss which penalties, if any, the tax adviser might be charged with in each of the following independent circumstances. In this regard, assume that the tax adviser:
 - a. provided information about the taxpayer's Federal income tax returns to the pertinent state income tax agency.
 - b. provided information about the taxpayer's Federal income tax returns to the pertinent county's property tax agency.
 - c. provided information about the taxpayer's Federal income tax returns to the FBI, which was interested in gathering evidence concerning the client's alleged drug dealing activities.
 - d. suggested to the client various means by which to acquire excludible income.
 - e. suggested to the client various means by which to conceal cash receipts from gross income.
 - f. suggested to the client means by which to improve her cash flow by delaying for six months or more the deposit of the employees' share of Federal employment taxes.

- g. suggested to the client means by which to improve her cash flow by delaying for six months or more the deposit of the employer's share of Federal employment taxes.
 - h. kept in his safe deposit box the concealed income of item (e).
19. Discuss which penalties, if any, the tax adviser might be charged with in each of the following independent circumstances. In this regard, assume that the tax adviser:
- a. suggested that the client invest in a real estate tax shelter.
 - b. provided a statement of assurance as to the accuracy of the financial data that is included in the prospectus of a real estate tax shelter.
 - c. suggested to the promoters of a real estate tax shelter that a specific accounting technique, not recognized by generally accepted accounting principles, should be used to construct the prospectus.
 - d. failed, because of pressing time conflicts, to conduct the usual review of the client's tax return. The IRS discovered that the return included fraudulent data.
 - e. failed, because of pressing time conflicts, to conduct the usual review of the client's tax return. The IRS discovered a mathematical error in the computation of the taxpayer's standard deduction.

PROBLEMS

20. Lefty, a calendar-year taxpayer subject to a 34 percent marginal tax rate, claimed a charitable contribution deduction of \$15,000 for a sculpture that the IRS later valued at \$10,000. Compute the applicable overvaluation penalty.
21. Righty, a calendar-year taxpayer subject to a 34 percent marginal tax rate, claimed a charitable contribution deduction of \$170,000 for a sculpture that the IRS later valued at \$100,000. Compute the applicable overvaluation penalty.
22. Shorty, a calendar-year taxpayer subject to a 34 percent marginal tax rate, claimed a charitable contribution deduction of \$400,000 for a sculpture that the IRS later valued at \$150,000. Compute the applicable overvaluation penalty.
23. Baldy, a calendar-year taxpayer subject to a 34 percent marginal tax rate, claimed a charitable contribution deduction of \$600,000 for a sculpture that the IRS later valued at \$100,000. Compute the applicable overvaluation penalty.
24. Slim, who is subject to a 50 percent marginal gift tax rate, made a gift of a sculpture to Red, valuing the property at \$7,000. The IRS later valued the gift at \$15,000. Compute the applicable undervaluation penalty.
25. Tiny, who is subject to a 50 percent marginal gift tax rate, made a gift of a sculpture to Blondie, valuing the property at \$80,000. The IRS later valued the gift at \$150,000. Compute the applicable undervaluation penalty.

26. Fuzzy, who is subject to a 50 percent marginal gift tax rate, made a gift of a sculpture to Pinky, valuing the property at \$100,000. The IRS later valued the gift at \$250,000. Compute the applicable undervaluation penalty.
27. Jumbo, who is subject to a 50 percent marginal gift tax rate, made a gift of a sculpture to Curly, valuing the property at \$100,000. The IRS later valued the gift at \$500,000. Compute the applicable undervaluation penalty.
28. Compute the overvaluation penalty for each of the following independent cases involving the taxpayer's reporting of the fair market value of charitable contribution property. In each case, assume a marginal income tax rate of 35 percent.

<u>Taxpayer</u>	<u>Corrected IRS Value</u>	<u>Reported Valuation</u>
a. Individual	\$ 30,000	\$ 40,000
b. C Corporation	30,000	50,000
c. S Corporation	40,000	50,000
d. Individual	150,000	210,000
e. Individual	150,000	250,000
f. C Corporation	150,000	900,000

29. Compute the undervaluation penalty for each of the following independent cases involving the executor's reporting of the value of a closely held business in the decedent's gross estate. In each case, assume a marginal estate tax rate of 50 percent.

<u>Reported Value</u>	<u>Corrected IRS Valuation</u>
a. \$ 20,000	\$ 25,000
b. 100,000	150,000
c. 150,000	250,000
d. 150,000	500,000

30. Kim underpaid her taxes by \$15,000. Of this amount, \$7,500 was due to negligence on her part because her record-keeping system is highly inadequate. Determine the amount of any negligence penalty.
31. Compute Dana's total penalties. She underpaid her tax by \$50,000 due to negligence, and by \$150,000 due to civil fraud.
32. Trudy's AGI last year was \$200,000. Her Federal income tax came to \$40,000, which she paid through a combination of withholding and estimated payments. This year, her AGI will be \$300,000, with a projected tax liability of \$60,000, all to be paid through estimates. Ignore the annualized income method. Compute Trudy's quarterly estimated payment schedule for the year, assuming that she wants to make the minimum necessary payments to avoid any underpayment penalties.
33. When Maggie accepted employment with Martin Corporation, she completed a Form W-4, listing fourteen exemptions. Since Maggie was single and had no exemptions, she misrepresented her tax situation in an attempt to increase her cash flow. To what penalties is Maggie exposed?
34. What is the applicable filing period under the statute of limitations in each of the following independent situations?

- a. No return was filed by the taxpayer.
 - b. The taxpayer incurred a bad debt loss that she failed to claim.
 - c. A taxpayer inadvertently omitted a large amount of gross income.
 - d. Same as part c, except that the omission was deliberate.
 - e. A taxpayer inadvertently overstated her deductions by a large amount.
35. Kold Corporation estimates that its 2008 taxable income will be \$900,000. Thus, it is subject to a flat 34 percent income tax rate and incurs a \$306,000 liability. For each of the following independent cases, compute the minimum quarterly estimated tax payments that will be required from Kold to avoid an underpayment penalty.
- a. Taxable income for 2007 was (\$100,000). Kold carried back all of its loss to prior years and exhausted the entire net operating loss in creating a zero 2007 liability.
 - b. For 2007, taxable income was \$200,000 and tax liability was \$68,000.
 - c. For 2006, taxable income was \$2 million and tax liability was \$680,000. For 2007, taxable income was \$200,000 and tax liability was \$68,000.
36. Mimi had \$40,000 in Federal income taxes withheld in 2008. Due to a sizable amount of itemized deductions, she figured that she had no further tax to pay for the year. For this reason and because of personal problems, and without securing an extension, she did not file her 2008 return until July 1, 2009. Actually, the return showed a refund of \$2,400, which Mimi ultimately received. On May 10, 2012, Mimi filed a \$16,000 claim for refund of her 2008 taxes.
- a. How much of the \$16,000 will Mimi rightfully recover?
 - b. How would your analysis differ if Mimi had secured from the IRS an automatic six-month extension of time for filing her 2008 return?

RESEARCH CASES

37. The Bird Estate committed tax fraud when it purposely understated the value of the business created and operated by the decedent, Beverly Bird. Executor Wilma Holmes admitted to the Tax Court that she had withheld several contracts and formulas that, had they been disclosed to the valuation experts used by the government and the estate, would have added \$1 million in value to the business and over half that amount in Federal estate tax liabilities. Summary data include the following.

	Reported on Form 706	Other Amounts
Gross estate	\$12 million	\$1 million understatement
Deductions on original return	\$ 2 million	
Interest on estate tax deficiency, professional fees incurred during administration period		\$400,000

Holmes asks you for advice in computing the fraud penalty. Ignore interest amounts. She wonders whether to take the 75 percent civil penalty against the full \$1 million understatement or against the \$600,000 net amount that the taxable estate would have increased had the administrative expenses been incurred prior to the filing date of the Form 706. Write Holmes, an experienced

CPA (certified public accountant) with an extensive tax practice, a letter stating your opinion.

38. Blanche Creek has engaged your firm because she has been charged with failure to file her 2008 Federal Form 1040.

Blanche maintains that the “reasonable cause” exception should apply. During the entire tax filing season in 2009, she was under a great deal of stress at work and in her personal life. As a result, Blanche developed a sleep disorder, which was treated through a combination of pills and counseling.

Your firm ultimately prepared the 2008 tax return for Blanche, but it was filed far beyond the due date. Blanche is willing to pay the delinquent tax and related interest. However, she feels that the failure to pay penalty is unfair, as she was ill. Consequently, she could not be expected to keep to the usual deadlines for filing.

Write a letter to Blanche concerning these matters.

39. The Church of Freedom encourages its members to file “tax protestor” returns with the IRS, objecting to both (1) the government’s failure to use a gold standard in payment of tax liabilities, and (2) its sizable expenditures for social welfare programs. These returns routinely are overturned by the tax court as frivolous, with delinquent taxes, penalties, and interest due, and the church has engaged in a long-standing, sometimes ugly battle with the IRS over various constitutional rights. Meanwhile, church members continue to file returns in this manner.

Ellen overheard church members talking about “roughing up” the IRS agents who were scheduled to conduct an audit of various members’ returns. She went to the IRS and informed them of the danger that they might encounter. At the IRS’s direction, Ellen then took a key clerical job at church headquarters. In this context, she had access to useful documentation and over a period of a few months gave to the IRS copies of church mailing lists and computer data. She also helped tape record key conversations among church leaders and search the church’s trash for other documents. In other words, Ellen helped the IRS build a case of civil and criminal tax fraud against the church and various members.

All of these materials were given voluntarily to Ellen by church leaders in her context as an employee. Church members never suspected that she was working with the IRS. After delivering the various materials to the IRS, Ellen quit her job with the church and severed all communications with the IRS.

After the parties were charged with fraud, the government’s case was found to be insufficiently supported by the evidence, and no penalties were assessed. Afterward, church leaders sued Ellen in her role as IRS informant, charging that she had violated their First Amendment rights of free association and their Fourth Amendment rights against illegal search and seizure. Government employees are immune from such charges, but Ellen was only an informant to the IRS and not its employee. Can the church collect damages from Ellen for informing on them?

40. Butcher attended meetings of tax protestors for many years in which the constitutionality of the Federal income tax and its means of collection were routinely challenged. Members of various protestor groups were provided with materials to assist them in preparing returns such that little or no tax would be due on the basis that, for instance, only gold- or silver-backed currency need

be submitted to pay the tax or that a tax bill had originated in the Senate rather than the House of Representatives. Some of the groups maintained that no returns need be filed by individuals at all on the grounds that the current law supporting a Federal income tax violates various elements of the U.S. Constitution.

The U.S. Tax Court routinely has overturned such means of avoiding the tax, charging that such protestor returns were frivolously filed and charging the protestors with delinquent taxes, interest, and a variety of negligence and other accuracy-related penalties, especially where taxpayers failed to file altogether. The results of these cases never were discussed in the meetings that Butcher attended, though. Thus, although he never joined any of the groups, Butcher felt comfortable with the arguments of the protestor groups and never filed a Federal income tax return for himself or his profitable sole-proprietorship carpentry business.

When the IRS discovered his failure to file and charged him with tax, interest, and penalties, Butcher went to the tax library and found that judicial precedent and administrative authority were stacked against him. He asked the court for relief from the civil fraud penalties related to his failure to file and failure to pay tax on the basis of his good-faith belief that the tax protestor information he had received was an acceptable interpretation of the law. Under this argument, a taxpayer cannot be found to willfully have failed to file and pay if he or she had a good-faith belief that no such requirement was supported by the Constitution. Should Butcher be required to pay civil fraud penalties?

41. Chang wants to claim a cost recovery deduction for the acquisition of master-work paintings to be hung in the reception area of her dental office. The paintings were specially chosen because of their tendency to relax the patients who would be viewing them, thereby facilitating the conduct of Chang's business. Chang lives and works in the Fifth Circuit. A recent Eleventh Circuit case seems to support such a deduction, in limited circumstances. Complete the following chart, indicating for each independent assumption the actions that Chang can take without incurring the civil penalty for substantial understatement of taxes, but still maximizing her legitimate deductions for the year.

Probability of Success in Court	Claim the Deduction?	File a Form 8275 Disclosure?
80%		
40		
20		
2		

42. Continue with the facts of Research Case 41. Now assume that you are Chang's tax adviser. You wish to eliminate any chance of incurring a preparer civil unreasonable position penalty. Indicate the actions that you would recommend that Chang take.

Probability of Success in Court	Claim the Deduction?	File a Form 8275 Disclosure?
80%		
40		
20		
2		

43. Your client, Lee Ann Harkness, has been accused of criminal tax fraud. A high school dropout, she received hundreds of thousands of dollars over the years

from Bentley, an elderly gentleman, in exchange for love and companionship. When Bentley died and Harkness was left out of the will, she sued the estate for compensatory payments earned throughout her years of attending to Bentley. The government now accuses Harkness of fraud in failing to file income and self-employment tax returns for the open tax years. Construct a defense on Harkness's behalf.

44. The Scooter Company, owned equally by Julie (chair of the board of directors) and Jeff (company president), is in very difficult financial straits. Last month, Jeff used the \$100,000 withheld from employee paychecks for Federal payroll and income taxes to pay off a creditor who threatened to cut off all supplies. To keep the company afloat, Jeff used these government funds willfully for the operations of the business, but even that effort was not enough. The company missed the next two payrolls, and today other creditors took action to shut down Scooter altogether. From whom and for how much will the IRS assess in taxes and penalties in the matter?
45. For the completion and filing of his 2008 Federal income tax return, Ron retains the services of a tax preparer. Because of a particularly hectic tax preparation season, the preparer does not complete and file the return until June 2009. Is Ron excused from the failure to file and pay penalties under the reasonable cause exception?