TOP TEN TAX TRAPS AND HOW TO DEAL WITH THEM

Table of Contents

Table of Contents (cont'd)

TOP TEN TAX TRAPS AND HOW TO DEAL WITH THEM

Presented By

David D. Aughtry

In the words of Theodore Roosevelt:

> It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, who comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows great enthusiasms, the great devotions; who spends himself in a worthy cause; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place shall never be with those cold and timid souls who neither know victory nor defeat.

A. TOP TEN TELLTALE HIGH RISK CLIENTS AND CONTEXTS.

What keeps us up at night? Knowing no one scores a 100 on a test as complicated as a tax return – much less 250-500 tax returns for a typical return preparer. We will focus on the ten most common traps and the best practices for dealing with them, but first let us focus on the type of clients who create the greatest danger.

1. "It's always someone else's fault."

   a. History of failed, short term CPA relationships.

   b. History of failed bookkeeper relationships.

   c. Litigious.

   d. Greedy – more important than doing the right thing.

   e. Cheap.

   f. Integrity issues.

2. “Do it on the cheap”: Skimp on Time.

   a. Can’t or won’t pay you to handle accounting properly.

   b. Can’t or won’t pay IRS undisputed amounts.

3. Late, disorganized, incomplete, inadequate internal controls.

4. Can’t or Won’t Follow Recommendations.

   a. Never gets around to cleaning up records

   b. History of missing quarterly employment tax or estimated tax filings

   c. Resists or neglects internal accounting recommendations – why?

   d. Client or bookkeeper evasive re: vendor invoices, bank accounts, personnel relations – why?

5. “Walk on the Wild Side”

   a. Exotic offshore activity.

   b. Life style – neglect of business.

   c. High risk businesses – syndications, securities, shelters, loans, multi-state, etc.

6. Domineering client.

   a. Bully in business: bully CPA.

   b. Excessive control over the reporting.

   c. Mission creep coupled with delayed engagement letter.

7. Disproportionate profit margins, expense ratios, *etc.* – by RMA industry standards.

8. CPA firm spread too thin. Short people – audit partner assigned tax matters, inadequately trained staff, and inadequate supervision.

9. “Asset protection” to defeat known creditors: aiding and abetting / co-conspiracy.

10. Divorcing, failing, or exploding clients – individuals and businesses.

    a. Fractured families.

    b. Conflicts and complexities.

B. TOP TEN TAX TRAPS, BEST PRACTICES, AND SOLUTIONS.

1. Claims for Refund.

a. **Tax Trap: Timely Protective Claims.** What do you do when the IRS challenges a deduction in one tax year but that may be taken in another tax year? What if the statute of limitations will soon close the alternate tax year? What if the deficiency relates to a recurring or carryover item and you have to file a subsequent year's return during pending litigation? Unique statute of limitations requirements and *de minimis* burdens of proof placed on the IRS, poorly drafted and investigated claims for refund, and unfiled protective claims for refund may prevent a taxpayer from remedying an intentional delay by the IRS on a related deficiency assertion – resulting in a double disallowance of an entitled deduction.

b. **Staggered Statute of Limitations.**

i. **Sections 6511: Limitations for Filing Claim for Refund.** Section 6511 requires a taxpayer to file a claim for refund within 3 years from the date the return for the subject tax year was filed or within 2 years from the date the taxes were paid for the subject tax year, whichever is later. If proceeding under the 2 year period from the date the taxes were paid, the taxpayer will only be permitted to a refund of amounts paid within the 2 year period. For taxpayers paying under an installment agreement, each payment starts a 2-year period. Thus, if a taxpayer makes installment payments over a 5-year period and then seeks a refund, the taxpayer would be limited to claiming a refund with respect to payments made in the last two years (not all 5 years of payments). *See Pham v. United States*, 42 Fed. Cl. 886, 889 (Ct. Cl. 1999).

ii. **Section 6532: Limitations for Contesting Denial.** Under Sections 7422 and 6532, the taxpayer must *wait* to file suit until the earlier of 6 months from filing a (timely claim or the date of denial) of the claim. The suit *must* be filed within 2 years or the IRS denies the claim. The 2-year time period begins to run on the date the IRS *sends* the denial by *registered or certified* mail. Neither the statute nor the Courts require proof that the taxpayer or their advisor received the denial. *See Rosser v. United States*, 9 F.3d 1519 (11th Cir. 1993). The IRS enjoys a presumption of regularity and the Courts have been liberal in their preference for believing the IRS sent the denial letter, even where the IRS fails to produce a copy of the registered or certified mail receipt or confirmation. *Id.; Knight v. United States*, No. CV199-076, 2000 WL 702630 (S.D. Ga. Mar. 21, 2000). Thus, the unwary taxpayer (or advisor) that files a claim for refund and allows too much time to pass loses their rights to a refund solely on procedural grounds.

iii. **Cure: Do Not Sleep On Your Rights.** When in doubt, file protective claims now and calendar the 2 year denial trigger for suit from the date of the denial. It is important to be aware of the statute of limitations on every return and with respect to any payments made for the tax year after the return for that tax year was filed with the IRS. It is even more important to actively pursue the claim for refund after it is filed. If six months passes without acceptance or denial of the refund, you should engage counsel to investigate the need for litigation and prevent the IRS from alleging it denied the claim and waiting for the two year Section 6532 limitation period to run before informing you of the denial.

c. Beware the Doctrine of Variance: An Incomplete Claim Spells Disaster.

i. **Inadequate Disclosure.** In pursuing a claim or suit for refund, the taxpayer will be limited to the issues raised in the administrative claim for refund filed with the IRS. Under Treas. Reg. § 301.6402-2(b)(1), the claim for refund must set forth in detail the grounds upon which the taxpayer seeks a refund. This notice-based requirement limits the taxpayer to pursuing the refund on those grounds upon which the IRS has notice. The taxpayer (or advisor) who fails to adequately put the IRS on notice of the grounds upon which it seeks a refund will preclude themselves from raising additional grounds or substantially varying the grounds upon which it seeks the refund. *See Lockheed Martin Corp. v. United States*, 210 F.3d 1366, 1371 (Fed. Cir. 2000).

ii. **Cure I: Find the Balance Between Broad and Detailed.** The DOJ raises the variance doctrine as a defense in a majority of cases. Ideally, one would have adequate time to fully investigate the already filed return and ascertain the list of adjustments that make up the claim for refund. In the likely event that such luxury of time is not present, it is important to carefully draft the language of any formal claim for refund to marry the detail needed to put the IRS on adequate notice of the grounds upon which the claim for refund rests while also using broad enough language to not foreclose potential grounds later discovered. **AMEND BEFORE THE IRS ACTS.**

d. Failure to File Formal Claim: Danger in Reliance on Revenue Agent.

i. The IRS Whipsaw. Imagine the IRS challenges your client's business losses in Year 1 on the grounds that the losses should be resulted from a passive activity which would push a portion of the losses into the next year. While trying to reach a resolution on the proper treatment of those losses, the Section 6511 three-year statute of limitations for the subsequent year is about to expire. How do you preserve your right to any passive losses created which should be carried forward to that soon-to-close tax year? Too many taxpayers get caught in what amounts to a double disallowance of the loss deductions because they rely on the IRS to do the right thing and offset any deficiency created in the challenged year by the refund that should be available by carrying the passive activity losses forward.

ii. Cure I: Informal Protective Claim for Refund. You will not find a statutory or regulatory provision providing the taxpayer with the ability to file a protective claim for refund. However, the Courts and the IRS have recognized the taxpayer's ability to preserve their claim to a refund as a protective measure. *See Sun Chem. Corp. v. United States*, 698 F.2d 1203, 1208 n.8 (Fed. Cir. 1983); *Swietlik v. United States*, 779 F.2d 1306, 1307 (7th Cir. 1985); Rev. Proc. 2011-48, 2011-42 I.R.B. 527 (providing procedures for protective claims for refund for estate tax purposes). This informal claim for refund does not ask the IRS to process the refund immediately. As its name denotes, it protects the taxpayer's right to later assert a claim for refund pending the resolution of related proceedings (audit, Tax Court litigation, etc.). The protective claim must meet limitations, no variance, and other requirements, *supra.*

iii. Cure II: Mitigation Provisions. Though complex, Code §§ 1311 *et. seq.,* can open the limitations period where the IRS engages in a double disallowance or inclusion. *See* discussion, *supra*.

2. <u>Missed Elections and Section 9100 Relief</u>.

a. Tax Trap. The taxpayer needs to timely file an election, either with a return or by the due date of the election. The deadline is missed.

b. Partial Cure. Treas. Reg. §§ 301.9100-1 through -3 ("9100 Relief") provides the rules on when the Service will grant automatic and non-automatic extension of time to make certain elections.

c. **Automatic Extensions – Treas. Reg. § 301.9100-2.**

i. **12-month Extensions for Regulatory Elections.** 9100-2 provides an automatic extension (*i.e.*, no private letter ruling) from the due date of making a regulatory election. A regulatory election means an election whose due date is prescribed by a regulation, or other IRS announcement. Treas. Reg. § 301.9100-1(b). The 12-month deadline runs from the due date (or extended due date) of the return. Treas. Reg. § 301.9100-2(a). This extension is available regardless of whether the taxpayer timely filed the original return and applies to the following elections:

(1) To use a taxable year other than that required by Code § 444;

(2) To use the LIFO inventory method (Code §472);

(3) To be treated as a homeowners association (Code § 528);

(4) To adjust basis upon the transfer of partnership interest or upon distribution (Code § 754);

(5) To apply the estate tax special use valuation provisions (Code § 2032A);

(6) To treat qualifying payments and distributions as qualified payments (Code § 2701(c)(3)(C)); and

(7) To apply the 15-month rule for certain applications under Sections 505 and 508.

ii. **Six-month Extension for Certain Regulatory and Statutory Elections.** Taxpayers can get an automatic six-month extension to file regulatory or statutory elections (except those specifically exempted by statute or where the statute include alternative relief) if (i) the due date for the election is the return date or the extended return date and (ii) the taxpayer timely filed the return. Treas. Reg. § 301.9100-2(b). A statutory election means an election whose due date is prescribed by statute. Treas. Reg. § 301.9100-1(b).

iii. **Corrective Action.** A taxpayer filing for an automatic extension must take the steps to file the election in accordance with the regulations. For those elections required to be filed with a return, the taxpayer must file a regular or amended return (and include the necessary statements) and file the amended return in a manner consistent with the election. Treas. Reg. § 301.9100-2(c).

d. Non-Automatic Extensions – Treas. Reg. § 301.9100-3.

i. Reasonable Extension of Time. If the taxpayer does not qualify for the automatic extensions, the regulations allow for non-automatic extensions for regulatory elections where the taxpayer acted reasonably and in good faith and the relief will not prejudice the Government's interest. Treas. Reg. § 301.9100-3(a).

ii. Reasonable Action and Good Faith. Treas. Reg. § 301.9100-3(b).

(1) Requests relief prior to the IRS discovering the failure;

(2) Failed to make the election because of intervening events beyond the taxpayer's control;

(3) Failed to make the election because (after exercising reasonable diligence), the taxpayer was unaware of the need to file the election;

(4) Reasonably relied on the IRS' written advice; or

(5) Reasonably relied on a qualified tax professional.

iii. Taxpayer Deemed Unreasonable. Treas. Reg. § 301.9100-3(b)(3). Taxpayer requests relief where the IRS asserts accuracy-penalties; taxpayer affirmatively chose not to file the election; or taxpayer uses hindsight to request relief.

iv. Prejudice to Interests of the Government. Treas. Reg. § 301.9100-3(c). The government will be prejudiced where:

(1) Granting relief will result in a lower overall tax liability, aggregating all tax years affected by the election, than if the election had not been made (taking into account the time value of money).

(2) The year in which the election should have been made, or any other period affected by the election, remains closed under the period of limitations.

v. Accounting Methods. The regulations proscribe specific rules for such changes.

vi. Procedure. The taxpayer must include affidavits signed under penalties of perjury which describe the facts relied upon. The taxpayer requests a private letter ruling for a non-automatic extension. *Id.* at -3(e)(5).

e. **Fighting City Hall.** A taxpayer can contest the Service's refusal to grant Section 9100 relief. *See Vines v. Commissioner*, 126 T.C. 279 (2006). The Code and pronouncements may provide other avenues of alternative relief. *See, e.g.*, Code § 1362(b)(5) (IRS may grant relief for S election); Rev. Proc. 2002-59 (late check the box election procedures).

f. **Beware Unintended *De Facto* Elections.** A taxpayer must present "strong proof" to overcome or reverse tax treatment on his or her original return, but that can be done. *See, e.g., Topping v. Commissioner*, T.C. Memo. 2007-12 (aggregation of two Schedules C into one activity).

3. <u>Barred Carryover and Correlative Adjustments: How Did that Happen</u>?

a. Method of Accounting Rules.

i. **Tax Trap.** Imagine your anchor client incurs a huge fee for terminating a contract and the client comes to you to determine whether it should capitalize or expense the fees, and, if it capitalizes, can't recover those costs through depreciation. Now imagine the client brings you this information right before the filing deadline for the tax year in which that cost was incurred. How do you report the cost? What happens if you realize in the complexity of the capitalization regulations that your treatment was inappropriate or that you recovered the cost using the wrong recovery provisions? Many tax practitioners get themselves into trouble by inadvertently adopting tax treatment that they cannot change without the consent of the IRS – consent which the IRS is under no obligation or incentive to give the taxpayer.

ii. **Accounting Method Rules.** A method of accounting under Section 446 means more than overall reporting methods (*i.e.*, cash vs. accrual). It includes a vast array of timing items, including whether to capitalize or expense a cost, and how to recover the costs of that capitalized amount.

iii. **Adopting a Method of Accounting.** A taxpayer adopts a method of accounting by simply reporting the tax consequences of that method on a single return. *See Pacific Nat. Co. v. Welch*, 304 U.S. 191, 194 (1938). A permissible method of accounting is defined as any method the IRS determines clearly reflects income by consistent application of generally accepted accounting principles. Treas. Reg. § 1.446-1(a)(2). However, the IRS provides that a taxpayer adopting an impermissible method of accounting does not adopt the method for purposes of Section 446 until they report the tax consequences of that method on two returns. *See* Rev. Rul. 90-38, 1990-1 C.B. 57. Thus, a taxpayer may inadvertently adopt a permissible method by merely filing a single return and adopt an impermissible method by filing back to back returns.

iv. **Changing a Method of Accounting.** Under Section 446(e), once a taxpayer adopts a method of accounting, he may not change that method of accounting without the consent of the IRS. In general, a taxpayer changes a method of accounting if the change relates solely to the timing of a deduction, and not to the lifetime amount of a deduction. Treas. Reg. § 1.446-1(e)(2)(ii)(a). This applies even if the year the taxpayer originally adopted the method of accounting is still open under Section 6511. Certain changes in method of accounting qualify for automatic consent – *i.e.*, meeting certain requirements entitles the taxpayer to file Form 3115 and report the tax consequences under the new method of accounting without waiting for consent from the IRS. *See* Rev. Proc. 2006-12, 2006-1 C.B. 310; Rev. Proc. 2015-33, 2015-5 I.R.B. 419; Rev. Proc. 2017-30, 2017-18 I.R.B. 1131.

v. **IRS Challenges to Method of Accounting.** If the IRS challenges the taxpayer's method of accounting, the taxpayer may disavow the method as impermissible and seek to adopt a new method of accounting. *See Silver Queen Motel v. Commissioner*, 55 T.C. 1101, 1102-05 (1971) (once IRS challenges the first use of a method of accounting, the taxpayer may disavow that method and adopt a new method of accounting); *Convergent Technologies, Inc. v. Commissioner*, T.C. Memo. 1995-320 (distinguishing cases like *Silver Queen* from those preventing taxpayer adjustments to impermissible methods without consent on the ground that the IRS challenged the first use of the accounting method in *Silver Queen* and its progeny).

b. **Capitalization and Cost Recovery Methods.**

i. **Capitalization vs. Expense.** The promulgation of the Section 263 and Section 263A capitalization regulations have complicated the capitalization vs. immediate expense determination for Section 162 expenses. That labyrinth is further complicated by the myriad of cost recovery provisions stemming from Sections 167, 168, 179, 197, *etc.* The unwary tax practitioner may capitalize when they should expense and may recover that capitalized amount under an inappropriate cost recovery mechanism. Determining the nature of the expense and identifying the benefits obtained from it prove critical to this inquiry. A taxpayer that adopts a wrong or disadvantageous method may be stuck with that treatment.

ii. **Changing a Cost Recovery Method.** Treas. Reg. § 1.446-1(e)(2)(ii)(d) provides special rules for determining whether capitalization and cost recovery method changes constitute a change in method of accounting. For example, changes from capitalization to immediate expense (or vice versa) and changes in cost recovery method constitute changes in method of accounting requiring consent of the IRS. *Id.* Changes in the useful life of the capitalized asset under Section 167 (except for changes to or from a cost recovery method under Section 168, 197, and other Code mandated recovery periods), however, do not constitute changes in the method of accounting. Treas. Reg. § 1.446-1(e)(2)(ii) (d)(3)(i).

c. **Cure.**

i. **Get It Right OR Correct the First Year Quickly.** Of course, the best way to prevent the inadvertent adoption of an impermissible or disadvantageous method of accounting is the adequate investigation of the tax consequences of the method of reporting an item, before first reporting that item on a tax return. An unsure advisor would be better off reporting the item in manner that produced the greatest immediate tax benefit, file a disclosure statement stating that the taxpayer is still investigating the appropriate tax treatment, and then filing an amended return. If that original treatment proves incorrect, either the IRS will challenge the treatment, allowing the taxpayer to adopt a new, more appropriate method of accounting under *Silver Queen* and its progeny, or the taxpayer can request consent to change the method. The IRS will likely be more prone to grant consent to change a method of accounting which delays tax benefits, rather than accelerate them.

ii. **Cost Recovery Challenges.** If the taxpayer has adopted a capitalization/cost recovery treatment and later determines that other treatment would be more appropriate or beneficial, then the taxpayer should attempt to fit their purported change within one of the exceptions (*i.e.* changing the useful life or making one of the enumerated permissible changes) or within one of the automatic consent provisions. Any change which can accelerate the reporting of the cost recovery will prove beneficial to the taxpayer.

4. **Passive Loss Dispute: IRS Inconsistency on Carryover Impact**.

a. **Tax Trap.** The IRS argues on audit of Year 1 that activities A, B, and C were passive (rather than active) under Section 469 and the losses should be suspended until subsequent years. The taxpayer completely disposes of activity A in Year 2, reports large operating income on activity B in Year 3 (paying taxes on that income. Activity C floats along with continued losses. Twice, the agent demand and obtains an extension of the Year 1 limitations period, Exam finally issues Notice of Deficiency, and the case is settled in Appeals by casting A and B as passive and C as active. Practitioner assumes IRS will make the correlative adjustments in Years 2 and 3 on A and B.

i. **Wrong I –** IRS argues claim for refund barred by limitations period of Years 2 and 3.

ii. **Wrong II –** IRS argues that, even if claim were timely, IRS mailed denial and taxpayer failed to file suit within 2 years.

b. **Cure I.** Taxpayer argues mitigation provisions in rebuttal to untimely claim.

c. **Cure II.** While taxpayer receipt of the denial is not required or generally relevant, the denial must be mailed by registered mail. Further, presumption of regular IRS practice rebutted by regularity violations in retaining proof of registered mailing.

5. **Protective Claims for Refund in Reasonable Compensation Cases.**

a. **Tax Trap.**

i. Suppose the IRS asks for an extension of the statute of limitations in a reasonable compensation audit.

ii. C corporations and their shareholder officers consistently treat compensation as deductible from the corporate income, subject to employment taxes, and includible as ordinary wage income on the individual returns.

iii. In a reasonable compensation dispute, the IRS invariably takes the inconsistent positions of recasting the “excessive” compensation as a non-deductible corporate dividend in order to increase the corporate income tax, but continuing to treat the compensation as compensation for corporate employment tax and individual income tax purposes where that inconsistency serves the financial interests of the IRS.

b. The Taxpayer Must File a Claim for Refund.

i. Under Section 6511(a), a claim for a credit or refund of any tax imposed by Title 26 and which requires a return shall be filed within the later of (i) 3 years after the taxpayer files the return and (ii) 2 years after the taxpayer pays the tax. Section 6511(b) allows for the payment of no credit or refund after the expiration of the period in Section 6511(a) unless the taxpayer files a claim for refund within that period.

ii. Section 6513(a) treats a return filed or tax paid before the last day prescribed for the filing thereof as filed on the last day determined without regard to any extension.

iii. Section 6513(e) deems all annual Forms 940 (reporting the company's annual FUTA tax paid) filed on the later of January 31 or the extended filing of the return.

iv. Section 6513(c) of the Code treats Forms 941 as filed on April 15 of the next year.

v. An 872 extension likely fails to extend the time for these claims – Form SS-10 may be required.

c. Other Potential Cures.

i. Mitigation Provisions in Code §§ 1311-1314.

(1) May provide relief if

(a) Any claim for refund would be barred by the statute of limitations;

(b) A determination creates a circumstance necessary for adjustment;

(c) The taxpayer meets the conditions necessary for an adjustment; and

(d) The taxpayer made a claim for refund within one year of the determination.

(2) IRS takes the position that mitigation only applies to taxes under Subtitle A and thus provides no relief with respect to Form 940 or Form 941 claims. *See*, Treas. Reg. § 1.1311(a)-2(a) and (b).

ii. Doctrine of Equitable Recoupment: Set Off.

(1) Equitable recoupment operates as a defense to inconsistent tax treatment by the IRS or the taxpayer. Generally, equitable recoupment allows a taxpayer to recoup an otherwise time-barred refund by offsetting the amount against an alleged deficiency. *See Bull v. United States*, 295 U.S. 247, 261-62 (1935) (allowing taxpayer to offset alleged income tax deficiency by amount erroneously collected on estate tax liability despite expiration of statute of limitations for filing the claim for refund of overpaid estate taxes).

(2) Equitable recoupment only applies to an inequitable windfall to the IRS that flows from inconsistent treatment of a single transaction, item, or event affecting the same or sufficiently related taxpayer. *Estate of Mueller v. Commissioner*, 101 T.C. 551, 552 (1993).

(3) In order to establish equitable recoupment, the taxpayer must prove:

- **(a)** The overpayment for which recoupment is sought by way of offset is barred by an expired period of limitation;
- **(b)** The time-barred overpayment arose out of the same transaction, item, or taxable event as the deficiency before the Court;
- **(c)** The transaction, item, or taxable event has been inconsistently subjected to two taxes; and
- **(d)** If the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one.

See United States v. Dalm, 494 U.S. 596, 604-05 (1990); *Estate of Branson v. Commissioner*, 113 T.C. 6, 15 (1999), *aff'd*, 264 F.3d 904 (9th Cir. 2001).

(4) Here, the doctrine might avoid the double taxation.

(a) First, the company should argue that the income tax deficiency should be offset by the payroll tax liability paid on the "excess" compensation – the compensation the IRS deems unreasonable.

(b) Second, the employees who reported the compensation as ordinary income should request an offset for the difference between the tax rate on ordinary income and the tax rate on dividends and an offset for their portion of the payroll taxes paid on the now disallowed excess compensation.

(5) The overpayment of payroll and individual income taxes arise from the same transaction as the underpayment of corporate income taxes – the payment of compensation to the shareholder-employee. The amount of "excess" compensation will have been subject to two taxes – corporate level income taxes on pre-distribution amounts and payroll and individual income taxes on compensation not typically subjected to corporate level income taxes.

(6) Assuming limitations bar the refund claims, the issue is whether the shareholder-employees have sufficient identity to the corporation to satisfy the fourth prong of the equitable recoupment test. *See, e.g., Menard, Inc. v. Commissioner*, 130 T.C. 54 (2008) (taxpayer entitled to equitable recoupment for hospital taxes paid on portion of compensation determined to be a dividend).

(7) Unlike the mitigation provisions which support an independent cause of action outside of the Section 6511 statute of limitations, a taxpayer cannot sue for refund on the basis of equitable recoupment. *See United States v. Dalm*, 494 U.S. 596, 602-08 (1990) (taxpayer who paid gift taxes on amounts received and then settled subsequent tax court litigation treating the amounts as income, not gifts, could not use equitable recoupment to reopen statute of limitations for claim for refund on theory of equitable recoupment). Thus, a taxpayer seeking to raise equitable recoupment must do so in the proceeding that alleges the deficiency on inconsistent grounds.

iii. **Rescission.** Compensation may be rescinded if done so in the same year and the rescission returns the parties to the status quo. *See Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940).

6. **<u>Failure to Document, Document, Document</u>.**

a. **Tax Trap.** On audit, the taxpayer discovers that it lacks old documentation to support its deductions, net operating loss carryovers, or basis.

b. **Rule.** Section 6001 requires taxpayers to maintain records which can establish "the amount of gross income, deductions, credits, or other matters required to be shown" on any return for so long as the records are needed and for IRS inspection. Treas. Reg. § 1.6001-1(a), (e). In the case of a net operating loss ("NOL"), a taxpayer bears the burden of proving the amount of any NOL from the year of loss and the amount to be carried into the year of deduction. *See, e.g. Hoopengarner v. Commissioner*, T.C. Memo. 2003-343. If the IRS determines the taxpayer owes additional tax, he generally bears the burden, including providing substantiation, of proving the IRS wrong. *See, e.g.,* TAX COURT RULE 142(a).

The taxpayer's statements (alone) or tax returns (alone) generally cannot substantiate deductions. *See, e.g.*, *Arnold v. Commissioner*, T.C. Memo. 2007-168 (Court not required to accept taxpayer's unsubstantiated testimony to prove deductions); *Hoopengarner* (tax return constitutes a statement of claim, not evidence of the truth of the matters included).

c. **Cures.** Alternatives to traditional substantiation.

i. ***Cohan* Rule.**

(1) If the taxpayer incurs deductible expenses but fails to keep adequate records, the Court can estimate the expenses, bearing heavily against the taxpayer whose inexactitude is of his own making. *Cohan v. Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930). The *Cohan* rule has been used to estimate basis and capital improvements. *See, e.g. Sandoval v. Commissioner*, T.C. Memo. 2000-189.

(2) In making the estimate, the Court must rely on some evidentiary basis. *Vanicek v. Commissioner*, 85. T.C. 731, 742-3 (1985). The Tax Court is not required to guess to determine the correct amount of expenses. *Nogaard v. Commissioner*, 939 F.2d 874, 879 (9th Cir. 1991).

ii. Expenses Ineligible for the *Cohan* Rule – Section 274(d).

(1) Types of Expenses. Code § 274(d)–

(a) Traveling expenses (including meals away from home) under Sections 162 or 212;

(b) Entertainment, amusement, or recreational costs, including both expenses of activities generally considered to be entertainment, amusement or recreation and items relating to facilities used in connection with these activities;

(c) Deductible gifts; and

(d) Deductions or credits with respect to listed property (passenger automobile, property used as a means of transportation, property used for entertainment purposes, computers or peripheral equipment, and cellular telephones).

(2) Substantiation. The taxpayer must provide adequate records or other sufficient evidence to corroborate: 1) the amount of the expense; 2) the time and place of the travel, entertainment, or use of the facility or the date and description of the gift; 3) the business purpose of the expense or other item; and 4) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. Code§ 274(d).

(a) **Adequate Records.** Includes an account book, diary, statement of expense or other similar record made at or near the time of such expenditure and documentary evidence such as receipts, paid bills, or similar evidence. Treas. Reg. § 1.274-5A(c)(2).

(b) **Other Sufficient Evidence.** If the taxpayer cannot establish an element by adequate records, the taxpayer can establish such element: 1) by his own statement containing specific information in detail as to such element; and 2) by other corroborative evidence sufficient to establish such element. Treas. Reg. § 1.274-5A(c)(3).

(c) Congress enacted Section 274(d) to overrule the *Cohan* rule in certain instances. Treas. Reg. § 1.274-5A(a). The substantiation provided should constitute clear proof of the expense. *Id.* at (c)(1).

(3) **Exempted Expenses.** Code § 274(e), (f).

(a) Expenses which remain deductible regardless of their connection to the taxpayer's business, such as interest or real property taxes. Code § 274(f).

(b) Expenses treated as compensation. Code § 275(e)(2).

(c) Other items listed in Section 274(e).

iii. **Journals, Ledgers, and Other Contemporaneous Business Records.** The Federal Rules of Evidence specifically provide for the admissibility (*i.e.*, proof) through regularly maintained business records. *See* F.R.EVID. 803(6)(A)-(C), 902 (ii).

d. **Best Practices.** Taxpayers should keep source and summary documents for at least three years and tax returns and financial statements (perhaps general ledgers) forever. If a tax return includes a net operating loss or other carryover, the taxpayer should keep the source documents until three years after he or she exhausts the carryover.

e. **Related Issues.** The failure to call a witness can create a presumption that their testimony would have been unfavorable. *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946). If the taxpayer maintains adequate records, he or she can potentially shift the burden of proof in a Tax Court trial. Code § 7491(a).

7. <u>Most of Gift Tax Returns Go Unfiled: My CPA, Estate Planner, or Closing Attorney Should Have Told Me</u>?

a. **Requirement of a Gift Tax Return.**

i. Section 6019 requires a gift tax return (Form 709) for any individual making a transfer by gift in any calendar year. Section 6072(b)(1) provides for filing a required gift tax return by April 15 of the year after the transfer. Section 6072(b)(2) provides that an extension of a personal income tax return also extends the gift tax return filing but not payment. Form 8892 accompanies estimated gift tax payments with a return on extension, and it can extend the gift tax return filing if the donor does not need to extend the individual return filing.

ii. Any transfer made for less than full and adequate consideration in money or money's worth constitutes a gift.

iii. Section 6019 contains specific exceptions for annual exclusion gifts, gifts which are qualified transfers to pay medical expenses or tuition expenses, spousal transfers leading to a deduction under Section 2523, and some charitable transfers.

b. Dancing With the Devil 10, 20, or 30 Years After the Fact?

i. The limitations period never begins to run against the IRS until the return is filed.

ii. When you want to lock in value, such as for purposes of Section 2001(f). Now, once a donor adequately discloses a transaction (*see* Section 301.6501-1(f)) and the statute under Section 6501(a) runs, the disclosure establishes the value of the transferred property for all transfer tax purposes. Sections 2504(c), 2001(f), and 2642(b)(1)(A).

iii. Split gift elections (and their ability to convert majority transfers into minority transfers) need to be protected.

c. Non-gift Disclosures.

i. Consider a non-gift disclosure when you maintain that you did not intend to make a gift but need to start the limitations period.

ii. Consider a non-gift disclosure for any transaction that might be recast as a transfer for less than adequate consideration.

iii. Any sale to a family member or to a trust that might be considered an estate planning technique invites serious consideration here, particularly those that result in zero gift tax.

iv. BUT – we did not make a gift, right? The donor may object to "telling the IRS about it before we have to," but in the right circumstances the donor will appreciate it later if the disclosure precludes the IRS from arguing that a gift occurred or a larger gift occurred, assuming adequate disclosure and the lapse of the period under Section 6501(a).

d. Adequate Disclosure for Gifts and for Non-Gift Disclosures.

i. Treas. Reg. § 301.6501(c)-1(f)(1) contains the adequate disclosure rule: "If a transfer of property . . . is not adequately disclosed on a gift tax return . . ., or in a statement attached to the return, filed for the calendar period in which the transfer occurs, then any gift tax imposed by chapter 12 of subtitle B of the Internal Revenue Code on the transfer may be assessed, or a proceeding in court for the collection of the appropriate tax may be begun without assessment, at any time (underlining added)."

ii. Treas. Reg. § 301.6501(c)-1(f)(2) sets out the elements of "adequate disclosure," stating that a complete and accurate description of a transaction includes:

(1) A description of the transferred property and any consideration received by the transferor;

(2) The relationship between the transferor and transferee;

(3) If property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust (or a copy of the trust instrument);

(4) A detailed description of the method used to determine the fair market value of the property transferred; and

(5) A statement describing any position taken on the return that is contrary to any proposed, temporary, or final regulation or revenue rulings published at the time of the transfer.

8. <u>IRS Audit Mine Field – Waiving (Inadvertently) the Client's Rights Without Their Fully Informed Consent</u>.

a. Tax Trap.

i. Code § 7521(c) and 5 U.S.C. § 500(c) provide authority for a qualified CPA to represent a taxpayer before the IRS. A power of attorney granted by a taxpayer to his or her qualified representative grants broad powers to the representative. Through his or her interactions with the IRS, the representative can knowingly or inadvertently waive the taxpayer's rights.

ii. Most of these waivers arise from the representative's desire to cooperate with the IRS in an effort to demonstrate that his or her client has nothing to hide and the belief that, if they do what the IRS asks, eventually the agent will leave his or her client alone.

b. Examples.

i. Tax Trap - Production of Documents.

(1) As part of its examination, the IRS will issue information document requests ("IDRs") requesting all invoices, correspondence, and maybe emails.

(2) The representative has or obtains the request and makes it available for IRS review or produces a disk without any objections or a thorough review.

(3) The invoices and correspondence contain privileged information.

(4) Any action inconsistent with maintenance of a privilege may waive the privilege as to the entire subject matter.

Rule: Limit your responses to any IDRs to the questions specifically asked for the years under examination and thoroughly review all documents for any privilege or work product protections. Consider coordinating any responses to the IDRs with counsel to assist in the review of the production to avoid production of damaging materials outside the scope of the examination or that may inadvertently waive privilege. There will always be opportunities to produce documents further down the road, if necessary.

ii. Waiver of Privilege.

(1) Attorney-client privilege can be invoked to protect from disclosure both documents and testimony that involve confidential communications between a taxpayer and his attorney.

(2) Section 7525 extends the common law protections that apply to communications between a taxpayer and an attorney to a taxpayer and "any federally authorized tax practitioner to the extent such communications would be considered a privileged communication if it were between a taxpayer and an attorney."

(3) Privilege can be waived upon the disclosure of the communication to persons other than the attorney, the client, or their agents.

(4) E-mail threads to third parties not covered by the attorney-client privilege that contain otherwise privileged discussions waive that privilege.

(5) Voluntary disclosure of privileged communications to anyone outside the privileged relationship results in a waiver of the privilege as to all other communications on the same subject. *See, Weil v. Investment/Indicator, Research & Management*, 647 F.2d 18 (9th Cir. 1981); *In re Horowitz*, 482 F.2d 71 (2d Cir. 1973); *Chubb Integrated Sys. Ltd. v. Nat'l Bank*, 103 F.R.D. 52 (D.D.C. 1984); *Bernardo v. Commissioner*, 104 T.C. 677 (1995).

Cure: Execute joint defense agreements pursuant to *United States v. Kovel*, 296 F.2d 918 (2nd Cir. 1961), with all third parties assisting in the representation of the client to ensure that communications made to assist the attorney in rendering legal advice to the client remain privileged. Carefully, review all e-mail correspondence for any inadvertent disclosure of privileged communications and always start with a new e-mail whenever possible. *Kovel* agreements need to be signed the client, the lawyer, and the accountants assisting in the defense of any anticipated litigation.

iii. Waiver of Limitations Period: Unknowable Consequences.

(1) Generally, the IRS has 3 years (6 years in limited cases) from the date the taxpayer filed his or her return to make an assessment of additional tax. Oftentimes, the IRS will ask the representative to agree to an extension of that time to allow the Revenue Agent to complete his or her examination.

(2) Fairly often, Agents inaccurately state that, absent a signed consent, the tax will be assessed or the taxpayer will lose his Appeal rights. Not true.

(3) Without an extension, the IRS will issue a Notice of Deficiency. The taxpayer can petition the Tax Court and then go to Appeals.

(4) The representative hopes that by granting just a little more time, the IRS will determine that no adjustments are necessary. Often, the representative just does not want to make the agent mad.

(5) The extension allows a pre-disposed agent to do a better job hurting the client, including raising new issues.

(6) The client cannot be fully informed about issues raised in the future and may blame the representative.

Cure: When being asked by the IRS to agree to an extension, ask yourself how that extension benefits your client, if at all. It is likely that the only party benefiting is the IRS. Let the Service know that your client has no interest in dragging out this matter any longer than necessary and needs an accurate answer.

Other Thoughts: The statutory provisions in the Code exist to protect the taxpayer from delays in resolution. Don't let the Service bully you into waiving those statutory protections. Always consult with the client before agreeing to anything that would affect their statutory rights and get their consent.

9. Unwitting "Material Advisor" on Syndicated Conservation Easements, Captives, Etc.

Trap: You facilitate a relationship between the taxpayer and an organization that provides reportable transactions and the taxpayer pays you. In addition to facilitating the relationship, you prepare the affected tax return.

a. Material Advisor Must Disclose Reportable Transaction. Each material advisor with respect to a reportable transaction shall file a Material Advisor Disclosure Statement, Form 8918, with the Commissioner that includes: 1) information identifying the transaction; 2) information describing any tax benefits expected to result from the transaction; and 3) such other information that the Secretary may prescribe. Code § 6111(a).

b. Classification As a Material Advisor. A person is a material advisor with respect to a transaction if the person provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and directly or indirectly derives gross income in excess of the threshold amount for the material aid, assistance, or advice. "Transaction" includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan or arrangement, and includes any series of steps carried out as part of a plan. Treas. Reg. § 301.6111-3(b)(1).

i. **Material Aid, Assistance, or Advice.** A person provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any transaction if the person makes or provides a tax statement to or for the benefit of:

(a) A participant in a listed transaction or transaction of interest who is required to file a Form 8886, or would have been required to file a Form 8886 if the transaction had become a listed transaction or transaction of interest within the applicable period of limitations; or

(b) A material advisor who is required to disclose the transaction because it is a listed transaction or a transaction of interest. Treas. Reg. § 301.6111-3(b)(2)(i).

ii. **Tax Statement.** A tax statement is any statement (including another person's statement), oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction. Treas. Reg. § 301.6111-3(b)(2)(ii)(A).

iii. **Applicable Threshold Amount for Material Advisors.**

(1) The threshold amount of gross income is $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons (looking through any partnerships, S corporations, or trusts). For all other transactions, the threshold amount is $250,000. Code § 6111(b)(1)(B); Treas. Reg. § 301.6111-3(b)(3)(i)(A). For listed transactions, the thresholds above are reduced from $50,000 to $10,000 and from $250,000 to $25,000. Treas. Reg. § 301.6111-3(b)(3)(i)(B).

(2) Whether "substantially all of the tax benefits" are provided to natural persons is based upon facts and circumstances. Generally, unless the facts and circumstances prove otherwise, if 70 percent or more of the tax benefits from a reportable transaction are provided to natural persons (looking through any partnerships, S corporations, or trusts) then substantially all of the tax benefits will be considered to be provided to natural persons. Treas. Reg. § 301.6111-3(b)(3)(i)(D).

(3) A tax benefit includes deductions, exclusions from gross income, and nonrecognition of gain, tax credits, adjustments (or the absence of adjustments) to the basis of property, status as an entity exempt from federal income taxation, and any other tax consequences. Treas. Reg. § 301.6111-3(c)(7).

(4) Gross income includes all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a reportable transaction are taken into account. Treas. Reg. § 301.6111-3(b)(3)(ii).

c. Federal Disclosure Obligations for Material Advisors.

i. Material Advisor Disclosure Statement: Form 8918. A material advisor required to file a disclosure statement pursuant to Section 6111 and Treas. Reg. § 301.6111-3 must file a completed Material Advisor Disclosure Statement: Form 8918. Treas. Reg. § 301.6111-3(d)(1). A Form 8918 for a reportable transaction must be filed with Office of Tax Shelter Analysis by the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor with respect to the reportable transaction or in which the circumstances necessitating an amended Form 8918 occur. Treas. Reg. § 301.6111-3.

ii. Federal List Maintenance Obligations for Material Advisors. Each material advisor with respect to any reportable transaction shall maintain and prepare a list identifying each person with respect to whom such advisor acted as a material advisor with respect to the reportable transaction. Code § 6112(a).

d. Consequences of Noncompliance By Material Advisors.

i. Penalties for Failure to File Form 8918. Material advisors who fail to file their Form 8918 or file false or incomplete information shall be subject to a penalty under Section 6707(a). The penalty imposed by Section 6707(a) shall be $50,000. The penalty for listed transactions shall be the greater of $200,000 or 50 percent of the gross income derived; the penalty is 75 percent in the case of an intentional failure. Code § 6707(b).

ii. Penalties for Failure to Comply with the "List" Requirements. Failure to furnish the list to the IRS within 20 business days after the request results in a $10,000 per day penalty for each day of such failure after such 20th day. Code § 6708(a)(1).

e. Best Practice. When in doubt, disclose.

10. TEFRA Partnership Repeal: Cure Worse Than Ailment.

a. **Partnership Audit Rules Change Effective January 1, 2018.** The Bipartisan Budget Act of 2015 (the "BBA"), P.L. 114-74, Sec. 1101 (Nov. 2, 2015), repeals TEFRA and overhauls its partnership audit rules for tax years beginning on or after January 1, 2018. The BBA fundamentally changes not only how partnerships will be audited by IRS, but also who will be responsible for paying any additional tax liability. The Joint Committee on Taxation estimated that the BBA will generate an additional $9.325 billion in revenues for fiscal years 2016-2025. JOINT COMMITTEE ON TAXATION, ESTIMATED REVENUE EFFECTS OF THE TAX PROVISIONS CONTAINED IN H.R. 1314, THE "BIPARTISAN BUDGET ACT OF 2015," JCX-135-15 (Oct. 28, 2015). Consider the following example:

> A, B, and C are all equal partners in Partnership XYZ that was formed on January 2, 2015. XYZ's partnership agreement dated January 2, 2015 contains standard TEFRA partnership audit provisions. In 2018, XYZ takes a $150,000 deduction. On January 31, 2019, A sells his 1/3 interest in XYZ to D. XYZ, A, B, and C all file their 2018 tax returns on April 15, 2019; XYZ makes no elections. On February 28, 2020, B sells his 1/3 interest to E. On September 1, 2021, the IRS provides XYZ with a $150,000 notice of deficiency. XYZ's partnership agreement dated January 2, 2015 remains unamended.

b. **Highlights of the BBA.**

i. **Section 6221(a).** Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner's distributive share thereof) shall be determined, any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share shall be determined, at the partnership level.

ii. **Section 6221(b).** A partnership may elect out of the Section 6221(a) treatment if: (1) it so elects on a timely filed return for the taxable year; and (2) it has 100 or fewer partners during such taxable year, each of which is an individual, a C corporation, an S corporation (each shareholder of an S corporation is also deemed a partner), or an estate of a deceased partner.

iii. **Section 6223(a).** Each partnership shall designate a partner (or other person) with a substantial presence in the United States as the partnership representative who shall have the sole authority to act on behalf of the partnership. If a designation is not in effect, the IRS may select any person as the partnership representative.

iv. **Section 6225.** In the case of any adjustment in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof, the partnership shall pay any imputed underpayment with respect to such adjustment in the adjustment year. The amount of any imputed underpayment is generally determined by multiplying the net amount of adjustments by the highest tax rate for the reviewed year.

v. **Section 6226(a).** The partnership may elect out of Section 6225(a) treatment by filing, not later than 45 days after the date of the notice of final partnership adjustment, an election to have any adjustment taken into account by each partner of the partnership for the reviewed year.

vi. **Additional Guidance.** Proposed regulations were issued, but many critical issues were reserved for future guidance or ignored entirely.

c. **Problems on the Horizon.**

i. **Not Ready for Primetime.** The BBA, by itself, does not provide a complete partnership audit regime. The Technical Corrections Act, H.R. 6439 — 114th Congress: Tax Technical Corrections Act of 2016, was introduced in 2016 and included several revisions to the BBA. However, Congress failed to pass the bill and has not yet passed similar legislation. The BBA allows the Secretary to supplement a number of its provisions by Regulation. Proposed Regulations were published in the Federal Register on June 14, 2017. The Tax Section of the ABA wrote a letter to the House Ways and Means Committee and Senate Finance Committee requesting a one-year delay in implementing the BBA so that rules may be finalized and advisors may adequately advise their clients.

ii. **Inadequate Agreements.** Most existing partnership agreements, including XYZ's, are inadequate under the new rules because they only address TEFRA audit procedures. If a partnership agreement only references a Tax Matters Partner (and not a Partnership Representative), it's inadequate.

iii. **Back to the Example.** XYZ did not file a Section 6221(b) election, so the BBA applies. Who will serve as XYZ's partnership representative and what notice and information must he provide A, B, C, D, and E? Unlike TEFRA, the BBA does not entitle all of the partners to notice. Will XYZ file a Section 6626(a) election? Either XYZ, A, B, and C, or C, D, and E must satisfy the $150,000 liability, which is not deductible when paid. The parties that pay the adjustment may not be the parties who received the deduction.

d. **Contact Your Clients, Now.** Send a letter to your clients notifying them of these changes. Provide an overview of the BBA and its impact, including the potentially unfavorable and unintended default provisions, and the potential for additional change in the future. Most importantly, advise your clients to contact an attorney to discuss amending their partnership agreements so that they may take action well before 2018 tax season. Though it is more than two years until many 2018 tax returns will be filed, clients should amend their partnership agreements this year so that they are effective before any significant tax events, such as interest transfers and substantial recognition events, occur next year.

2541646.1