TOP TEN TAX TRAPS AND HOW TO DEAL WITH THEM

David D. Aughtry, Esq.
Chamberlain, Hrdlicka, White, Williams & Aughtry
191 Peachtree Street, N.E. - 46th Floor
Atlanta, Georgia 30303
Phone: 404-658-5486
david.aughtry@chamberlainlaw.com

HIGH RISK CLIENTS AND CONTEXTS

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1. It's always someone else's fault
2. "Do it on the cheap"
3. Late, disorganized, incomplete, inadequate internal controls
4. Can't or won't follow recommendations
5. "Walk on the wild side"
6. Domineering client
7. Disproportionate profit margins, expenses, etc.
8. CPA firm spread too thin
9. "Asset protection" to defeat known creditors
10. Divorcing, failing, or exploding clients.

TOP TEN TAX TRAPS, BEST PRACTICES, AND SOLUTIONS

1. Claims for Refund

Tax Trap: Statute expires prior to refund claim

Rule:

- File for refund within 3 years of return due date or 2 years of tax payment.
- File suit for refund with District Court or Court of Federal Claims within 2 years of date of administrative denial.

Solution:

- If facing deficiency proceedings, **file protective claims for refund to prevent statute of limitations expiration**.
- Six months after filing refund claim, begin reviewing whether to file suit. Avoid pitfall of IRS claiming it sent a denial letter you never received.

Stay vigilant.

1. Claims for Refund(cont.)

Tax Trap: Court bars defenses, theories, and issues not raised in claim for refund are barred

Rule:

- The administrative claim for refund must set out in detail the grounds upon which the taxpayer seeks a refund – prior to IRS acting on claim. Use it or lose it.
- The taxpayer cannot raise new grounds in later proceedings unless the IRS was timely put on notice of such grounds.

Solution:

- Make sure to adequately investigate the potential grounds for a claim for refund.
- Err on the side of inclusion.
- Marry detailed descriptions of the grounds with broad language.
- Supplement claim within limitations OR IRS action.

2. Missed Elections and Section 9100 Relief

Tax Trap: Election not filed or included with return
Solution: Section 9100 Relief

- 12-month automatic extension – Treas. Reg. § 301.9100-2
  - Only applies to regulatory elections.
  - Taxpayer does not have to timely file.
- 6 month automatic extension – Treas. Reg. § 301.9100-2
  - Applies to regulatory and statutory elections.
  - Taxpayer must timely file.
- Discretionary Extension – Treas. Reg. § 301.9100-3
  - IRS should provide reasonable extension of time.
  - Taxpayer must act reasonably and in good faith.
  - No prejudice to interest of government.

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3. Barred Carryover and Correlative Adjustments

Tax Trap: Inadvertent adoption of a method of accounting
Rule:

- Sections 263 and 263A require capitalization of costs otherwise deductible.
- Reporting an expense as capitalized or immediately deductible adopts a method of accounting with respect to that item.
- Cost recovery determinations also constitute methods of accounting.

Solution:

- Identify the appropriate treatment before filing the first return – utilize filing extensions where necessary.
- Err on the side of immediate expense or accelerated cost recovery and file a disclosure statement explaining the continued investigation of the appropriate treatment.
- Fit subsequent changes into special exceptions to method of accounting rules or to those changes subject to automatic consent procedures.
- Invoke an IRS challenge to the original treatment in order to abandon and adopt a new method of accounting – playing with fire.

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4. Passive Loss Dispute: IRS Inconsistency on Carryover Impact

Tax Trap: IRS reclassifies active business as passive but fails to make correlative adjustments. Limitations period for refund claim expires.

Solution: Mitigation and Procedure

- Mitigation provisions may render untimely claim timely. Code §§ 1341-1314.
- Argue IRS failed to follow Code § 6532 by requiring denial by registered or certified mail.

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5. Protective Claims for Refund in Reasonable Compensation Cases

Tax Trap: Corporation treats compensation consistently while IRS treats inconsistently.

Solution:

- File protective claims for refund for offsetting individual income and corporate employment taxes.
- Equitable recoupment and setoff.
- Mitigation may not help here.

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6. Failure to Document, Document, Document – Substantiation Issues

Tax Trap: Taxpayer lacks documentation.
Rule: Code requires taxpayers to document all items. Service will not accept taxpayer's oral statements or returns.
Solution: *Cohan* Rule.

- Court will estimate certain expenses.
- Can be used for expenses and basis.
- Must have some evidentiary foundation.
- Court is not required to guess.
- Exception - Section 274(d) expenses.

Keep source documents for three years and NOL source documents for three years after taking loss.

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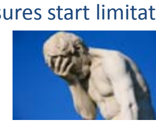
7. 70± Percent of Gift Tax Returns Go Unfiled

Tax Trap: IRS alleges gift 10, 20, or 30 years later.

Solution:

- When in doubt, file. Dancing with the Devil on limitations: lost opportunity to lock-in value.
- Non-gift disclosures start limitations period.



Don't have that moment!

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8. IRS Audit Mine Field – Waiving (Purposely and Inadvertently) the Taxpayer's Rights Without His or Her Consent

Tax Trap: IRS issues overly broad IDR and CPA demanding everything for years.

Solution:

- Answer the question asked for years under review.
- Review all documents for privilege.
- When in doubt, ask counsel.

Be vigilant

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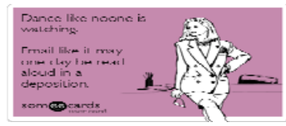
8. IRS Audit Mine Field – Waiving (Purposely and Inadvertently) the Taxpayer's Rights Without Their Consent (cont.)

Tax Trap: CPA inadvertently waives attorney-client privilege by disclosing confidential communication.

Solution:

- Joint Defense and *Kovel* agreements.
- Carefully review production.



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8. IRS Audit Mine Field – Waiving (Purposely and Inadvertently) the Taxpayer's Rights Without Their Consent (cont.)

Tax Trap: The IRS raises new issues and prolongs resolution after you convince the client to extend the limitations period.

Solution:

- Insist on prompt resolution in remaining time.
- Limited waivers – available?
- Almost every extension leads to heartache.

We must protect the client – not make the agent happy.

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

Tax Trap:

- Facilitation of an investment relationship?
- Preparation of the Partnership return?

Solution:

- **Disclosure Statement:** Form 8918 that: 1) identifies the transaction; 2) describes the expected tax benefits; and 3) includes other required information. Code § 6111(a).
- **List Requirements:** Material advisor must maintain list of advisees. Code § 6112(a).
- **Penalties**:
  - Failure to file Form 8918 for a listed transaction shall be the greater of $200,000 or 50 percent of the gross income derived. Code § 6707(a).
  - 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).

When in doubt, disclose!

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10. TEFRA Partnership Repeal: Cure Worse Than Ailment

Tax Trap: A, B, and C are equal members of XYZ, LLC in 2018. C, D, and E are equal members of XYZ, LLC in 2021. The IRS audits XYZ's 2018 return in 2021.

Solution:

- As of January 1, 2018, agreements that only provide for a "Tax Matters Partner" are inadequate.
- Agreements should be amended to address the changes imposed by the BBA and clearly define the rights, obligations, and remedies of all interested parties.

Update Agreements now!

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