Examining the Arsenal - Recent Developments in Tax Practice and Procedure that Tax Practitioners Need to Know

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I. INTRODUCTION

A. The last decade saw a significant number of tax law changes enacted by Congress. Several of the statutory changes enacted during the 1980's profoundly affected the way the tax laws are administered. Among the most significant are the following:

1. The enactment of the unified partnership audit and litigation procedures as part of TEFRA in 1982;

2. The enactment of the Taxpayer Bill of Rights ("Tl") as part of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA").

3. The comprehensive reform of the civil tax penalty system through the enactment of the Improved Penalty Administration and Compliance Tax Act of 1989 ("IMPACT") as part of the Revenue Reconciliation Act of 1989;

B. In addition, the Internal Revenue Service ("the Service") promulgated a panoply of temporary, proposed and final regulations, revenue rulings, revenue procedures and other administrative guidance designed to assist taxpayers and their representatives in interpreting and applying the new statutory provisions.

C. This outline reviews recent statutory and administrative developments in tax practice and procedure that every tax practitioner should know.

II. THE "NEW" OFFERS IN COMPROMISE PROCEDURES

A. Introduction

1. On February 26, 1992, the Service issued new Internal Revenue Manual ("the Manual") provisions with regard to offers in compromise.
2. The new policies and procedures were developed, at least in part, in response to recent criticism directed at the Service's evaluation and collection of its accounts receivables.

3. The new policies and procedures announce a new era in the Service's attitude and approach to offers in compromise.

B. An Overview

1. The objectives of the offers in compromise program are summarized as follows:

   a. To resolve accounts receivable which cannot be collected in full or on which there is a legitimate dispute as to what is owed;

   b. To affect collection of what could reasonably be collected at the earliest time possible and at the least cost to the government;

   c. To give taxpayers a fresh start to enable them to voluntarily comply with the tax laws;

   d. To collect funds which may not be collectible through any other means. MT 5700-34, §57(10)1.2.

2. As set forth in the offer policy,

   a. An offer will be considered "when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential." MT 5700-34, §57(10)1.1.

   b. An offer is a "legitimate alternative" to declaring an account currently uncollectible or to an extended installment pay arrangement. Id.

   c. The success of the program depends upon taxpayers making adequate offers consistent with their ability to pay and the Service making "prompt and reasonable decisions." Id.
d. Taxpayers are "expected to provide reasonable documentation to verify their ability to pay." Id.

3. **Scope and Effect of Offer.**

An offer applies to the entire liability for tax, penalty and interest for all periods covered by the offer. Once an offer is accepted, neither party to the offer can reopen it unless there was falsification or concealment of assets or a mutual mistake of material fact sufficient to set aside a contract occurs.

4. **Grounds for an Offer.**

An offer may be accepted by the Service only for one or both of the following reasons:

a. Doubt as to whether the taxpayer owes the liability ("doubt as to liability"); or

b. Doubt that the liability can be collected in full ("doubt as to collectibility").

The Service cannot accept an offer in compromise if the liability has been finally determined by a court and/or if there is no doubt that the liability can be collected. I.R.C. §7122.

5. **Statute of Limitations on Collection.**

If an assessment of tax is made within the statute of limitations for assessment imposed by IRC §6501, the Service may collect the liability by levy, court proceeding or other collection efforts, provided that the levy must be made or court proceeding begun within 10 years after the assessment of the tax or prior to the expiration of the collection period agreed to in writing by the taxpayer and the Service (as long as the extension is agreed to before the collection period expires). I.R.C. §6502.

6. **Procedure for Submitting Offer.**

a. An offer is made by submitting Form 656 to the Internal Revenue Service in triplicate.
b. The offer should be filed with the district office of the Internal Revenue Service for the district in which the taxpayer resides or has its principal office. If the taxpayer is already working with a revenue officer, the offer should be filed with the revenue officer.

c. The Form 656 must be filed with Form 433-A (Collection Information Statement for Individuals) or Form 433-B (Collection Information Statement for Business) if the offer is based on doubt as to collectibility.

d. Although not required at the time the offer is submitted, it is good practice to submit information with the offer sufficient to verify the accuracy of assets, liabilities, income and expenses listed on the Form 433-A and/or 433-B. This will often shorten the investigation of the offer and will demonstrate the taxpayer's intention to submit a serious offer.

e. All liabilities sought to be compromised must be listed on Form 656. If the taxpayer is solely liable for one liability and jointly liable for another and both of the taxpayers who are jointly liable are submitting an offer, two Forms 656 must be submitted.

f. Follow the instructions to Form 656 when preparing the offer. If the offer is not prepared consistent with the instructions, it will be returned.


a. Promptly after an offer is submitted, a determination will be made by the Service whether the offer is "processable." If it is not, the Form 656 will be returned to the taxpayer within 14 days from receipt with an explanation of what must be corrected or added. MT 5700-34, §57(10)9.1.
b. If the offer is processable, the examining officer should contact the taxpayer within 30 calendar days from receipt of the offer. At that time, the examining officer (also known as an "offer specialist") will advise the taxpayer of any information the examiner needs to make a decision on the offer. According to the Manual, "the request should be reasonable and the taxpayer should be given a reasonable time to comply."
MT 5700-34, §57(10)9.3.

c. **Offers based on Doubt as to Collectibility.** The adequacy of an offer based on doubt as to collectibility is evaluated by looking at several things.

1. The starting point is the value of the taxpayer's assets less any liabilities which have priority over the federal tax lien.

2. Ordinarily, the liquidating or quick sale value of assets, should be used in valuing a taxpayer's assets.

3. Liquidating or quick sale value is defined by the Manual as "the amount which would be realized from the sale of an asset in a situation where financial pressures cause the taxpayer to sell in a short period of time."

4. The Manual concedes that it would not be unreasonable in some cases to use "forced sale value."

5. The Manual also warns examiners that valuation of assets other than cash or cash equivalents is "not scientifically exact" and, therefore, "care should be exercised to avoid inflexible, non-negotiable values."
(6) The Service also will look at the amount that can be collected from taxpayer's future income. In so doing, it will consider the taxpayer's education, profession or trade, age, experience, health, and past and present income.

MT 5700-34, §57(10)(10).1.

(7) The Manual contains detailed instructions on how to evaluate the following assets:

(a) Cash;
(b) Securities;
(c) Life Insurance;
(d) Pension and Profit Sharing Plans;
(e) Furniture, Fixtures and Personal Effects;
(f) Machines and Equipment;
(g) Trucks, Automobiles and Delivery Equipment;
(h) Receivables;
(i) Real Estate (including jointly owned real estate).

MT 5700-37, §57(10)13.

d. **Offers Involving Employment and Collected Excise Tax Liabilities.**

(1) Ordinarily, if the business giving rise to the liability is still operating, the Service will not accept an offer for an amount less than the tax. However, if, after considering all of the factors including the taxpayer's demonstrated ability to stay current, the offer appears to be in the
best interests of both the government and the taxpayer, an offer in an amount less than the tax collected can be accepted if the amount reflects the reasonable collection potential.

(2) If the offer is submitted by a corporation and does not fully pay the trust fund portion of the tax, the assertion of the 100-percent penalty "need not be held in abeyance pending final disposition of the offer in compromise." MT 5700-34, §57(10)(14).21.

(3) In order to protect the interest of the government when the 100-percent penalty can be asserted, the Manual instructs revenue officers to use one of the following three alternatives whenever an offer is submitted by a corporation to compromise a trust fund liability:

(a) Assess the 100-percent penalty against responsible persons;

(b) Secure a "Waiver Extending Statutory Period for Assessment of 100-Percent Penalty" (Form 2750) from each responsible person and/or take other protective measures;

(c) Require the corporation and its responsible persons to make a joint offer.

(4) No protective steps are required if:

(a) The corporation files a cash offer equaling the
proposed trust fund portion of its liability; and

(b) There is enough time left before the statutory period for assessing the penalty expires, to complete consideration of the corporation's offer.

MT 5700-34, §57(10)(14).22.

e. Collateral Agreements.

A collateral agreement permits the government to collect funds in addition to the amount of the offer. Under the new procedures, collateral agreements should not be secured routinely. Rather, they should be obtained only when a significant additional recovery reasonably can be expected.

MT 5700-34, §57(10)(15).1.

(1) Collateral agreements can take several forms:

(a) Future income collateral agreements;

(b) Collateral agreement reducing the basis of assets;

(c) Collateral agreement waiving net operating losses or capital losses.

(2) Provisions governing collateral agreements are set forth at §57(10)(15).


a. If an offer is rejected, the taxpayer may appeal the rejection.

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b. If the total liability to be compromised does not exceed $2,500 for any taxable period, the taxpayer may appeal the determination orally or in writing. Although not required, the taxpayer may submit a written statement outlining the facts, law or arguments on which the taxpayer relies in appealing the rejection.

c. If the total liability exceeds $2,500 for any taxable period, the taxpayer must file a written protest.

d. If the taxpayer initiates a timely appeal, any protest filed will be reviewed before the case is forwarded to Appeals. If the information in the protest is insufficient to process the appeal adequately, the taxpayer will be advised of the information required and will be given 15 days to perfect the protest. If the information in the protest is new, it will be evaluated and could result in a different decision on the offer. If so, the taxpayer will be notified and the case will not be forwarded to Appeals.

e. If the case is forwarded to Appeals, the case file should contain the amount and terms of the offer determined to be acceptable or the reason why the offer was inappropriate.

MT 5700-34, §57(10)(17).8.

C. Practice Pointers

1. The new offer in compromise procedures, if followed by the field, represent a new realism on the part of the Service in evaluating its accounts receivable. For many taxpayers with past liabilities and present collection problems, an offer in compromise may be a very viable way of clearing away old tax problems.

2. Practitioners and taxpayers alike should keep in mind that an offer must be approached realistically and reasonably. The Service will not compromise a liability simply because it is old or for nuisance value.
3. Some practice pointers should be kept in mind:

a. Prepare an offer which you would accept if you were employed by the Service and knew the full facts.

b. Market your offer by demonstrating that it is serious and reasonable. Include appraisals, bank statements and other documentation of assets and liabilities that you know the Service will want to see in support of the offer.

c. Know the offer in compromise policies and procedures and use that knowledge in negotiating the terms of the offer. The offer specialist will respond to a knowledgeable practitioner favorably in the negotiating process.

d. Evaluate the adequacy of the offer using the Manual provisions before you submit it.

e. Work with the taxpayer to do some tax planning in anticipation of the offer. Keep in mind that, under the terms of the offer, any overpayments that a taxpayer would be entitled to receive for periods that end before, within, or as the end of the calendar year in which the offer is accepted are waived and are applied against the compromised liability. If an offer is anticipated, a taxpayer's withholding, estimated tax payments and any other payments should be carefully reviewed, planned and monitored before and during the offer process to keep the potential refunds to a minimum consistent with required tax compliance.

f. Do not submit an offer unless it is in an amount at least equal to, and preferably in excess of, the
taxpayer's net worth (i.e., the value of assets less the amount of any encumbrances having priority over the tax lien(s)).

III. CIVIL TAX PENALTY REFORM AND ITS EFFECT ON PRACTICE

A. Introduction

1. By 1986, the legislative activism in the tax area had resulted in the construction of a civil tax penalty structure within the Internal Revenue Code that consisted of over 150 separate tax penalties and was characterized by:
   a. the imposition of multiple penalties for a single act of tax misbehavior ("stacking");
   b. Disproportionate "punishment" for tax misconduct;
   c. Undue complexity in understanding and administering the civil tax penalties.

2. After much study and comment by a variety of interested parties, Congress finally enacted the "Improved Penalty Administration and Compliance Tax Act of 1989" ("IMPACT") as part of the Revenue Reconciliation Act of 1989.

3. As a general rule, the changes made by IMPACT became effective after December 31, 1989.

4. Two of the most significant changes made by IMPACT create new planning possibilities and issues for both practitioners and taxpayers. The Code provisions involved are:
   a. the newly created "accuracy-related penalty" and the modified fraud penalty authorized by I.R.C. §§6662 and 6663 respectively;
   b. The substantially amended preparer penalties authorized by I.R.C. §6694.

B. Accuracy-Related Penalty [I.R.C. §§6662]

1. I.R.C. §6662 authorizing the imposition of an "accuracy-related penalty" was added by IMPACT §7721 to replace several different penalties that could be applied under prior law. See pre-IMPACT Code §§6653(a), (b), (f) and (g); 6659; 6659A; 6660; 6661.
2. Section 6662(a) authorizes the imposition of a penalty for inaccuracy on a tax return equal to 20% of the portion of the underpayment to which the section applies.

3. Section 6662 applies to the portion of any underpayment which is attributable to one or more of the following tax mistakes:
   a. Negligence or disregard of rules and regulations [I.R.C. §6662(b)(1) and (c)];
   b. Any substantial understatement of income tax [I.R.C. §6662(b)(2) and (d)];
   c. Any substantial valuation overstatement [I.R.C. §6662(b)(3) and (e)];
   d. Any substantial overstatement of pension liabilities [I.R.C. §6662(b)(4) and (f)];
   e. Any substantial estate or gift tax valuation understatement [I.R.C. §6662(b)(5) and (g)].

4. Negligence or Disregard of Rules and Regulations.
   a. For purposes of Section 6662, "negligence" is defined to include any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws, any failure to exercise ordinary and reasonable care in preparing a tax return and any failure to keep adequate books and records or to substantiate items properly. I.R.C. §6662(c); Reg. §1.6662-3(b)(1).
   b. For purposes of Section 6662, "disregard" is defined to include any careless, reckless or intentional disregard of rules and regulations. I.R.C. §6662(c); Reg. §1.6662-3(b)(2).
   c. Although prior law created a presumption of negligence when a taxpayer failed to report income from an information return [Pre-IMPACT Code §6653(g)], Section 6662 creates no similar presumption. Rather, all negligent behavior is treated the same under Section 6662. However, the regulations make it clear that negligence is "strongly indicated" by certain acts which include, but are not limited to, a failure to include
an item shown on an information return on the taxpayer's tax return. Reg. §1.6662-3(b)(2).

d. Although the base penalty rate for negligence has been increased from 5% to 20% by IMPACT, the accuracy-related penalty imposed for negligent acts is targeted to that portion of an underpayment which is attributable to the negligence. Consequently, a negligent item giving rise to only a small portion of an underpayment will no longer invoke a penalty on the entire underpayment as happened under prior law.

5. **Substantial Understatement of Income Tax.**

a. The accuracy-related penalty authorized whenever there is a substantial understatement of income tax applies without regard to a taxpayer's intent or knowledge concerning a tax mistake. Rather, it applies whenever an income tax liability is sufficiently large that it meets the definition of "substantial understatement".

b. **Definition of Substantial Understatement.**

A substantial understatement of income tax exists whenever the amount of the understatement for a taxable year exceeds the greater of -

(1) 10% of the tax required to be shown on the return for that period; or
(2) $5,000. [I.R.C. §6662(d)(1)(A), Reg. §1.6662-4(b)(1)].

In the case of a corporation other than an S corporation or a personal holding company, the understatement must exceed 10% or $10,000, whichever is greater [I.R.C. §6662(d)(1)(B)].

c. **Definition of Understatement.**

(1) Generally, the term "understatement" for purposes of Section 6662(d)(1) means the excess of -

(a) the amount of the tax required to be shown on the return, over
(b) the amount of the tax imposed which is shown on the return reduced by any rebate (as defined by I.R.C. §6211(b)(2)).
[I.R.C. §6662(d)(2)(A); Reg. §1.6662-4(b)(2)].

(2) However, the amount of the understatement on which the penalty will be calculated must be reduced by the amount of the understatement attributable to -

(a) the tax treatment of any item if there is or was substantial authority for such treatment; or

(b) any item (other than a tax shelter item) where the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return. I.R.C. §6662(d)(2)(B)(i) and (ii); Reg. §1.6662-4(d)(f).

(3) Special rules apply to tax shelters.

(a) A taxpayer cannot avoid the substantial understatement penalty by disclosing the relevant facts concerning a tax shelter item on his or her tax return. [I.R.C. §6662(d)(2)(C)(i)(I)].

(b) Moreover, even if a taxpayer can demonstrate that he or she has or had substantial authority for the tax treatment of a tax shelter item, it will not be sufficient to avoid the penalty unless the taxpayer reasonably believed that the tax treatment of the tax shelter item was more likely than not the proper treatment. [I.R.C. §6662(d)(2)(C)(i)(II)].

(c) A "tax shelter" means -

(i) a partnership or other entity;

(ii) any investment plan or arrangement; or
(iii) any other plan or arrangement, if the principal purpose of it is the avoidance or evasion of federal income tax. [I.R.C. §6662(d)(2)(C)(ii)].

(4) The Secretary of the Treasury is required by Section 6662(d)(2)(D) to "prescribe", and revise no less frequently than annually, a list of positions for which he believes there is not substantial authority and which affect a significant number of taxpayers. The list must be published in the Federal Register.

(a) The purpose of the list is "to assist taxpayers in determining whether a position should be disclosed in order to avoid the substantial understatement penalty". H.Rep't.No. 101-386, 101st Cong., 1st Sess. (1989) ("House Report") at 1390.

(b) A taxpayer may still choose to take a position included on the secretarial list and avoid the penalty for substantial understatement by adequately disclosing the relevant facts as required by Section 6662(d)(2). Id.

NOTE: Disclosure may not avoid the negligence penalty, e.g. if the position is frivolous. Id.

(c) Inclusion of a position on the secretarial list is not conclusive as to whether there is no substantial authority for the position. Id.

(d) Similarly, the Committee intended that there be no inference of substantial authority arising from the failure to include the position on the secretarial list. Id.
d. Definition of Substantial Authority.

(1) The legislative history of IMPACT indicates that it was the intent of Congress to expand the list of authorities upon which taxpayers may rely. House Rpt., supra at 1389.

(2) Prior to the enactment of IMPACT, Treas. Reg. §1.6661-3(b)(2) provided that only the following will be considered "authority":

(a) the Internal Revenue Code and other statutory provisions;
(b) temporary and final regulations;
(c) court cases;
(d) administrative pronouncements including revenue rulings and revenue procedures;
(e) tax treaties and related regulations;
(f) official explanations of tax treaties;
(g) Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, floor statements made prior to enactment by one of a bill's managers.

(3) Treas. Reg. §1.6661-3(b)(2) prior to the enactment of IMPACT stated that the following would not be considered authority for purposes of I.R.C. §6661 (the predecessor of §6662(d)):

(a) treatises;
(b) legal periodicals;
(c) legal opinions;
(d) opinions of other tax professionals;
(e) description of statutes prepared after enactment;

(f) general counsel memoranda ("GCM's") (except those published in pre-1955 C.B. volumes);

(g) actions on decisions ("AOD's");

(h) technical advice memoranda ("TAM's");

(i) written determinations.

(4) The legislative history of IMPACT indicates that the Committee intended that the list of "authority" should be expanded to include:

(a) proposed regulations;

(b) private letter rulings;

(c) technical advice memoranda;

(d) actions on decisions;

(e) general counsel memoranda;

(f) information or press releases, notices and similar documents published by the IRS in the Internal Revenue Bulletin; and

(g) General Explanations of tax legislation prepared by the Joint Committee on Taxation ("the Blue Book"). House Rpt., supra at 1389-1390.

(5) The Committee's intent was to broaden the list of authorities. However, in a footnote, the Committee indicated that Treasury was permitted to issue regulations providing that specific items on the Committee's list of additional authorities (except for proposed regulations not yet superseded and the Blue Book) that were issued prior to the date of enactment were not to be considered substantial authority. House Rpt., supra note 79
at 1390. The Committee warned that any such limitation should be as narrow as practicable. *Id.*

(6) In final regulations promulgated on December 30, 1991, the Service confirmed that it would expand the list of "authority" in accordance with Congress' intent. However, the regulations limited private letter rulings and TAM's to those issued after 10/31/76 and AOD's and GCM's to those issued after 3/12/81. Reg. §1.6662-4(d)(3)(iii).

(7) The regulations also articulated the standard for determining substantial authority:

(a) The standard is "an objective standard involving an analysis of the law and an application of the law to relevant facts."

(b) The substantial authority standard is less stringent than the "more likely than not" standard but more stringent than the "reasonable basis" standard.

(c) A return position that is arguable but not likely to prevail in court does not satisfy the substantial authority standard but does satisfy the reasonable basis standard. Reg. §1.6662-4(d)(2).

(8) **Nature of a "Substantial Authority" Analysis.** According to the final regulations -

(a) The weight given an "authority" depends upon its relevance, its persuasiveness, and the type of document providing the authority.

(b) Any PLR, TAM, GCM or AOD more than 10 years old is given very little weight.

(c) "There may be substantial authority for the tax treatment of
an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision."

(9) Substantial authority for a position exists if an analysis supporting the position takes into account the relevant facts and circumstances and relevant authority and concludes that the weight of authority supporting the position is substantial compared to contrary authority. Reg. §1.6662-4(d)(3)(i); Notice 90-20, 1990-10 I.R.B. at 18.


a. The substantial valuation misstatement prong of the accuracy-related penalty will apply if the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 of the Code is 200% or more of the amount determined to be the correct value or adjusted basis [I.R.C. §6662(e)(1)(A)] or the price for any property or services (or for the use of property) claimed on a return in connection with any transaction between persons described in I.R.C. §482 is 200% or more (or 50 percent or less) of the amount determined under §482 to be the correct amount or the net §482 transfer price adjustment exceeds $10,000,000 [I.R.C. §6662(e)(1)(B)].

b. Even if there is a substantial valuation misstatement within the meaning of I.R.C. §6662(e)(1), the penalty will not be imposed unless the underpayment attributable to the overstatement exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company).

c. The substantial valuation misstatement prong of the accuracy-related penalty is quite similar to the valuation overstatement penalty imposed by pre-IMPACT Code §6659 except that -
(1) Section 6662(e) applies to all taxpayers and not just to individuals, closely held corporations, and personal service corporations;

(2) The definition of a substantial valuation misstatement has been changed from 150% of the correct value or adjusted basis to 200%;

(3) There must be a minimum underpayment attributable to the valuation misstatement in the amount of over $5,000 ($10,000 for corporations).

NOTE: Under pre-IMPACT Code §6659(d), the underpayment had to be $1,000 or more for the penalty to apply.

(4) The penalty now applies to I.R.C. §482 transfer pricing adjustments under certain circumstances.

d. If there is a "gross valuation misstatement", the rate of the penalty that applies is increased to 40% [I.R.C. §6662(h)(1)].

(1) A "substantial valuation misstatement under Chapter 1 becomes a "gross valuation misstatement" whenever an extreme valuation misstatement occurs within the meaning of I.R.C. §6662(h)(2).

e. "Property" is defined for purposes of the penalty under §6662(e) to include both tangible and in tangible property, Reg. §1.6662-5(e)(3).

f. If multiple valuation misstatements occur on one return, the determination whether there is a substantial or gross valuation misstatement is done on a property-by-property basis. Reg. §1.6662-5(f).

7. Substantial Overstatement of Pension Liabilities.

a. For purposes of Section 6662, there is a substantial overstatement of pension liabilities if the actuarial determination
of the liabilities taken into account in computing the deduction under I.R.C. §404(a)(1) or (2) is 200% or more of the amount determined to be the correct amount [I.R.C. §6662(f)(1)].

b. Even if there is a substantial overstatement of pension liabilities within the meaning of Section 6662(f)(1), the penalty will not be imposed unless the underpayment attributable to the overstatement exceeds $1,000 [I.R.C. §6662(f)(2)].

c. This provision is similar to pre-IMPACT Code §6659(A) except that the threshold for imposing the penalty has been increased by 150% to 200% or more and the minimum underpayment required to impose the penalty has been set at more than $1,000.

d. As with the substantial valuation misstatement prong, this penalty will double (to 40%) for a gross valuation misstatement. For purposes of Section 6662(f), a "gross valuation misstatement" is an actuarial determination of liabilities of 400% or more of the correct liability amount [I.R.C. §6662(h)(2)(B)].

8. Substantial Estate or Gift Tax Valuation Understatement.

a. This prong of the accuracy-related penalty will apply whenever the value of any property claimed on a return of tax imposed by subtitle B (dealing with estate and gift tax and the tax on generation-skipping transfers) is 50% or less of the correct value of such property. [I.R.C. §6662(g)(1)].

b. Even if there is a substantial estate or gift tax valuation understatement within the meaning of Section 6662(g)(1), the penalty will not be imposed unless the underpayment attributable to the understatement exceeds $5,000. [I.R.C. §6662(g)(2)].

c. The provision is similar to pre-IMPACT Code §6660 except that the threshold for imposing the penalty has been changed from 66 2/3% to 50% and the minimum underpayment required
for the penalty to be imposed has been increased from $1,000 to $5,000.

d. If the "substantial estate or gift tax valuation understatement" qualifies as a "gross valuation misstatement", the rate of the penalty will double (to 40%). For purposes of Section 6662(g), a gross valuation misstatement is a claimed value for property of 25% or less of the correct value. [I.R.C. §6662(h)(2)(C)].

C. The Fraud Penalty [I.R.C. §6663]

1. General Rule. If any part of any underpayment of tax required to be shown on a return is due to fraud, a fraud penalty in an amount equal to 75% of the portion of the underpayment attributable to fraud may be imposed. [I.R.C. §6663(a)].

2. Determining the Portion of the Underpayment Attributable to Fraud.
   a. If the Service establishes that any portion of the underpayment is attributable to fraud, then the entire underpayment must be treated as attributable to fraud unless and to the extent the taxpayer establishes, by a preponderance of the evidence, that any portion of the underpayment is not attributable to fraud. [I.R.C. §6663(b)].

   b. This provision follows the rules set forth in pre-IMPACT Code §6653(b)(2) which were promulgated as part of the 1986 Act.

   c. The taxpayer's task of disproving fraud as to some portion of an underpayment after the Service has met its initial burden is not easy. Proving a negative, i.e. that the underpayment was not fraudulent, is difficult and frustrating, particularly in cases where a portion of the underpayment is clearly fraudulent.

   a. The Internal Revenue Service has the burden of proving, by clear and convincing evidence, that at least some portion of the underpayment is attributable to fraud.
b. If the Service meets its burden of production and persuasion, the taxpayer must prove, by a preponderance of the evidence, that one or more portions of the underpayment were not attributable to fraud.

4. **Innocent Spouse Rule.** Section 6663(c) preserves the innocent-spouse rule of pre-IMPACT Code §6653(b)(3). It provides that, in the case of a joint return, the fraud penalty shall not apply with respect to a spouse unless some part of the underpayment is due to the fraud of such spouse.

5. **Coordination with the Accuracy-Related Penalty.** Section 6662 shall not apply to any portion of an underpayment in which the fraud penalty is imposed under Section 6663.

D. **Special Rules and Definitions Applicable to the Accuracy-Related and Fraud Penalties**

1. Section 6664 sets forth several definitions and special rules which apply to the accuracy-related and fraud penalties imposed by chapter 68, subchapter A, part II of the Code.

2. **Definition of "Underpayment".**
   
a. For purposes of part II (dealing with the accuracy-related and fraud penalties), the term "underpayment" means the amount by which the tax imposed exceeds the excess of -

   (1) the sum of the amount shown as tax on the taxpayer's return plus amounts not shown on the return but previously assessed (or collected without assessment) over

   (2) the amount of any rebates made [I.R.C. §6664(a); Reg. §1.6664-2(a)].

b. The term "rebate" means "so much of an abatement, credit, refund or other repayment as was made on the ground that the tax imposed was less than the excess of the amount specified [in (1) above] over the rebates previously made". Id.

3. **Penalties only apply to filed returns.** The penalties authorized by I.R.C. §§6662 and 6663 only apply to returns filed with the Service.
a. Where no return is filed, the delinquency penalties authorized by I.R.C. §6651 may be imposed.

b. IMPACT §7741 added a special penalty, codified as I.R.C. 6651(f), which attaches whenever a failure to file a return is fraudulent.

(1) The 5%-per-month failure to file penalty authorized by Section 6651(a)(1) is increased to 15% per month with the maximum penalty also being increased from 25% to 75%.

(2) This coincides with the 75% fraud penalty authorized for filed returns by Section 6663.

4. "Reasonable Cause" Exception applies to the accuracy-related and fraud penalties. Section 6664(c)(1) sets forth a general "reasonable cause" exception which applies to each of the penalties authorized by I.R.C. §§6662 and 6663. Under this exception, no penalty will be imposed under either Section 6662 or 6663 with respect to any portion of any underpayment if it is shown that there was reasonable cause for such underpayment and the taxpayer acted in good faith.

a. Special Rule for Charitable Deduction Property.

(1) If the underpayment is attributable to a substantial or gross valuation overstatement with respect to charitable deduction property, the reasonable cause exception of Section 6664(c)(1) will not apply unless -

(a) the claimed value of the property was based on a "qualified appraisal" made by "qualified appraiser", and

(b) the taxpayer made a good faith investigation of the value of the contributed property in addition to obtaining the appraisal [I.R.C. §6664(c)(2)].
(2) For purposes of the above,

(a) "Charitable deduction property" means any property contributed by the taxpayer for which a charitable deduction was claimed under I.R.C. §170 [I.R.C. §6664(c)(3)(A)].

NOTE: It does not include securities for which market quotations are readily available on an established securities market as of the date of contribution.

(b) "Qualified appraiser" means an appraiser meeting the requirements of the regulations under I.R.C. §170(a)(1) [I.R.C. §6664(c)(3)(B)].

(c) "Qualified appraisal" means an appraisal that meets the requirements of the regulations under I.R.C. §170(a)(1) [I.R.C. §6664(c)(3)(C)].

b. Legislative History of Section 6664(c).

(1) The House Report makes it clear that the standardized reasonable cause/good faith exception set forth in I.R.C. §6664(c)(1) was designed "to permit the courts to review the assertion of penalties under the same standards that apply in reviewing additional tax that the Internal Revenue Service asserts is due."

(2) In addition, Congress anticipated that the standardized exception would have other beneficial effects:

(a) Congress expressed concern that the pre-IMPACT accuracy penalties (particularly the Section 6661 penalty) have been determined too routinely and automatically by the Service. The standardized exception was intended to encourage the Service to consider fully whether imposition of the penalties is appropriate before they are imposed. House Rpt. supra at 1393.
(b) It would expand the scope of available judicial review and, by so doing, "lead to greater fairness of the penalty structure and minimize inappropriate determinations of these penalties". Id. Cf. Mailman v. Commissioner, 91 T.C. 1079 (19 ).

(c) With respect to the negligence prong of the Section 6662 penalty, Congress expressed its belief that the standardized exception would result in beneficial consequences to taxpayers.

(i) Complete, item-specific disclosure of a non-frivolous position on a tax return may generally permit an exception to the negligence penalty since it will tend to demonstrate no intentional disregard. House Rpt., supra at 1393.

(ii) The standardized exception may also permit a taxpayer to avoid the imposition of the penalty where the taxpayer makes a good faith, non-frivolous challenge to the validity of an IRS regulation if he makes a proper disclosure. Id.

E. Disclosure and its Effect on a Taxpayer's Exposure to the Accuracy-Related Penalty

1. I.R.C. §6662(d)(2)(B) provides that the amount of the understatement (for purposes of the substantial understatement prong of the accuracy related penalty) must be reduced by that portion of the understatement that is attributable to any item as to which the relevant facts affect the item's tax treatment are adequately disclosed in the return or in the statement attached to the return. See also, Reg. §1.6662-4(e)(1).

Note: Disclosure does not avoid the penalty if the item or position is frivolous, attributable to a tax shelter or is not properly substantiated
or the taxpayer failed to keep adequate books and records with respect to the item or position. Reg. §1.6662-4(e)(2).

2. Adequate disclosure will also avoid the negligence prong of the accuracy-related penalty unless the position or item is frivolous or the taxpayer fails to keep adequate books and records or to substantiate items properly. Reg. §1.6662-3(c).

3. Adequate disclosure will not avoid the valuation misstatement prongs of the accuracy-related penalty.

4. Disclosure is adequate for purposes of both the negligence and substantial understatement prongs of the accuracy-related penalty if made in accordance with Reg. §1.6662-3(c)(2).

   a. Reg. §1.6662-4(f)(1) provides that disclosure is adequate if -

      (1) disclosure is made on a properly completed form attached to the return or to a qualified amended return as defined by Reg. §1.6664-2(c)(3);

      (2) in the case of an item or position other than one that is contrary to a regulation, disclosure is made on Form 8275 (Disclosure Statement);

      (3) in the case of an item or position that is contrary to a regulation, disclosure is made on Form 8275-R (Regulation Disclosure Statement);

   b. Reg. §1.6662-4(f)(3) requires that disclosure with respect to a recurring item must be made for each taxable year in which the item is taken into account.


5. Disclosure is also adequate for purposes of the substantial understatement prong, but not the negligence prong, if it is made by disclosure of
information on a return or qualified amended
return in accordance with applicable forms and
instructions to the extent specified by the
Commissioner in an annual revenue procedure or

F. The Preparer Penalties after IMPACT

1. Prior Law.

a. Under pre-IMPACT Code §6694, an income tax
preparer was subject to a $100 penalty if
any part of an understatement in tax on a
return or claim for refund is due to the
return preparer's negligent or intentional
disregard of rules and regulations.

b. A preparer was also subject to a penalty of
$500 if any part of an understatement was
due to the preparer's willful attempt to
understate tax.

c. The standards of professional conduct
applicable to both lawyers and accountants
generally required that, in order for a
professional to recommend a position
concerning the tax treatment of an item on a
tax return, there must be a realistic
possibility of the position being sustained
on its merits if litigated. ABA Formal
Opinion 85-352; AICPA Statement on
Responsibilities in Tax Practice (1988 Rev.)
No. 1 (August, 1988).

d. However, there was a belief that the
penalties under pre-IMPACT Section 6694 did
not reflect that standard adequately.

e. As a result, IMPACT modified the
circumstances under which preparer penalties
would be imposed to track the professional
standards applicable to tax professionals
who advise taxpayers concerning positions on
their tax returns and to stiffen the
penalties that will apply if the standards
are not met.

2. Section 6694 as revised by IMPACT.

a. Section 6694(a), as revised by IMPACT §7732,
provides that if -
(1) any part of an understatement of tax liability on a return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits;

(2) an income tax preparer of the return or claim knew (or reasonably should have known) of such position; and

(3) the position was not disclosed as provided in Section 6662(d)(2)(B)(i) or was frivolous,

the preparer is liable for a $250 penalty unless it is shown that there is reasonable cause for the understatement and the preparer acted in good faith.

b. If any part of the understatement is due to a willful attempt, in any manner, to understate the tax liability by the preparer or to a reckless or intentional disregard of rules or regulations, then the preparer becomes liable for a penalty of $1,000 [I.R.C. §6694(b)].

(1) This penalty is reduced by any penalty imposed under Section 6694(a).

c. According to the legislative history of IMPACT, Congress believed that the new standard set forth in Section 6694 –

(1) conforms to the professional standards already applicable to lawyers and CPAs, and

(2) is stricter than that which applied under pre-IMPACT §6694. House Rpt., supra at 1396.

d. However, the legislative history also indicates that the imposition of a penalty under Section 6694 should not lead to an automatic referral to the IRS Director of Practice. Rather, the Service is expected, and directed, to exercise discretion in referring preparer penalty cases to the Director. In exercising its discretion, the Service is expected not to expand generally its investigation of preparer penalty cases. Id.
e. Prior to the issuance of final regulations in December, 1991, the Service had provided some guidance to practitioners concerning the application and interpretation of Section 6694 in Notice 90-20, supra and in temporary and proposed regulations.

f. On December 30, 1991, the Service issued its final regulations under Section 6694.

3. The Regulations under I.R.C. §6694

a. Who is the preparer for purposes of the preparer penalties?

(1) The term "income tax return preparer" means any person described in I.R.C. §7701(a)(36) and §301.7701-15 except that no more than one individual from a firm is treated as a preparer with respect to the same return or refund claim. Reg. §1.6694-1(b)(1).

(2) If a signing preparer is associated with a firm, only that person is a preparer for purposes of section 6694.

(3) If two or more persons from the same firm are "preparers" but are not the signing preparer, only one will be treated as a preparer for purposes of section 6694 and it ordinarily will be the individual with overall supervisory responsibility for the advice given by the firm with respect to a return or claim. Id.

(4) Both a firm and one individual within that firm can be liable for a preparer penalty in some circumstances. See, Reg. §1.6694-2(a)(2) and §1.6694-3(a)(2).

(5) Both a signing preparer and one or more non-signing preparers can be liable for a preparer penalty with respect to the same return or refund claim. A nonsigning preparer includes a person who provides written or oral advice to a taxpayer or to a preparer in another firm who otherwise satisfies the definition of preparer. Reg. §1.6694-1(b)(2).
b. **Obligations regarding Information Supplied by Taxpayer.**

(1) For purposes of the penalties authorized by Section 6694, a preparer generally may rely in good faith without verification upon information supplied by the taxpayer.

(2) However, the preparer "may not ignore the implications of information" furnished by the taxpayer or actually known to the preparer.

(3) The preparer must make reasonable inquiries if the information furnished appears to be incomplete or incorrect.

(4) In addition, the preparer must make "appropriate" inquiry to determine the existence of facts and circumstances required by a Code section or regulations as a condition to claiming a deduction. Reg. §1.6694-1(e)(1).

c. **The "RPOS" Standard.**

(1) Reg. §1.6694-2(b)(1) provides that a position is considered to have a "realistic possibility of being sustained on its merits" ("RPOS") "if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits . . . ."

(2) The same analysis required for determining whether substantial authority exists for purposes of the accuracy-related penalty is required in determining if the RPOS standard is met.

(3) The only authorities that a preparer can use in analyzing RPOS are the authorities allowed by Reg. §1.6662-4(d)(3). Reg. §1.6694-2(b)(2).

d. **Exception for Adequate Disclosure of Non-frivolous Position.**
(1) The penalty authorized by Section 6694(a) will not be imposed on a preparer if the position taken is not frivolous and is adequately disclosed even if it does not satisfy the RPOS standard.

(2) For a disclosure by a signing preparer to be adequate, it must be made in accordance with the requirements of Reg. §1.6662-4(f); i.e., it must be made on a properly completed and filed Form 8275 or 8275R or on the return in accordance with an annual revenue procedure.

(3) For a disclosure by a nonsigning preparer to be adequate, the position must be disclosed in accordance with Reg. §1.6662-4(f) or the preparer must comply with Reg. §1.6664-2(c)(3)(ii)(A) or (B).

(4) If a nonsigning preparer provides advice to a taxpayer with respect to a position that does not satisfy the RPOS standard, a disclosure is adequate with respect to a non-tax shelter item if the advice includes a statement that the position is not supported by substantial authority and the position might give rise to a penalty under Section 6662(d) unless adequately disclosed. If the advice is in writing, the statement concerning disclosure must also be in writing. If the advice is oral, the warning statement may also be oral but a risk exists that the preparer might not be able to prove the statement was made unless there is contemporaneously prepared documentation of the oral advice regarding disclosure. Reg. §1.6694-2(c)(3)(ii)(A).

(5) If the advice is given to another preparer, the nonsigning preparer satisfies the disclosure requirement of §6694(a) if the nonsigning preparer tells the other preparer that disclosure under §6694(a) is required. If the advice is written, the warning
must also be written. If the advice is oral, contemporaneous written documentation should be prepared concerning the warning to disclose. Reg. §1.6694-2(c)(3)(ii)(B).

e. Exception for Reasonable Cause and Good Faith.

(1) The penalty under Section 6694(a) will not be imposed if it is determined that the understatement was due to reasonable cause and the preparer acted in good faith.

(2) All of the facts and circumstances will be considered in determining if the reasonable cause exception applies.

(3) Some of the factors that will be considered are -

(a) the nature of the error causing the understatement;

(b) the frequency of errors;

(c) the materiality of the errors;

(d) the preparer's normal office practice;

(e) reliance on the advice of another preparer.

Reg. §1.6694-2(d).

f. Burden of Proof. The preparer has the burden of proof on the following issues:

(1) whether the preparer knew or reasonably should have known that the questioned position was on the return;

(2) whether the reasonable cause/good faith exception applies;

(3) whether the position was adequately disclosed.

Reg. §1.6694-2(e).

g. Willful, Reckless or Intentional Conduct. Final regulations were also promulgated on
December 30, 1991 with respect to the preparer penalty under §6694(b). See, Reg. §1.6694-3.

3. Practice Pointers and Problems.

The changes made to the preparer penalties by IMPACT, when considered in conjunction with the new accuracy-related penalty, suggest some new approaches and problems for the preparer.

a. As a general rule, when there is any exposure for either the negligence or substantial understatement prong of the §6662 penalty on the part of the taxpayer, and the item or position in question is non-frivolous and is not a tax shelter item, and the position does not or may not satisfy the RPOS standard, disclosure should be considered carefully. Otherwise stated, when in doubt, disclose!

b. Potential Conflict of Interest Problems. One can't help but question whether the preparer penalties as revised by IMPACT create a potential conflict of interest between a taxpayer and a preparer. Must a taxpayer be told that one factor affecting a preparer's advice to disclose is the preparer's desire to protect against a preparer penalty? What can or should a preparer do if a taxpayer chooses not to disclose and the return position in question does not satisfy the RPOS standard? Does the conclusion change if it is a position contrary to a published ruling or regulation?

c. Theoretically at least, under the new penalty regime, a preparer must review a taxpayer's return to determine if each position taken or item reported on the return is supported by substantial authority within the meaning of §6662 and/or satisfies the RPOS standard under the §6694(a). Alternatively, the preparer could recommend disclosure for all positions or items which are non-frivolous, are not tax shelter items, and are not valuation statements if the preparer concludes that there is any reasonable possibility that the position is not supported by substantial authority and/or does not satisfy the RPOS standard. What impact does this have (or should it have) on -

(1) a preparer's information gathering and return preparation and review procedures;
(2) the time and cost involved in preparing a return;

(3) the willingness of a preparer to take on a taxpayer as a new client;

(4) the willingness of a taxpayer/client to pay the cost;

(5) the ability of a taxpayer to test uncharted reporting positions?

d. A preparer should document disclosure advice. However, an unresolved question remains concerning the right of the Service to obtain such documentation during the course of the examination of the taxpayer and/or the preparer.

e. The Service issued on July 27, 1992 the "Consolidated Penalty Handbook" which will be included as part XX of the Internal Revenue Manual. Although portions of the handbook dealing with certain penalties have not yet been published, the handbook is, and should continue to be, a useful guide to the Service's approach to penalty administration.

IV. TAXPAYER BILL OF RIGHTS

A. Taxpayer Assistance Orders [I.R.C. §7811]

1. Before enactment of the Taxpayer Bill of Rights ("TI") as part of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), the Code generally prohibited any restraint of the tax collection process. See, I.R.C. §7241(a) (also known as the Anti-Injunction Act).

2. I.R.C. §7811 was added by TI. It authorizes the issuance of a taxpayer assistance order ("TAO") in certain circumstances.


4. Under Section 7811, if the Ombudsman (or his/her delegate) determines that the taxpayer is suffering or is about to suffer a significant hardship as a result of the manner in which the tax laws are being administered, a TAO can be issued to compel the Service -

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a. to release property of the taxpayer levied upon;

b. to cease or refrain from taking any action under the Code with respect to a taxpayer under chapter 64 (collection), subchapter B of chapter 70 (bankruptcy and receiverships), chapter 78 (discovery of liability and enforcement), and any other provision of law described in the order. I.R.C. §7811(b).

5. The Ombudsman may issue the order upon application of the taxpayer or on the Ombudsman's own initiative. Reg. §301.7811-1.

6. The filing of an application by the taxpayer suspends the period of limitations for all actions subject to the order -

a. from the date the application is filed until the later of the date a decision is made on the application or the date on which a review of the decision is completed by an official authorized to rescind or modify an order, and

b. any period specified in the order. Id.

7. The collection process, however, is not suspended by the filing of the application by the taxpayer.

8. The TAO may not do any of the following:

a. compel the Service to take affirmative action except the release of levy;

b. enjoin a criminal investigation;

c. contest the merits of a tax liability;

d. act as a substitute for, or in addition to, administrative or judicial review procedures; nor

e. affect the activities of the Office of Chief Counsel.

9. Final regulations under Section 7811 define the phrase "significant hardship" to mean "serious privation" as opposed to mere economic or personal inconvenience. However, the final regulations do not require financial hardship in order to satisfy the "significant hardship" standard.
B. Other TI Remedies to Keep in Mind


V. DAMAGE CONTROL – SOME USEFUL PROCEDURES, PROVISIONS AND PRACTICES

A. Mitigating the impact of the interest and penalty provisions

1. Advance payments and cash bond deposits
   a. The "cost" of a tax controversy has been substantially increased by the tax legislation enacted over the last ten years because of market rate interest, compounding of interest, "time sensitive" penalty and interest provisions, and "penalty" interest.
   b. By reason of this rather heavy "cost", it is often beneficial to remit funds to the IRS when faced with a prospective tax deficiency.
   c. Two types of remittances are recognized:
      i. payments;
      ii. cash bond deposits.

2. Payments
   a. A "payment" is a remittance which is applied to an assessment.
i. The assessment may have been made before the payment is received.

ii. The assessment may be made upon receipt of the payment -- for example, a payment submitted with a tax return.

b. A payment stops the accrual of interest to the extent of the payment.

c. A payment can be retrieved by the taxpayer only as a tax refund -- subject to the usual claim for refund rules.

d. A payment made prior to the issuance of a deficiency notice will affect the determination whether there is a "deficiency".

i. A deficiency exists, broadly speaking, if the IRS determines that the taxpayer owes more than has been paid for the period in issue.

ii. Accordingly, a payment of the full amount determined to be due by the IRS would eliminate any deficiency.

iii. As a result, there would be no deficiency notice and no Tax Court jurisdiction to review the IRS determination. The taxpayer would be able to pursue a refund claim and refund litigation, however.

iv. A payment may be made after a deficiency notice is issued without affecting Tax Court jurisdiction, §6212(b)(4).

v. A refund of a tax payment is a tax refund and, as such, bears interest in favor of the taxpayer.

3. Cash bond deposits

a. A cash bond deposit is a remittance which is not applied to an assessment but is held by the IRS as a bond to secure payment of a specific prospective assessment.
b. A cash bond deposit stops the accrual of interest to the extent of the bond during the period the bond is held by the IRS.

c. A cash bond deposit is not a payment -- a demand for its return can be made by the taxpayer at any time prior to assessment.

i. Absent jeopardy, the cash bond will be returned.

ii. The returned bond will not bear interest in favor of the taxpayer.

iii. The taxpayer will not receive credit for the period during which the bond was held by the IRS.

4. Taxpayer Considerations

a. Any remittance to the IRS should be designated specifically:

i. As to whether it is a payment or cash bond deposit;

ii. As to the tax and period involved;

iii. As to what portion is allocated to tax, what portion to which penalties and what portion to interest.

b. The IRS concedes that the taxpayer can allocate a payment to interest (and hence get a deduction) under the following circumstances:

i. Where the liability is paid in full;

ii. If the taxpayer agrees to assessment and collection of any unpaid liability;

iii. Where the tax is paid in full and the amount allocated to interest does not exceed the interest accrued on the tax paid.

c. The IRS will not allow a cash bond deposit to be treated as a "payment" of interest to warrant a deduction.

d. The taxpayer-investor's decision whether to make a remittance to the IRS and how to designate the remittance is an important one which necessarily depends upon the taxpayer's financial and tax circumstances.

B. **Avoiding a Dispute Concerning Last Known Address**

1. Ordinarily, the Internal Revenue Service will direct correspondence to a taxpayer at the address shown on the taxpayer's federal income tax return.

2. Under I.R.C. §6212(b), the IRS is required to send a notice of deficiency to a taxpayer's "last known address" in most cases.

3. There has been quite a bit of litigation in recent years over the IRS' alleged failure to send a notice of deficiency to the taxpayer's last known address. E.g., Abeles v. Commissioner, 90 T.C. 103 (1988); Pomeroy v. Commissioner, 864 F.2d 1191 (5th Cir. 1989); Monge v. Commissioner, 93 T.C. No. 4 (July 12, 1989). The dispute typically arises after the IRS has sent a notice of deficiency, the 90-day period for filing a petition in the Tax Court has expired, and the IRS has assessed (and is attempting to collect) the disputed tax liability.

4. In an effort to clarify the manner in which the IRS will determine taxpayer's last known address, the IRS issued Rev. Proc. 90-18.

   a. Under Rev. Proc. 90-18, the IRS will use the address on the "most recently filed and properly processed return" as the address of record for notices specified in section 2.01 of the revenue procedure. These notices include a notice of deficiency, notice and demand for tax, notice of intention to levy, notice of third party summons, and others.

   b. If a taxpayer no longer wishes the address of record to be the address on the most recently filed return, he must give "clear and concise written notification" as provided in the revenue procedure.
c. For purposes of Rev. Proc. 90-18,

(1) the term "return" does not include applications for extension of time to file a return.

(2) a return is considered to be "properly processed" after a 45-day processing period which begins the day after the day of receipt of the return by the Service Center.

   i. If a return is received prior to the due date, the 45-day period starts the day after the due date of the return.

   ii. If a 1040, 1040A, 1040EZ, 1040NR, 1040PR, 1040SS or 1040X is received after February 14 and before June 1, the return will be considered properly processed on July 16.

(3) A clear and concise written notification of a change of address will be considered properly processed after a 45-day processing period which begins on the date after receipt by i. the Internal Revenue Service Center serving the taxpayer's old address or ii. the Chief, Taxpayer Services Division in the local district office or iii. an IRS employee who contacted the taxpayer in connection with the filing of a return or an adjustment in the taxpayer's account.

d. Section 5.04 of Rev. Proc. 90-18 defines what constitutes "clear and concise written notification."

(1) Clear and concise written notification is a statement signed by the taxpayer informing the Service of a change in address.

(2) The notification must specify -

   i. the new address;

   ii. the taxpayer's full name;
iii. the old address;

iv. the taxpayer's social security number or EIN;

v. in the case of a change in name, the last name shown on the most recently filed return and the new last name;

vi. in the case of a joint return, the names and social security numbers of both the husband and wife.

vii. the taxpayer's signature.

(3) Form 8822 may be used to provide the notification. A copy of the form is attached to this outline.

(4) IRS correspondence requiring or soliciting a response from a taxpayer may be corrected to show the taxpayer's new address and returned to the IRS.

C. Innocent Spouse Relief

1. Practitioners are often faced with the problem of representing a married or divorced taxpayer in a tax matter arising in whole or in part from the actions of a spouse or ex-spouse who did not report income and/or expenses correctly on a joint return.

2. In some cases, the non-culpable spouse is "innocent" of any tax misconduct. He or she did not benefit from, or even know about, the tax misstatement.

3. Although it is not a new provision, I.R.C. §6013(e) is a weapon available to practitioners who are trying to avoid the imposition of a substantial tax liability on the non-culpable spouse.

4. I.R.C. §6013(e)(1) provides that, under applicable regulations, if -

   a. a joint return has been made;

   b. there is a substantial understatement of tax attributable to grossly erroneous items of one spouse;
c. the other spouse establishes that he or she did not know, or have reason to know, of the substantial understatement; and

d. it would be inequitable to hold the other spouse liable for the tax deficiency attributable to the substantial understatement taking into account all the facts and circumstances,

then the innocent spouse is relieved of the liability (including interest, penalties, and other amounts) attributable to the substantial understatement.


6. "Grossly erroneous items" means -

a. any item of gross income attributable to such spouse which is omitted from gross income,

b. any claim of a deduction, credit, or basis by a spouse in an amount for which there is no basis in fact or law. I.R.C. §6013(e)(2).

7. In order to qualify for innocent spouse relief, the understatement in question must exceed 10% of the spouse's adjusted gross income for the preadjustment year ("AGI") if AGI is $20,000 or less and 25% if AGI is over $20,000. I.R.C. §6013(4)(A) and (B).

a. "Preadjustment year" means the most recent taxable year of the spouse ending before the date the deficiency notice is mailed. I.R.C. §6013(e)(4)(C).

b. However, this provision does not apply if the liability at issue is attributable to the omission of an item from gross income. I.R.C. §6013(e)(4)(E).

8. The determination required under I.R.C. §6013(e) is made without regard to community property laws. I.R.C. §6013(e)(5).
9. The regulations, which were promulgated in 1974, have not been amended to reflect the amendments to Section 6013(e) since July 7, 1984. See, Reg. §1.6013-5.

10. Where an underpayment of tax on a joint return is attributable to fraud, a spouse will not be liable for the fraud penalty under I.R.C. §6663 unless some part of the underpayment is due to that spouse's fraud. I.R.C. §6663(c). This rule applies regardless of whether the requirements for innocent spouse relief under I.R.C. §6013(e) are satisfied.