Surgent cpe
EDUCATION FOR PROS

Hot IRS Tax Examination Issues For Individuals And Businesses

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Table of Contents

Examinations and Audits.............................. 1

Individual Audits -- Virtual Currency 2

Trust Fund Recovery Penalty........................ 3

Audit Techniques Guides, Practice Units, and Cash Intensive Businesses.................... 4

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NOTES

Examinations and Audits

Learning objectives	***1***
I. Introduction	***3***
A. Selection of returns for examination	**3**
1. In general	*3*
2. Screening of returns	*4*
3. The IRS Examination plan	*5*
4. Campus examination procedures	*5*
5. Office audit examination procedures	*6*
6. Field examination procedures	*7*
7. Documentation	*8*
8. Examination outcomes	*10*
9. Examination reports	*11*
10. Thirty-Day Letter	*11*
11. Appeals	*12*
B. Miscellaneous points	**14**
1. Chances of being audited	*14*
2. Audit results	*15*
3. Correspondence audits	*16*
4. International issues	*16*
5. Preventing an examination	*16*
6. Current trends	*17*
C. Burden of proof	**19**
1. General burden of proof	*19*
2. Section 7491	*19*
3. Impact on audits	*21*
D. Psychological checklist for an audit	**22**

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Examinations and Audits

Learning objectives

Upon reviewing these materials, the reader will be able to:

- Identify the criteria used to select a return for examination;
- Explain what the DIF is and why not all high-score DIF returns are examined;
- Discuss the differences between a campus exam and office-interview examinations;
- Distinguish the use, purpose, and procedures associated with a 30-day letter from those of a 90-day letter;
- Describe an IDR and an Explanation of Items;
- Explain the burden of proof in tax cases and how it may be affected by the taxpayer tactics in an audit of the return; and
- Describe some of the general strategies a taxpayer representative might pursue in an audit.

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Note:

The chances of facing an IRS audit remained somewhat consistent over the last few years according to the IRS 2021 Data Book. The audit rate continues to be at the lowest level in over a decade, according to updated data from the nation's tax-collection agency, and the decreasing trend continued in FY 2020. This is due to an increase in the number of returns filed and a decrease in resources available to examine the returns filed. The 2021 Data Book covers IRS activities conducted from the period October 1, 2020, through September 30, 2021.

The audit rate and the percentage of all returns examined, according to the IRS 2021 Data Book, was .55 percent for all individual returns filed and .92 percent for all corporations. This represents a decline from the 2020 examinations of .63 percent for all individual returns filed and 1.0 percent for all corporations filed as of the end of FY 2020. For individual tax returns this represents approximately more than a 40-percent downward shift in audits since FY 2010 when the audit rate was 1.1 percent for all individual returns and 1.0 percent for all returns. FY 2010 data showed a five-year surge in audit rates before the decline began. The general statistics were reflected in almost all demographic areas and income levels.

The reason most often proffered for these audit declines is the steady reduction in IRS funding and the resulting loss of revenue agents and other personnel necessary to the examination process. Since 2010, the IRS has lost approximately 31.6 percent of its entire workforce. There were 107,621 full-time equivalent positions in 2010 compared to 75,733 in 2020. According to the Data Book, in FY 2021 the IRS was able to increase its full-time equivalent positions to 78,661. Of course, most of these positions are for people who do not examine returns. The actual workforce that examines returns consisted of 16,214 workers in FY 2020 and 17,079 in FY 2021. The increase was attributed to those workers who perform office examinations. The number of workers (Revenue Agents) who actually perform the examination of the high-income earners and businesses in fact declined (the IRS indicated in its update on audits that IRS "Revenue Agents must be trained on the job for at least 2-3 years in order to have the experience and expertise to audit more complex returns"). Considering the continued increase in return filings since 2010 and complexity of the law, the IRS still managed to assess an additional $26.8 billion due to tax examinations in FY 2021. This is a significant increase over the $12.9 billion in additional tax assesses due to examinations in FY 2020. When comparing the 2021 data to 2010, the data represent a significant decline from the $44.8 billion in additional examination assessments in FY 2010. It appears that the Tax Cuts and Jobs Act (TCJA), pandemic legislation, reduced funding, and reduced staffing continues to decimate the American taxing agency.

The coronavirus-related legislation created a heavy burden on the IRS to implement the new law with a very short turnaround time and as a result, the Service's compliance activities continued to spiral. IRS personnel have not caught up with all the processing necessary for the 2020 filing season, making it more difficult for taxpayers and practitioners to reach them on the telephone help lines. Since their automated systems keep sending out Notices, taxpayers are plagued with incorrect assessments with little to no assistance to get the problems resolved. The additional COVID-19 legislation in early 2021 compounded their problems, coupled with the 2020 filing season; one has to wonder when and if the Agency will catch up. In the meantime, taxpayers are suffering and will continue to suffer until something is done.

The Biden administration has indicated that it will provide more than $80 billion in additional funding to the IRS to step up compliance enforcement. These monies are earmarked to increase the IRS audit force and improve their technology. Unfortunately, it will take years for those new agents to be trained and the new technology to be purchased and rolled out; so, although the funding initiative will certainly help years in the future, it will do little to correct the problems the Agency faces today.

Due to this environment, it is sometimes difficult to identify issues that are "hot" because selection is by necessity and requires more economic justification (how much more revenue would the Service successfully bring in?) than just principled examinations relying on other markers.

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In the past, the Service would break down its workforce by specialty issues. For example, where there were international issues involved, an international specialist would examine those issues while domestic examiners would examine the rest of the tax return. The Service announced that it is moving away from that practice due to its workforce reduction. Cross-issue examiners will certainly pose stress for practitioners. Not only will there be the normal headaches that result from being under an IRS audit, but practitioners will also be faced with training the agents in areas of the tax law in which they have no experience.

IRS has also indicated that additional resources are being diverted from traditional examinations to high-wealth taxpayers. The current statistics are not indicative that the IRS has started moving in this direction. For example, for FY 2020, individual taxpayers with returns showing more than $10 million of total positive income were audited at a rate of 2 percent versus the 8.7-percent rate for FY 2019. In FY 2020, the audit rate for taxpayers with total positive income of $5 million to $10 million was 1 percent compared to the previous 1.9 percent, while the rate for those with total positive income between $1 million and $5 million remained relatively constant around 1 percent. Even though it does not appear that resources are being diverted to high-income individuals, the statistics confirm that taxpayers in higher income brackets have an increased likelihood of being examined.

I. Introduction

A. Selection of returns for examination

1. In general

The primary objective of the IRS in identifying and selecting returns for examination is to try to promote the highest degree of voluntary compliance. To accomplish this in an effective manner, the process of classification is used to determine which returns are most in need of examination.

a. Tax returns are classified and selected for examination by computer or by manual identification. Returns that are classified by computer as having examination potential may also be manually screened to identify issues for consideration and set the scope of the examination, and to accept as filed those returns that were initially computer classified, but do not warrant examination or cannot be examined because of resource limitations.

b. The Discriminant Function (DIF) system is a mathematical technique used for identifying and selecting returns for examination. Under the DIF system, mathematical formulas are developed and programmed into the computer to identify returns by assigning weights to certain basic return characteristics. The weights are then added together to produce a score for each return processed. Returns are then ranked in numerical sequence based on their score (highest to lowest). Generally, the higher the score the greater the likelihood of a significant tax change on examination. Returns with the highest score are made available to examination upon request.

   (i) The DIF mathematical formulas are confidential in nature and are not to be distributed to IRS personnel other than on a need-to-know basis. Similarly, the DIF score for a return should not be disclosed.

   (ii) All individual returns are computer scored under the DIF system, as are all corporation returns having no balance sheet or assets under $10,000,000 and all S corporation returns having assets under $10,000,000.

c. Examinations may be initiated by the IRS on the basis of information received from informants or other IRS examinations or programs (e.g., matching information documents such as a Form 1099), or by specific IRS compliance programs.

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d. The filing of certain forms as part of the taxpayer's return, for example, Form 1040X, *Individual Amended Tax Return*, Form 8283, *Non-Cash Charitable Contributions,* Form 8275, *Disclosure Statement,* or Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, or the filing of a tax-shelter return, is **likely** to result in the selection of a return for examination.

2. Screening of returns

During the classification/screening process, returns are identified and classified for examination by campuses (formerly service centers) or area offices and are further identified for the kind of examination to be performed (i.e., correspondence, office, or field). With respect to returns classified for area office examination, significant issues are also identified. The higher the DIF score, the greater the potential for a significant tax change. DIF scores, however, only indicate examination potential. Tax examiners must manually screen returns to identify issues in need of examination and to eliminate those returns where examination is not warranted. The screener/classifier is instructed to first review the return in its entirety to gain an overview of the total return, to consider the income, expense, and credit items of the return, and to evaluate each item as to its significance. Several different methods of examination can be conducted. They are the correspondence examination, office examination, or field examination. Correspondence examinations can be conducted either by an IRS Campus, a revenue agent, or tax compliance officer.

a. Individual returns generally are identified for a correspondence examination where information concerning questionable items can readily be furnished by mail and there are indications on the return that the taxpayer can effectively communicate in writing. Returns that do not meet this test generally should not be examined by correspondence, even if the taxpayer is located in a remote area. Individual returns that are not correspondence examinations typically contain issues that require an analytical approach and individual judgment to direct verification of records. These examinations will be conducted by a tax compliance officer (TCO) as an office examination or a revenue agent as a field examination.

b. Campus examinations are conducted almost entirely by correspondence, although telephone contact is possible. Consequently, such examinations are generally limited to individual tax returns and typically involve simple issues that lend themselves to resolution through direct verification from records that can be mailed to the IRS. Returns that contain issues that are too complex for correspondence are transferred to an area office. While these issues seem simple, many of these audit categories can encompass complicated rules, procedures, or factual situations that could give rise to taxpayer questions or the need for assistance.

c. Examinations are conducted in the Wage and Investment (W&I) Division, Small Business and Self-Employed (SBSE) Division, or Large, Business and International (LB&I) Division of the Service. Correspondence examinations are conducted by all Divisions. An office examination is conducted by SBSE while field examinations are conducted by SBSE and LB&I.

    (i) W&I provides customers with the information, support, and assistance they need to understand and fulfill their tax obligations. In addition, they are responsible for taxpayer relationships through filing, including processing submissions and payments; providing taxpayers with information on the status of their returns; and resolving the majority of problems and inconsistencies. This is to ensure trouble-free filing, faster refunds, and efficient resolution of inquiries and issues. Lastly, the organization works to strengthen revenue protection and pre-refund

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compliance, administer refundable credits, and prevent and detect tax-related identity theft fraud through Notices and Campus examinations.

(ii) SBSE serves taxpayers who file Form 1040, Schedules C, E, or F, or Form 2106, as well as small businesses with assets under $10 million. This includes disseminating information, training, and examinations for these types of taxpayers.

(iii) The Large Business and International (LB&I) Division serves corporations, subchapter S corporations, and partnerships with assets greater than $10 million.

Note:

There is a fourth Operating Division in the Service, Tax Exempt/Government Entities (TEGE). The Tax Exempt/Government Entities Division serves exempt organizations, Indian Tribal Governments, as well as federal, state, and local governments including cities, counties, and schools. Since this is beyond the scope of this course, it will not be discussed.

3. The IRS Examination plan

The IRS examination plan is based on long-range coverage objectives and on resources requested in the Congressional budget. The exam plan has two major components: number of return closures and number of return starts. In order to meet long-range coverage objectives, the exam starts and closures plans are focused on specific return categories. Resources, inventory, and examination starts are aligned to accomplish the staff allocation to reflect the return closures in each fiscal year's exam plan. The focus provides coverage across the following categories, but does not preclude examinations of other categories:

a. Individual returns with Total Positive Income (TPI) less than $200,000

b. Individual returns with TPI greater than $200,000 including those with TPI greater than $1,000,000

c. Individual returns with a Schedule C regardless of TPI

d. Small Business Corporations

e. Small Business Flow Through Entities - S Corporations, Partnerships, and Fiduciaries

As a result of the examination plan, once the computer selects the returns under the DIF and those returns are classified, those returns that make the cut will be available for audit and disseminated based on the examination plan.

4. Campus examination procedures

Campus examinations are conducted by correspondence and telephone. The campus sends the taxpayer an initial contact letter requesting information or explaining corrections to the return along with a solicitation of the taxpayer's agreement to the corrections. Campus correspondences provide no point of contact. There is no phone number or IRS employee associated with the campus correspondence audits.

a. The possible responses of the taxpayer to the initial contact letter include the agreement to the correction in tax liability, a request for additional explanation of the correction, an explanation by the taxpayer of the items questioned, a request for an interview, and no response or non-agreement.

(i) If the taxpayer agrees to a correction and has not indicated an inability to pay, or requested an installment agreement, the case is closed.

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(ii) If the taxpayer requests an additional explanation from the IRS, a tax examiner will prepare a letter within 30 days responding to the taxpayer's question and requesting a correction or agreement.

(iii) Where the taxpayer does not respond, or where an agreement cannot be reached, a proposed notice of deficiency (i.e., a "30-Day Letter") advising the taxpayer of the proposed tax change and appeal rights is issued. Again, telephone contact should be made, if feasible. Where no response is received from the taxpayer, the IRS makes no effort to contact the taxpayer before issuing the notice of deficiency.[1]

(iv) If the taxpayer fails to respond to the 30-Day Letter, or if the initial contact letter is received by the taxpayer but the subsequent 30-Day Letter is returned undeliverable, a statutory notice of deficiency (a "90-Day Letter") is issued at the expiration of the 60-day period.

b. According to the 2021 IRS Data Book, more than 70 percent of the taxpayers subject to campus correspondence audits had total positive income of less than $50,000. The Taxpayer Advocate identified the most examined issues by IRS correspondence audits conducted by the Campuses as the Earned Income Tax Credit (EITC); refundable credits; filing status; non-filers; and questionable refunds.

c. Unlike other IRS audits, correspondence audits are not assigned to a single examiner who will work the case in its entirety and serve as the taxpayer's single point of contact for questions. Taxpayers undergoing a correspondence audit are referred to a toll-free number where they may discuss their case with an IRS phone assistor who generally holds no responsibility for the actions or determinations made with their audit. The high volume of correspondence audits combined with limited communication alternatives, insufficient levels of service, and the inability to contact a knowledgeable and accountable IRS employee often cause unnecessary taxpayer burden and hinder taxpayer rights.

5. Office audit examination procedures

Office audit examinations are conducted by correspondence or in person in an IRS office by a tax compliance officer (TCO). Returns selected and classified by the campus for office interview examinations generally involve issues that may be too complex to be resolved by mail, but not complex enough to warrant a field examination. Office interview examinations should involve issues that lend themselves to an analytical approach and require individual judgment, in addition to direct verification. Office interview examinations are used to handle such issues as unusual or large itemized deductions, travel expenses, and income from rents or royalties. The TCO will receive the taxpayer's case file, which will include the tax return and a classification sheet. The classification sheet will identify the issues the TCO is required to examine. The TCO will send the taxpayer a letter, scheduling an appointment requesting the documentation the taxpayer should bring to the appointment.

When the office examination is conducted, the TCO will take oral testimony and review receipts to determine whether the items on the return are accepted as filed or not. Once the determination is made, there are three outcomes -- no-change, a deficiency, or an overassessment. If the outcome is a no-change, the Service will issue a Letter 590, *No Change Letter* once all internal reviews have been conducted. If the outcome is a deficiency (the taxpayer owes money) or an overassessment (the taxpayer

[1] 2021 Taxpayer Advocate Report to Congress.

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is entitled to an additional refund) an examination report will be issued and the taxpayer can either agree or disagree. This process will be discussed later in the chapter.

6. Field examination procedures

Field examinations are conducted by correspondence or in-person at the taxpayer's business by revenue agents. The taxpayer can request that the examination be conducted at their accountant's office, however, the location of a taxpayer's representative will not be a consideration in determining the place of the examination.[2] The examination will be conducted at the location where the original books, records, and source documents are maintained. This includes all phases of the examination, the initial interview, review of books and records, fact finding, issue resolution, report writing, and the closing conference, etc. This location is usually the taxpayer's principal place of business. Therefore, to conduct the examination at the accountant's office, it will be necessary to have the records available at their office. IRS examiners use their experience and knowledge to determine what will be examined on the return. However, all examiners use the following standards when determining what will be examined on a return:

a. All large, unusual, or questionable items should be considered, including balance sheet and Schedule M items, income, deduction, credit, or classified items, and the scope of the examination should be limited or expanded to the point that all significant items are considered for the correct determination of tax liability.
   - (i) Inquiries should be made for unreported income, including consideration of internal controls for all business returns, the type of taxpayer, and the taxpayer's standard of living. Indirect methods should be used when appropriate.
   - (ii) Package examination procedures should be followed, including consideration of prior and subsequent returns, related returns, and compliance items such as employment tax returns.
   - (iii) Issues should be examined to the extent necessary to provide sufficient information to determine the substantially correct tax, including conducting adequate interviews, the use of adequate exam techniques, consideration, and development of indicators of fraud, and sufficient development of the issues.
   - (iv) Examination conclusions should be supported by a correct application of the tax law.
   - (v) Penalties should be considered and applied correctly.
   - (vi) Workpapers should document the examination audit trail and techniques used, and IRS report writing procedures should be followed.

b. In the examination, the examiner conducts a minimum income probe unless the examination is a "limited scope" examination. For a business return, the examiner prepares a **preliminary cash transaction account** based on the tax return data and information in the case file. If the preliminary analysis shows that the account is **materially** out of balance, then the examiner conducts additional interviews and gathers more information to resolve the imbalance. Materiality is the significance or importance of an item in making a correct determination of the taxpayer's tax liability. In deciding whether an item on the return is "significant," or whether the imbalance is material, the examiner considers the following factors.
   - (i) The comparative size of the item (e.g., a $6,000 expense item out of total expenses of $30,000 would be significant, but not if total expenses were $300,000) or the imbalance.

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[2] Internal Revenue Manual (IRM) 4.10.2.9.2.3.

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(ii) The absolute size of the imbalance.

(iii) The inherent character of the item (e.g., airplane expenses claimed on a plumber's Schedule C).

(iv) The beneficial effect of the manner in which an item is reported (such as expenses claimed on a business schedule rather than as an itemized deduction).

(v) The evidence of intent to mislead (such as misleading or incomplete schedules).

(vi) The relationship to or with other items on a return (e.g., no dividends reported when Schedule D shows sales of stock).

(vii) Whether there is a potential whipsaw issue. This is when there is a transaction between two parties and characteristics of the transaction will benefit one party and harm the other. Examples include alimony vs. child support, sale vs. rental/royalty, employee vs. independent contractor, gift vs. income.

(viii) If there is a potential for missing items, consideration should be given to items which are not shown on the return but would normally appear on the returns of similar taxpayers. This applies not only to the examination of income, but also to expenses, deductions, etc. that would result in tax changes favorable to the taxpayer.

Note:

In FY 2021, only 21.6 percent of the individual audits were conducted as site audits; the bulk of the audits, about 78.4 percent, were correspondence audits. Correspondence audits decreased from the 72.6-percent rate in FY 2020. Correspondence audits are more costly as the documentation is mailed into (sometimes faxing is permitted) the IRS Service Centers and the same person does not perform the audit throughout the time span. These audits are also less efficient as the taxpayer cannot speak to anyone and the IRS sometimes makes decisions without ever reviewing the documentation the taxpayer sends in. Due to the pandemic in 2020 and the lengthy closures of the IRS Service Centers, many taxpayers continue to receive disallowances without the IRS ever reviewing information they provided, prompting an increase in issuances of the “90-Day Letter,” which has overburdened the Tax Court.

Question to Ponder:

With the IRS focusing on performing more correspondence audits than field examinations, there are many challenges. What are some of the challenges faced representing clients in the correspondence audits versus the filed examination?

7. Documentation

Although examinations typically are initiated by the IRS, the taxpayer is expected to show that the items on a return are correct. Every taxpayer is required to “keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe.” Every taxpayer must maintain adequate books and records to substantiate both the fact and the amount of items reflected in the return.[3] If a taxpayer fails to comply with the law and regulations for maintaining adequate books and records, the IRS will issue an Inadequate Records Notice.[4]

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[3] I.R.C. §6001; Treas. Regs. §1.6001-1(a). Records must be retained as long as they may be considered material in the administration of the tax law. Treas. Regs. §1.6001-1(e).

[4] Treas. Regs. §1.6001-1(d).

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a. While taxpayers are required to maintain adequate books and records,[5] the books and records do not need to be maintained in paper form. The IRS sets forth specific conditions for the following.

(i) The requirements for microfilm (including microfiche) reproductions of a taxpayer's general books of account (i.e., cash books, journals, voucher registers, ledgers, and supporting records of detail) to be considered adequate books and records under §6001.[6]

(ii) The information that must be included in certain financial account statements for them to be treated as proof of payment of an expense.[7]

(iii) The requirements for books and records maintained on an electronic storage system that either images their hardcopy (paper) books and records or transfers their computerized books and records to an electronic storage media, such as an optimal disk, to be considered adequate books and records under §6001.[8]

(iv) The requirements for books and records maintained on an automatic data processing system to be considered adequate books and records under §6001.[9]

(v) The IRS will request the client's electronic Quick Books and the taxpayer is required to provide them to meet the substantiation requirements under IRC 6001. The IRS website has been updated to explain the need for the electronic records rather than the printed reports, and failure to provide them can be an IRC 6001 documentation issue. In the website's Q&A section on the use of electronic records, Question 7 states that the legal authority for the IRS to request accounting records in electronic format is based on Internal Revenue Code §7602(a), Internal Revenue Code §6001, Regulation 1.6001-1(a) and -1(e), Revenue Ruling 71-20 and Revenue Procedure 98-25. Although Revenue Procedure 98-25 exempts certain taxpayers from the requirements of the Revenue Procedure, this does not create an exemption for any taxpayer from having to produce electronic books and records if they otherwise exist when a business chooses to use an electronic accounting software program to maintain their books and records. As a result, failure to provide the Quick Books will be deemed a failure to satisfy the IRC §6001 substantiation requirements.

b. An examiner has discretion in deciding whether to allow items for which the taxpayer lacks adequate documentation. An examiner may accept a close approximation established through reliable secondary sources and collateral evidence. An examiner may also accept a taxpayer's oral statements if he finds the evidence credible based on all the surrounding circumstances.

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[5] See the *Guide to Record Retention Requirements* (last revised by the Service in January of 1994) which is in digest form and identifies each section of the Code and the Treasury regulations that have record retention requirements. The guide informs taxpayers about: (i) what records must be retained; (ii) who must keep them; and (iii) how long the records must be retained.

[6] Rev. Proc. 81-46, 1981-2 C.B. 621, clarified by Rev. Proc. 83-6, 1983-1 C.B. 582.

[7] Rev. Proc. 92-71, 1992-2 C.B. 437.

[8] Rev. Proc. 97-22, 1997-1 C.B. 652.

[9] Rev. Proc. 98-25, 1998-1 C.B. 689.

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Note:

In a legal memorandum, the IRS concluded that if metadata in electronic files may be relevant to a proper purpose for which an examination is being conducted, the IRS may serve a summons on the taxpayer to produce the original electronic files, even if the taxpayer offers to provide hard copies of the material.[10] The IRS also concluded that an examiner may summon original electronic data even though the taxpayer offers to provide a version of the original data that has been scrubbed to remove the metadata. If a taxpayer gives an examiner an electronic or paper copy of its records without a court order, the examiner should immediately copy the records, the IRS stated, because the taxpayer can require the examiner to return the copy.

Metadata is information that describes how, when, and by whom a particular item or set of electronic information was collected, created, accessed, modified, and formatted. The IRS said that in many instances, examinations could be advanced by mining metadata that identifies the date a transaction was entered in electronic records, dates of changes, and the username of the person who made the entries.

8. Examination outcomes

a. There are four possible outcomes to an examiner's review of a return.

(i) **No change** — The examiner proposes no change in the taxpayer's tax liability. The examiner will prepare and provide Letter 3401, *No Change Report Transmittal Letter,* advising the taxpayer that a no change is proposed but is subject to review. A Letter 590, *No Change Final Letter* will be sent when the report has been reviewed and accepted.

(ii) **Agreed** — The examiner proposes adjustments to the taxpayer's tax liability and the taxpayer agrees to sign a consent with respect to all of the adjustments. If the examiner proposes adjustments to the taxpayer's liability, the basic choice for the taxpayer is whether he wishes to contest the adjustments. If the taxpayer does not wish to contest the adjustments, he should sign the standard Form 4549, *Income Tax Examination Changes* and pay the deficiency. The taxpayer will be furnished a copy of the examination report in the agreed case. If the taxpayer wants to contest the adjustments but does not wish to avail himself or herself of the IRS Appeals procedures or litigation in the Tax Court, he can sign the Form 4549, pay the tax, and then file a claim for refund. After the examination is closed by the signing of Form 4549, the IRS will not reopen the case to assert additional changes in the tax liability of the taxpayer, except in limited circumstances.

(iii) **Unagreed** — The examiner proposes adjustments to the taxpayer's tax liability and the taxpayer does not agree to sign a consent with respect to all adjustments, using Letter 950, *30 Day Letter-Straight Deficiency or Over-Assessment.*

- To ensure that the operating division and the Appeals office are successfully resolving taxpayer disputes, the Service has instituted a new process. A mandatory group manager conference between a group manager and the taxpayer must be held in an attempt to resolve any factual issues before closing the case in the operating division. If the group manager conference is unsuccessful, the case can be passed to the “Fast Track Mediation” process. This new process will seek to resolve factual issues within an average of 14 days.

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Note:

> If this procedure is not used, or if used, does not result in settlement, presumably the Service will issue a 30-Day Letter to the taxpayer. Receipt of such a letter permits the taxpayer to file a protest with the IRS Appeals office within 30 days. If the taxpayer does not file an appeal, or is unsuccessful in the appeals procedure, a 90-Day Letter (i.e., a statutory notice of deficiency) is issued to the taxpayer; the taxpayer can then file a petition for redetermination with the Tax Court before assessment of the deficiency is permitted.

- Taxpayers who are unsatisfied with the results of Fast Track Mediation will still have the option of requesting a traditional appeal. Implementing the new Fast Track Mediation process will require coordination with the operating divisions.

(iv) **Partially Agreed** — The examiner proposes adjustments to the taxpayer's tax liability and the taxpayer agrees to sign a consent with respect to some of the adjustments, but not to others. The examiner will request that the taxpayer execute a waiver covering some of the proposed adjustments. If the taxpayer signs a waiver of restrictions, the taxpayer may avail himself of the IRS Appeals procedures or petition the Tax Court for a determination concerning the proposed adjustments not covered by the waiver of restrictions. Form 870, *Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*, is used for partially agreed cases. The taxpayer can then pay the portion of the deficiency that is agreed.

9. Examination reports

As part of the examination process, the examiner prepares a report of his examination on Form 4549, *Income Tax Examination Changes.* The most important element of the examination report is the examiner's proposed adjustments to the taxpayer's tax liability. Written explanations of adjustments in all unagreed cases (and when needed in partially agreed cases) are made on Form 886-A, *Explanation of Items*.

10. Thirty-Day Letter

In an office interview examination, if the taxpayer disagrees with the proposed changes, the group manager will discuss the disputed adjustments with the taxpayer in a further attempt to resolve the issues and obtain the taxpayer's agreement. The IRS inserts a statement in the administrative copy of the examiner's report discussing the group manager's involvement in the case.

a. If, at the conclusion of an examination, including a discussion with the group manager, the taxpayer is still not in agreement, the IRS will issue a 30-Day Letter to the taxpayer and the taxpayer will be informed of his or her appeal rights. The taxpayer is furnished with a copy of the examination report and advised of his or her rights to appeal.

(i) The 30-Day Letter requests that the taxpayer sign and return Form 4549, *Income Tax Examination Changes* if the taxpayer agrees with the findings, or that the taxpayer exercises his or her appeal rights.

(ii) The 30-Day Letter informs the taxpayer that if he or she fails to take appropriate action within thirty days, the case will be processed on the basis of the proposed adjustments and a 90-Day Letter will be issued.

b. If the taxpayer's response to a 30-Day Letter indicates a disagreement and the taxpayer requests an Appeals conference, an examiner will review the case files to consider any additional information submitted that may allow the issues to be resolved at the

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examining level. If the additional information indicates that further development is warranted, the examiner will expedite the examination.

c. A 30-Day Letter, as its name suggests, allows the taxpayer 30 days to request Appeals' consideration of his or her case, but the IRS, upon request by the taxpayer or his representative, grants extensions of time almost as a matter of course if a reasonable justification is offered.

d. If the taxpayer submits a written protest and/or requests Appeals' consideration, the case file and written protest are transferred to the local Appeals office. A protest generally will be reviewed at the group level within seven days of receipt to determine whether the protest is adequate, whether the case requires further development by the examiner, whether the examination report should be modified, and whether the written protest includes the requested information. When a protest is inadequate, the protest is returned to the taxpayer for improvement.

e. If the taxpayer fails to respond to the 30-Day Letter a statutory notice of deficiency (i.e., a 90-Day Letter) is issued if it reasonably appears that the taxpayer or his or her representative received the 30-Day Letter or, if not received, that the IRS exercised due diligence in determining the taxpayer's last known address.

    (i) In all events, a 90-Day Letter will be issued within the time frame fixed by law if the period of limitations will expire within 150 days and the taxpayer will not execute a consent to extend the period.

    (ii) Notices of deficiency generally are issued within 60 days after the expiration of the thirty-day period specified in the 30-Day Letter and any extensions.

11. Appeals

Appeals' review of a taxpayer's case is neither automatic nor required. Taxpayers must specifically request that their case be considered by Appeals.

a. The method for requesting Appeals' consideration depends upon the amount in controversy and the type of case.

    (i) For cases in which the total amount of the proposed additional tax, penalties, proposed overassessment, or claimed refund at issue exceeds $25,000 for any taxable period, the taxpayer must submit a formal written protest.

    (ii) A taxpayer must file a formal written protest in all employee plans and exempt organization cases as well as in all partnership and S corporation cases.

    (iii) In other cases, where the total amount of proposed additional tax, additions to tax and penalties, proposed overassessment, or claimed refund, credit, or abatement for any tax period, is $25,000 or less, the taxpayer may request an appeal using small case procedures, whereby a written request is required setting forth the changes with which the taxpayer does not agree and any reasons for disagreement.

b. There is no official IRS form for a written protest (although the Campus usually requires Form 12203*, Request for Appeals Review*, be completed and returned for a correspondence audit to be forwarded to Appeals). The IRS will reject a protest and the taxpayer will be required to perfect the document if the protest fails to include the following:

    (i) A statement that the taxpayer wants to appeal the examiner's findings to the Appeals office;

    (ii) The taxpayer's name, address, and daytime telephone number;

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(iii) A copy of the letter showing the proposed changes and findings being protested or the date and symbols from the letter;

(iv) The tax periods or years involved;

(v) An itemized schedule of the adjustments with which the taxpayer does not agree;

(vi) A statement of facts supporting the taxpayer's position on any contested factual issue;

(vii) A statement outlining the law or other authority, if any, upon which the taxpayer is relying; and

(viii) A declaration under penalties of perjury attesting the statement of facts is true and accurate.

c. The taxpayer's representative should consider the submission of documentary and/or affidavit evidence in support of the stated facts. The protest should deal with any defects and deficiencies in the examiner's report, such as improperly framed issues, misstatements or omissions of fact, or incorrect conclusions of law. Frequently, practitioners supplement the protest to supply further factual or legal support for the taxpayer's position.

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B. Miscellaneous points

1. Chances of being audited

The IRS's 2020 Data Book provides statistical data on tax returns audited for all returns filed in calendar year 2019, including the number of tax returns the IRS examines, the number of cases closed, and the number of cases that remain in process. FY 2020 reveals examinations on individual returns based on total positive income categories reported on the filed tax returns. For corporations, FY 2020 examinations are categorized by the balance sheet (BS). Finally, flow-through categories for partnerships and S Corporations are not categorized but rather by Form 1065 or Form 1120S. The total of Individual, Corporation, and Pass-Through returns closed and in process in 2021 was 682,693 returns; and in 2020 the total was 473,517. The data is as follows:

Positive Income	2021 Examined	Percentage	2020 Examined	Percentage
Total Positive Income (TPI) < $100,000	539,221	92%	350,888	74%
TPI $100,000 but < $200,000	72,440	10%	61,332	13%
TPI > $200,000 but < $1,000,000	33,112	5%	28,490	6%
TPI > $1.000.000	13,969	2%	11,805	3%
Small Corp BS < $1M	4,880	.7%	3,872	.8%
Small Corp BS > $1M < $5M	1,512	.2%	1,066	.2%
Small Corp BS > $5M < $10M	255	.04%	280	.06%
Large Corp BS > $10M < $250M	1,898	.28%	2,363	.5%
Large Corp BS > $250M < $500M	269	.04%	334	.07%
Large Corp BS > $500M < $20B	1,156	.17%	1,278	.27%
Large Corp BS > $20B	312	.05%	302	.06%
Partnerships	4,141	.61%	4,969	1%
S Corporations	7,091	1%	6,538	1.4%

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2. *Audit results*

The additional tax assessed compared over the years is as follows:

Taxpayer	FY 2021 Additional Tax From Audit	FY 2020 Additional Tax From Audit	FY 2019 Additional Tax From Audit	FY 2018 Additional Tax From Audit	FY 2017 Additional Tax From Audit
Individuals with total positive income under $100,000	$5.1 billion	$1.2 billion	$702 million	$794 million	$ 766 million
TPI > $100,000 < $200,000	$586 million	$520 million	$1.1 billion	$1.35 billion	$1.1 billion
TPI > $200,000 < $1M	$7.1 billion	$674 million	$1.25 billion	$1.75 billion	$1.7 billion
TPI > 1M	$1.6 billion	$969 million	$1.32 billion	$1.88 billion	$1.8 billion
Small corporation – balance sheet under $1M	$4.3 billion	$151 million	$125 million	$210 million	$126 million
Small corporation – balance sheet $1M under $5M	$184 million	$55 million	$71.4 million	$99.7 million	$68 million
Small corporation – balance sheet $5M under $10M	$19 million	$29 million	$33.6 million	$44 million	$87 million
Large corporation – balance sheet $10M to $250M	$717 million	$293 million	$230 million	$985 million	$314 million
Large corporation – balance sheet $250M to $20B	$2.4 billion	$1.3 billion	$291 million	$257 million	$422 million
Large corporation – balance sheet $20B & over	$11.4 billion	$4.1 billion	$17.1 billion	$12.5 billion	$16 billion

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3. Correspondence audits

Because it costs less and requires less manpower than field or in-person audits, the Service has increasingly turned to auditing by mail – so-called "correspondence and discretionary examinations." Taxpayers continue to complain about errors and conduct by IRS employees. The Taxpayer Advocate stated in the 2021 Report to Congress, "The IRS correspondence audit process is structured to expend the least amount of resources to conduct the largest number of examinations – resulting in the lowest level of customer service to taxpayers having the greatest need for assistance. Correspondence audits produce the lowest agreement rate, the highest no-response rate, and the highest volume of cases assessed by default." The 2021 Data Book shows that approximately 70 percent of those audited by correspondence audits are taxpayers whose total positive income is $50,000 or less, and approximately 50 percent of those claimed the Earned Income Tax Credit.

The Taxpayer Advocate's 2021 report identified the following as the most examined issues by IRS correspondence audits conducted by the Campuses: the Earned Income Tax Credit (EITC); refundable credits; filing status; non-filers; and questionable refunds. Correspondence audits represent the largest percentage of examinations by the IRS and are aimed at the least sophisticated taxpayer population when it comes to the tax laws. It is not surprising that this process continues to be disastrous.

In the 2021 IRS Data Book, correspondence audits accounted for 78.4 percent of all audits conducted by the IRS. This leaves only 21.6 percent for in-person examinations, which have been proven to be the most productive.

Note:

> The AICPA has communicated with the IRS on a number of occasions over the years about the problems taxpayers have faced with correspondence examinations. Its members have raised concerns about: (i) the excessive time it takes the IRS to resolve a taxpayer's case; (ii) the great difficulties taxpayers face when trying to contact the IRS to obtain information regarding the status of their correspondence audit case; (iii) the numerous telephone inquiry calls taxpayers or their tax representative make to the IRS that go unreturned; and (iv) the IRS employees routinely closing cases and issuing the statutory notice of deficiency (i.e., the "90-day letter") without having reviewed correspondence submitted by the taxpayer. There has been some progress with respect to IRS employees routinely closing cases and simply issuing the statutory notice of deficiency but little with respect to the excessive time it takes to resolve a taxpayer's case.[11]

4. International issues

The IRS has hired international examiners when budget permits and shifted domestic resources to focus on international issues. In addition, due to the attention on foreign bank accounts and the implementation of the Foreign Account Tax Compliance Act (FATCA), it is no surprise that there is more attention on international examinations. Although the IRS hired many international specialists in the past, it has announced that due to the Service's limited resources, it will now be moving its international specialists to examine domestic issues as well. This also includes domestic agents auditing international issues. So as the agency continues to face staffing challenges, it continues to try to adapt by moving its resources around.

5. Preventing an examination

Before beginning the actual analysis of a return for examination issues, consideration should be given to factors which may prevent examiners from initiating an examination. Listed below are some of the factors

[11] Tax Analysts Tax Notes today, 2012 TNT 40-32 (February 28, 2012).

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that an examiner considers before an examination is initiated or an in-depth pre-contact analysis is performed:

a. **Statute of limitations (SOL)** -- An examiner cannot initiate an examination on any return with less than 12 months remaining on the statute of limitations for assessment, without prior managerial approval.

b. **Examination cycles** -- The examination and disposition of income tax returns is to be completed within 26 months for individual returns and within 27 months for business returns (Forms 1120, 1041, 1065, etc.) after the due date of the return or the date filed, whichever is later. Strict adherence to these guidelines is needed to ensure that the examination and all other processing can be completed within the statute of limitation. However, a return can be started with group manager approval. Approval for deviation from the examination cycle requirements is to be documented in the agent's workpapers.

c. **Conflict of interest** -- Examiners are prohibited from examining or surveying a tax return if a relationship impairs their impartiality. A conflict of interest exists if an examiner's personal relationship(s) or private interest (usually of a financial or economic nature) conflict, or raise a reasonable question of conflict, with the examiner's public duties and responsibilities.

d. **Repeat audits by the same examiner** -- Examiners or specialists are prohibited from surveying or examining a tax return of a taxpayer for more than five consecutive years (60 months) from the date of assignment. If the examination is in process at the five-consecutive-year point, the examiner or specialist is allowed to complete the examination provided the current cycle or audit has less than 12 months remaining from the five-consecutive-year point. An examiner or specialist will not be reassigned to the same taxpayer for at least one intervening examination or two intervening surveys. If an examiner is assigned a return described above, the tax return should be returned to the group manager for survey or reassignment.

e. **Repetitive audits** -- Taxpayers can request no audit be conducted if the repetitive audit procedures apply. These procedures apply to individual tax returns **without** a Schedule C or Schedule F, when the following criteria are met:

   (i) An examination of one or both of the two preceding tax years resulted in no change or a small tax change (deficiency or overassessment); and

   (ii) The issues examined in either of the two preceding tax years are the same as the issues selected for examination in the current year.

   The Service has changed its procedures so that when there is a Schedule C or Schedule F included on the return, the repetitive audit procedures do not apply.

6. Current trends

The IRS faces daunting challenges in an era with reduced funding, and it has responded with increasingly targeted audit policies that reflect its need to be smarter in where it applies its resources. In fact, audits numerically have declined rather dramatically but have increased in certain definable taxpayer profile groups. In the past, the Service would be largely driven by the results of its computer programs, which, after comparing various items with statistical norms, flagged returns that claimed deductions or credits that exceeded those bounds for further examination, a discriminator function (DIF). While this continues, the DIF now more selectively flags upper-income taxpayers: those reporting $200,000 or more in earnings — and more rarely now targets lower-income taxpayers.

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a. Among some of the indicators the Service or its software find suspect are too many round numbers (like $14,000 rather than $14,283) and the use by such taxpayers of large deductions that while previously normative, nonetheless have the effect of offsetting large income items in other areas in situations where there are no statutory limitations. This provides the IRS computers opportunity to easily target these types of returns.

b. Areas that now seem to be of the most interest to the Service are FATCA/FBAR issues relating to the perceived underreporting of income through foreign accounts and other investments, travel, charitable deductions, and passive activities. The latter three types of cases are generally pursued and won by the Service because taxpayers lack the required substantiation for these deductions, which does not require much manpower to determine. With respect to the foreign accounts, the Service is showing increased audit sensitivity: the 90-22.1 was summarily replaced by FinCen 114 to be filed in connection with 1040 reporting that now bears within its shield logo the designation "FINCEN," which stands for Financial Crimes Enforcement Network, emphasis on "crime."

c. Starting in late 2019 and moving forward, the IRS targeting those that deal in virtual currency. The IRS has initiated several different types of correspondence contacts with many individuals regarding their participation in virtual currencies. They have issued numerous Jon Doe Summonses to begin to identify those participating in virtual currency transactions. They created a section on their website solely dedicated to virtual currency information. Anyone being contacted by the IRS regarding their potential participation in virtual currency transactions should take them very seriously and consult a tax practitioner and or an attorney due to the potential criminal implications.

d. Shareholders of S corporations and general partners may likewise invite audit of whether the income is passive (even where the taxpayer is claiming no passive losses from any other activity) as even trade or business income is included in net investment income if the taxpayer is passive with respect to the activity. In addition, the recent final regulations on net investment income afford a special treatment to real estate professionals for rental income that is likely to result in policing audits to prevent abuse. There are several areas where taxpayers can go wrong with this exception.

d. Another area that has been of great interest to the Treasury is worker classification. The Service launched a Voluntary Classification Settlement Program to enable taxpayers to avoid the costs of an audit by "coming clean" at a substantially reduced cost relative to the tax liability that would result from an examination. There are signals that the offshore voluntary disclosure program will both be extended but with added examination activity to incentivize taxpayers to "come clean." In general, taxpayers are required to file amended tax returns and foreign bank account reports for the last eight tax years, pay tax and either an accuracy-related penalty or delinquency penalty, accrued interest, and an offshore penalty of 27.5% of the aggregate high balance of the noncompliant foreign accounts and the value of any foreign income-producing property where the income was not reported; but this 27.5% penalty may be reduced to 12.5% or 5% if the taxpayer meets specific criteria. The Taxpayer Advocate has submitted a list of proposals and recommendations that may relieve small infractions from the full force of the penalty. The current provision seems to catch the unwary more than those who have sophisticated advice.

e. Of course, income that is reported to the Service through W-2s, K-1s, and 1099s but is not reported on the individual tax return will cause the matching program to trigger scrutiny and an adjustment letter, but not necessarily an audit, depending on the size of

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the omission in relation to other items that were reported. A recent sign of the times is the failure to report cancellation of indebtedness income as many taxpayers work out their debts. With the introduction of the net investment income tax, one may expect the Service to increase its examination of the character of certain types of income – specifically, rent, interest, dividends, royalties, and gains – where such amounts are not included on a taxpayer's Form 8960.

f. Practitioners should finally be aware that the IRS has one more matching program, one that matches the return with the tax return preparer. Nevertheless, regardless of income levels, returns prepared by certain tax return preparers are flagged for audit regularly. Those preparers include those under criminal investigation, those where a whistleblower is involved and those under investigation in the Office of Professional Responsibility, or their state CPA licensing authority to name a few. In addition to the taxpayer's substantive tax issues relating to the potential for audit, a return preparer's reputation, and history itself, can be the trigger.

C. Burden of proof

1. General burden of proof

The general rule in a tax case is that the burden of proof in civil tax cases has generally been placed on the taxpayer, with the Service enjoying a presumption of correctness.[12] However, in 1998, the Congress enacted the Taxpayer Bill of Rights which, among other things, eliminated the Service's presumption of correctness if the taxpayer satisfies certain requirements and shifts the burden of proof from the taxpayer to the Service.

a. The burden of production, which is also known as the burden of going forward, requires the party with the burden to present some evidence in support of his or her position, or he or she will lose automatically for having failed to satisfy this initial burden.

b. The burden of persuasion applies when each side has presented its evidence; if the outcome is genuinely in doubt, with neither side's position seeming discernibly more likely to be correct than the others, the burden of persuasion dictates that the side without the burden wins. This is presumably pro-taxpayer because the burden of persuasion, once the taxpayer produces credible evidence, shifts to the Service if the taxpayer meets the criteria for the shift of the burden.

Note:

Under the default rules, in a court proceeding, the taxpayer had both the burden of production and the burden of persuasion in most civil tax cases. The taxpayer was first required to go forward with prima facie evidence sufficient to show that the taxpayer's assertion could be correct. A court could determine that the evidence presented was not sufficiently strong or unequivocal to persuade the court of the correctness of the taxpayer's claim. However, this might not have been enough for the taxpayer to prevail because the Service had a presumptive correctness with respect to the burden of persuasion.

2. Section 7491

Under Code §7491, the burden of proof will be presumed to be with the **Service** if the taxpayer introduces **credible evidence** with respect to any factual issue relevant to ascertaining the liability of the taxpayer.

[12] *Welch v. Helvering*, 290 US 111 (1933), 12 AFTR ¶1456, 78 L Ed 212.

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a. The burden shifts with respect to any factual issue in a court proceeding only if the taxpayer:

(i) Has met any **substantiation** requirements;

Note:

Taxpayers must comply with both the general recordkeeping and substantiation requirements of the Code, as well as requirements relating to specific items, such as charitable contributions, meals, entertainment, travel, and other expenses.

(ii) Maintained **records**; and

(iii) **Cooperated with reasonable IRS requests for meetings, interviews, witnesses, information, and documents**. All of these involve matters arising in the context of an audit or examination. Cooperation includes exhausting all **administrative remedies**, including any **appeal rights** provided by the IRS, before pursuing a judicial remedy.

(iv) It does not apply to any issue if any other provision of this title provides for a specific burden of proof with respect to such issue.

(v) Taxpayers that are corporations, partnerships, or trusts with net worth in excess of $7,000,000 are not entitled to the benefits of the burden of proof rules.

b. Credible evidence is defined as the quality of evidence that a court, after initial analysis, would find sufficient to make a decision if no contrary evidence were submitted. Evidence does not satisfy this standard if a court does not find it worthy of belief.

Note:

The taxpayer must offer a minimum quantum of evidence necessary to establish that there is a specific factual basis for finding the taxpayer's assertion correct. The taxpayer must bring forth credible evidence. If the taxpayer cannot do that, the burden of production has not been satisfied without any need to consider any contrary evidence the Service may or may not have.

Note:

The court will determine whether the evidence offered by the taxpayer is in fact credible; the evidence must be worthy of belief to the extent that it would be sufficient for a court to base a decision if no contrary evidence were submitted. Implausible, frivolous assertions, or claims such as tax-protester type arguments do not meet this standard. In most cases, it is the **implausibility** of what is claimed that will debase the value of any purported claim.

c. Assume that the taxpayer either does not have the burden of production or the taxpayer satisfies the burden of production by offering some credible evidence. Two situations are possible.

(i) The taxpayer's evidence is so overwhelming that the judge determines that, based on the evidence (solely that produced by the taxpayer), the court must adopt the taxpayer's position. In this situation, the burden of producing contrary evidence shifts to the Service. The Service can either refute the taxpayer’s evidence or produce equally strong evidence that points in the opposite direction. But this is rare in practice.

(ii) More likely, the taxpayer presents evidence that is credible, but not overwhelming, so the conflicting evidence must be weighed to determine which side is more strongly supported by the evidence. If the taxpayer has the burden of persuasion, the taxpayer must persuade the fact finder by a preponderance of

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the evidence that the notice of deficiency is incorrect. If the fact finder decides it is equally likely the notice is correct, the taxpayer loses because the burden of persuasion is on the taxpayer under the old law.

3. Impact on audits

These rules only apply to judicial proceedings; they have no application in an administrative proceeding such as an examination, where taxpayers should realize that they have a heavy burden of both production and persuasion. Yet what one does in an examination can affect the application of the shifting of the burden of proof (as described). Actions taken to reduce costs of examination, penalties, or interest accruals can adversely (negate) the potential shifting of the burden.

a. Does the burden of proof rules do much to help taxpayers? Only the burden of persuasion shifts to the IRS, preventing the taxpayer from simply making general assertions and refuse to pay on grounds for which no specific documentation is offered.

b. The taxpayer-plaintiff is not required to **offer** information but will have to comply with the Service's request for information. Since the taxpayer, and not the Service, is the only one who fully understands what the facts are and what information is relevant, the Service will need to figure out which questions to ask, what documents to request, and which witnesses to interview.

(i) Because the burden-of-proof rules apply only at the trial level, taxpayers have an incentive to stonewall at the administrative level. Given this potential, the Service has become more aggressive at the administrative level. Although relatively few cases ever make it to trial, the potential for litigation always exists. In general, the taxpayer prefers the Tax Court because the taxpayer can file there without first paying the tax and suing for refund.

(ii) Exhaustion of administrative remedies is a factor used to determine whether the taxpayer has fully cooperated with the IRS, regardless of whether the pursuit of administrative remedies is cost effective. Since interests and penalties continue to accrue during the administrative process, the Service can apply a leverage technique by attempting to lengthen the administrative process.

Note:

> The cost of Appeals represents a dilemma for taxpayers who otherwise would qualify for the benefits of the burden of proof. Failure to go to Appeals (and incur the concomitant expense) will cause the taxpayer to lose whatever advantage he or she might have in Tax Court.

(iii) One of the advantages a taxpayer enjoys in the Tax Court is the relaxed discovery rules: depositions in general are relatively rare, and depositions of parties are even rarer. The Service has no right to depose a taxpayer prior to trial, and depositions of nonparty witnesses are an "extraordinary" method of discovery, to be permitted only on court order, unless both parties' consent. The same limitations apply to depositions of expert witnesses.

- While the taxpayer is very familiar with the facts by reason of personal involvement in the transaction in question and not in need of discovery, the Service, being generally in the dark, needs discovery.
- Under the credible evidence rules, however, the taxpayer may not shift the burden of proof to the Service without complying with requests for witness interviews. Thus, in order for the taxpayer to gain the advantage

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as described of shifting the burden of proof to the IRS, the taxpayer must effectively waive his or her rights to avoid discovery.

c. According to the cases, the placement of the burden of proof on one party or the other is almost always irrelevant, because the party supported by the preponderance of the evidence will prevail regardless of which party bore the burden.[13]

d. The default rules still apply to taxpayers, perhaps the majority, who decide to not attempt to shift the burden of proof under the new rules.

(i) If the taxpayer's evidence is stronger than the Service's, the taxpayer would prevail because the taxpayer is supported by the preponderance of the evidence.

(ii) If the taxpayer's evidence is not as strong as the Service's, the IRS would prevail because it would be supported by the preponderance of the evidence. Thus, every factual issue is decided in favor of the party supported by the preponderance of the evidence, regardless of which party bore the burden of proof.

Note:

Only in the extremely rare case of evenly weighted evidence would the result vary. Under the default rules, the Service prevails in the event of a tie because the taxpayer would have failed to satisfy the burden of persuasion. The taxpayer, however, would prevail if a tie occurred after shifting the burden under the new rules.

D. Psychological checklist for an audit

- Always treat the examiner with respect. From the first telephone call, make the examiner feel comfortable. If the examiner is hardballed or discounted, a more intensive audit than necessary is likely to follow.
- Always pre-audit the return to determine the client’s strengths and weaknesses in this matter. With a cordial relationship with the examiner established, the initial conversation can inquire into what the examiner is looking at or looking for with a fairly good chance of obtaining useful information. This intelligence will inform the tax professional’s review of the return.
- Try to control the flow of the audit by beginning with an area of strength. This can establish the credibility of the preparation and lead the examiner to believe that other issues are similarly covered, which can be important if the examiner runs out of time. Allowing the auditor to begin in an area that will be exposed as weak will prompt a longer drawn-out inquiry into all areas, including those of strength.
- Never leave the examiner alone. A representative should always be present unless they really insist on being alone. Being alone, however, deprives one of the opportunity to dispossess the examiner of erroneous conclusions of fact and law but also of the personal interplay. This means that engagement with the examiner, whether in professional discourse or personal conversations, reinforces the personal tie and stretches out the audit.

[13] *Blodget v. Commissioner,* 95 AFTR2d 2005-448 (8th Cir., 2005), aff'g TC Memo 2003-212 (adopting *Polack v. Commissioner,* 366 F3d 608 (8th Cir. 2004), 93 AFTR 2d 2004-2094. Cf. *Griffin v. Commissioner*, 315 F.3d 1017(8th Cir. 2003), 91 AFTR 2d 2003-486, rev'g.

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- Reasonable delay serves the client well, although this cannot be carried so far as to interfere with the audit; it can, however, be used to cause the audit to end at the optimal place from the client's perspective. The client is more likely to receive a no adjustment report with respect to issues the examiner did not cover in sufficient depth given the limits imposed by the Service for the examination.

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Individual Audits -- Virtual Currency

I. Virtual currency *1*

A. In general **1**

B. More information **1**

1. What is virtual currency? *1*

2. Tax consequences *1*

3. Current audit concerns *1*

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Individual Audits -- Virtual Currency

I. Virtual currency

A. In general

Virtual currency transactions are taxable by law just like transactions in any other property. Taxpayers transacting in virtual currency may have to report those transactions on their tax returns.

B. More information

1. What is virtual currency?

a. Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in any jurisdiction.

b. Cryptocurrency is a type of virtual currency that utilizes cryptography to validate and secure transactions that are digitally recorded on a distributed ledger, such as a blockchain.

c. Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" virtual currency.

   (i) Bitcoin is one example of a convertible virtual currency. Bitcoin can be digitally traded between users and can be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.

2. Tax consequences

a. The sale or other exchange of virtual currencies, or the use of virtual currencies to pay for goods or services, or holding virtual currencies as an investment, generally has tax consequences that could result in tax liability.

b. The IRS issued IRS Notice 2014-21, IRB 2014-16, as guidance for individuals and businesses on the tax treatment of transactions using virtual currencies.

c. The IRS also published Frequently Asked Questions on Virtual Currency Transactions which provides guidance on the taxability of various virtual currency transactions.

3. Current audit concerns

a. IRS pursuing virtual currency is no surprise since as they have been trying to obtain records for those transaction for years. In 2017 they issued a John Doe summons to Coinbase Inc. requesting information on their clients who conducted any transaction equal to $20,000 or more in any one transaction type. Coinbase Inc. operates a virtual currency wallet and exchange business. As a result, IRS received information on approximately 8.9 million transaction for over 14,000 account holders. Once the information was obtained IRS ran the information against their database to determine if taxpayers were reporting the identified transactions. This led to IRS sending letters to

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taxpayers that were identified[1]. Taxpayers should take these letters very seriously by reviewing their tax filing and if appropriate filing or amending tax returns to reflect any virtual currency transactions. IRS has announced that they will continue to target virtual currency transactions through outreach educational programs. However, virtual currency is an ongoing focus of their Criminal Investigation Division, so it is a very serious matter.

b. Letter 6173 states that the IRS information that the taxpayer has one or more accounts containing virtual currency. It states that for 2013-2017 they either have not received either a federal income tax return or an applicable form or schedule reporting the information they have. They recommend filing a return if one has not been filed, amend the return to report the transactions if applicable, or explain in a statement signed **under penalties of perjury**, the facts relating to reporting the virtual currency transactions. Failure to respond means potential examination referral.

c. Letter 6174 also identifies that the IRS has information regarding virtual currency transactions entered into by the taxpayer and states that if the transactions have not been reported the taxpayer should file amended returns. The difference with this letter is no response is due. It is more informational regarding the information they obtained versus Letter 6173 which is more accusatory (they have information that they know was not reported).

d. Letter 6174-A also states that they have account information regarding virtual currency accounts held by the taxpayer. It provides information on the reporting requirements of different types of virtual currency transactions and recommends that if the taxpayer did not report their transactions that they file amended or delinquent returns. This letter also has no response due but suggests that they may send other correspondence regarding additional enforcement activities in the future.

e. Since the Coinbase John Doe summonses, Abra, Uphold, Kraken, and Circle Internet Financial have been served with John Doe summonses, including their predecessors, subsidiaries, divisions, and affiliates, seeking the records of Americans who engaged in transaction with these companies' digital currency exchanges to obtain their client records. In addition, James Harper filed suit in the U.S. District Court of New Hampshire stating that his constitutional rights were violated when the IRS likely obtained his account information via John Doe summonses issued to Coinbase, Abra, and Uphold. The Court found that Mr. Harper's constitutional rights were not violated, and the IRS had every right to issue summonses for the information. So, although the program is in its infancy stages, it appears that it will blossom into the same type of program as the one the IRS pursued regarding foreign financial accounts.

f. The IRS is currently pursuing other summonses for U.S. companies regarding virtual currency transactions as well as pressuring the United States' treaty countries all over the world to provide any information they have on American citizens regarding virtual currency transactions in their foreign jurisdictions. Regarding treaty countries, the IRS has been looking to Malta to provide information regarding American citizens who are using Malta Pension Plans to manage their cryptocurrency investment portfolios. Not only do these accounts have Fin-Cen 114 and possible F-8938 filing requirements, now they are tied to virtual currency transactions. The IRS is using existing Treaty requirements with Malta to try to force Malta to provide the information requested.

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[1] IR-2019-132.

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Trust Fund Recovery Penalty

Learning objectives *1*
I. Persons liable for the 100-percent penalty on under-withheld trust-fund taxes *1*
A. In general 1
B. Dentist held responsible party who acted willfully for trust fund recovery penalty 2
C. Co-owners of LLC/Partnership were liable for trust fund recovery penalty 3
D. Law firm shareholder was liable for trust fund recovery penalty 5
E. Co-owner of member managed LLC liable for trust fund recovery penalty 6
F. Manager of nursing homes was liable for trust fund recovery penalty 6
G. Company co-owner responsible party and reasonable cause exception not applicable 7
H. Taxpayer responsible party despite PEO contract 9
I. Nonprofit organization 11
J. Franchisee vice president liable for trust fund recovery penalties 12
K. Company president denied refund of trust fund recovery penalties 15
L. Accountants hit with trust fund penalty tax for failure to remit client's payroll taxes 19
M. Office manager 20
N. Manager liable 21
O. Court refuses to abate trust fund recovery penalties 21
P. Company president liable for trust fund penalty despite taking action upon learning of deficiency 22
Q. Taxpayer was responsible person who acted willfully when he loaned money to business to make payroll 24
R. Business owner's wife was not responsible person despite bank signatory authority 25

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Trust Fund Recovery Penalty

Learning objectives

Upon completing this material, the reader will be able to:

- Describe the circumstances in which an individual will become personally liable to the 100-percent penalty on underpaid employment taxes.

I. Persons liable for the 100-percent penalty on under-withheld trust-fund taxes

The Code requires employers to withhold federal income and Social Security taxes from their employees' wages.[1] An employer who fails to remit withheld sums is liable for the unpaid taxes.[2] The liability may be imposed directly and individually on those persons responsible for the tax delinquency.[3] Since the employee is credited with the withholding even though it has not been remitted, the IRS is relentless in identifying the responsible person or persons from whom they can collect the tax. This is a very hot topic in examinations because the IRS takes the employer's fiduciary responsibility very seriously. The IRS has pursued corporate officers, bookkeepers, and accountants as the responsible party to pay the tax and there are numerous Court cases published each year on this issue. On July 1, 2016, the Small Business/Self-Employed Division issued a memorandum to their Agents and Collection Officers on the procedures for Trust Fund Recovery Penalty Cases. This memorandum serves as interim guidance to IRS employees until the pertinent sections of Internal Revenue Manual 5.7 can be updated. In addition, IRS updated Notice 784 (*Could you be Personally Liable for Certain Unpaid Federal Taxes?*), to explain who could be held liable for the unpaid taxes. The Notice includes an officer or employee of a corporation, a partner, or employee of a partnership. Accountants, trustees in bankruptcy, members of a board, banks, insurance companies, sureties, another corporation, a volunteer director/trustee, or an employee of a sole proprietorship. Just because you outsource some or all payroll duties to third-party payroll service providers (PSP), the employer still remains responsible for the deposit of the federal tax liabilities and timely filing of returns even when the PSP does not deposit, remit, or file the payroll tax returns. However, depending on the facts and circumstances, and the type of third-party arrangement, an employer who uses a third party to perform Federal employment tax functions on its behalf may remain solely liable for Federal employment taxes, or may become jointly and severally liable for such taxes.[4] This is a very hot topic for the IRS and as a result, there are numerous cases every year.

A. In general

Liability under §6672 falls upon those persons who satisfy both prongs of a two-part inquiry. First, the person must be "responsible" for collecting, accounting for, and paying over the taxes. Second, if, and only if, the person is deemed responsible, he is liable if he acted "willfully." Even the obvious case where the president of the company has check-signing authority, knows of the failure to pay the Service, and directs the payment of corporate funds to other creditors in preference to the Service is litigated. The taxpayer does not win.[5]

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1 See *Slodov v. United States*, 436 U.S. 238 (1978).
2 I.R.C. §6672.
3 See *Gephart v. United States*, 818 F.2d 469 (6th Cir. 1987) (per curiam).
4 Notice 784.
5 *United States v. Jepsen.* 87 AFTR2d ¶2001-467 (W.D. Ark. 2001).

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1. When the president of a corporation used corporate funds to pay other creditors at a time in which he knew that the employment taxes were due, he was held to have acted willfully in failing to pay the employment taxes.[6]
2. The new president of a company who was brought in to turn it around nevertheless had other bills paid while knowing that employment taxes were due. His position and duties at the company and his arrangements to pay other creditors before the government made him a responsible person who willfully failed to pay over withholding taxes.[7]

Note:

> The president of a company with signature authority is almost always a responsible person by status, and the only way the individual can escape the penalty tax is to show a lack of willfulness. Arguing that the Treasury is garnishing more than one-half of the individual's Social Security disability payments is not a defense.[8]

B. Dentist held responsible party who acted willfully for trust fund recovery penalty

A district upheld the IRS assessment of the trust fund recovery penalty against the owner of a dental practice that failed to remit payroll taxes.[9] Taxpayer Charles I. Williams owned and operated several dentistry practices. In 2012, Williams faced a "cash flow crisis." He reduced his salary, refinanced his home, and brought two of the dentistry practices into Chapter 11 bankruptcy proceedings. He also left unpaid a portion of the payroll taxes owed by the two practices and the entity handling their business affairs between 2012 and 2014. During this time, Williams signed IRS forms reflecting that he owed outstanding payroll taxes and indicating that in some quarters his businesses did not turn over any payroll taxes. During these years in which his dental practices faced financial difficulty, he was also experiencing extreme personal hardship. He continued to practice dentistry and stayed involved in business affairs. He saw patients in 2012, 2013, and 2014. He initiated and participated in bankruptcy proceedings for the two practices in 2013. That same year, he also negotiated the sale of a document storage business he had founded the previous decade. Williams did not dispute that the dental practices owed the unpaid payroll taxes, but he opposed the government's motion for summary judgment on the ground that he could not be held personally liable for the unpaid payroll taxes because he did not willfully violate the tax laws. The Court determined otherwise. The Court reasoned that the Internal Revenue Code requires employers to withhold taxes from their employees' wages. Employers hold the withheld taxes "in trust" for the United States until they are remitted, usually on a quarterly basis. When an employer fails to pay over the trust funds, §6672(a) of the Code imposes a penalty equal to the entire amount of the unpaid taxes on "any person" required to collect, account for, or pay over the withheld taxes, who "willfully" fails to do so. The Court determined that personal liability for the penalty attaches if the person is a "responsible person" who "willfully" failed to pay over the withheld taxes. Once a penalty under §6672 is assessed and the taxpayer is found to be a responsible person, "the burden of proving lack of willfulness is on the taxpayer."

In this case, Williams did not dispute his status as a responsible person, but contested only whether his failure to remit taxes was willful. Willfulness under §6672 requires only a voluntary, conscious, and intentional act, not a bad motive or evil intent. A considered decision not to fulfill one's obligation to pay

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[6] United States v. Breaux, 87 AFTR2d ¶2001-367 (E.D. La. 2000). See also *Thosteson v. United States*; No. 01-14520 (11th Cir. 2003).
[7] *Borland v. United States*, 88 AFTR2d ¶2001-5525 (6th Cir. 2001), aff'g (E.D. Mich. 2000).
[8] *United States v. Hankins*, 88 AFTR2d ¶2001-5345 (S.D. Ind. 2001).
[9] *U.S. v. Williams, DDS*, 128 AFTR 2d 2021-5077, Code §§6672; 7422 (CA5), 07/06/2021.

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the taxes owed, evidenced by payments made to other creditors in the knowledge that the taxes are due, is all that is required to establish willfulness. Although the willfulness "determination is usually factual," "evidence that the responsible person had knowledge of payments to other creditors after he was aware of the failure to pay withholding tax is sufficient for summary judgment on the question of willfulness." In other words, where there is undisputed evidence that the responsible person directed payments to other creditors while knowing of the tax deficiency, willfulness is established as a matter of law.

Williams' former bookkeeper testified that Williams knew of his unpaid payroll taxes but directed her to pay other bills instead of the payroll taxes. The Court determined that her testimony was credible and established that Williams continued to pay other creditors in lieu of the United States.

The Court concluded that Williams acted willfully as a matter of law because the United States put forth uncontroverted evidence that Williams directed payments to other creditors despite knowing that he owed unpaid payroll taxes. The government established that Williams knew of his outstanding payroll tax obligations through his deposition statements that he recalled having payroll tax issues in 2012, 2013, and 2014, and through IRS forms bearing his signature that reported a balance due on withheld payroll taxes. The record also shows that, although Williams was aware that he owed payroll taxes, he drew a salary, paid employees and vendors, and directed the payment of rent and other bills instead of his IRS debt. By "paying private creditors in preference to the government" while he "actually knew the taxes were unpaid," Williams acted willfully as a matter of law. Therefore, the Court held that Williams acted "willfully" in his failure to pay withheld payroll taxes, and he was thus personally liable for the trust fund recovery penalties under §6672(a).

C. Co-owners of LLC/Partnership were liable for trust fund recovery penalty

A district court upheld the IRS's assessment of the trust fund recovery penalty against a co-owner of an LLC/Partnership that failed to remit their payroll taxes.[10] Lawrence Danduran and Cheryl Huntzinger were co-owners of Mill Pump & Cheers LLC that operated a convenience store and gas station. Danduran primarily handled fuel management, maintenance, and inventory. Danduran and Huntzinger jointly managed the day-to-day operations of Mill Pump after the store initially opened. Danduran and Huntzinger both had signature authority on Mill Pump's checking account. Danduran signed for and acquired Mill Pump's liquor license and tobacco license. Huntzinger wrote the vast majority of the checks to Mill Pump's creditors. Danduran signed checks to vendors when necessary. Danduran relied on Huntzinger to file employment tax returns, pay employment taxes, prepare payroll, and to collect and remit trust fund taxes. Mill Pump employed several persons to operate the convenience store. Huntzinger was primarily responsible for calculating or preparing Mill Pump's payroll checks and tax withholdings. Huntzinger signed and filed the payroll tax returns for Mill Pump.

Sometime in 2011 or 2012, Danduran and Huntzinger had a "falling-out" and Danduran found another job in sales at a car dealership. After he took the car dealership job, Danduran continued to come to Mill Pump most days to handle fuel management and maintenance. Danduran received both a salary from Mill Pump and monthly repayments on the personal loan he made to renovate the store and purchase inventory.

Mill Pump, like all employers, was required by law to withhold federal income and Federal Insurance Contributions Act (FICA) taxes, which include Social Security and Medicare taxes, from its employees'

[10] *Darduran v. United States*, 123 AFTRA 2d 2019-1027, (DC ND 3/12/2019).

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wages and pay the withheld wages over to the IRS. The amounts withheld from employee wages are commonly referred to as "trust fund taxes" because the employee's income and FICA taxes are said to be held in trust by the employer for the United States.

Mill Pump failed to pay its federal income and FICA taxes, which include Social Security and Medicare taxes, withheld from its employees' wages for: (1) the third and fourth quarters of 2010; (2) the first, second, third, and fourth quarters of 2011; (3) the first, second, third, and fourth quarters of 2012; and (4) the first quarter of 2013 (collectively, the "tax periods at issue"). **The persons responsible for collecting, accounting for, and paying over trust fund taxes withheld from employees' wages, who willfully fail to do so, are liable for a penalty in the amount of tax withheld but not paid over.**

On March 24, 2014, the IRS assessed the trust fund recovery penalty against Danduran for the tax periods at issue. On August 7, 2014, Danduran paid the full amount assessed plus interest in the amount of $56,280.44. On June 19, 2015, Danduran filed a Form 843 Claim for Refund and Request for Abatement for the tax periods at issue. On October 20, 2015, the IRS sent Danduran notice that his claim for refund and abatement was disallowed. On November 18, 2015, Danduran filed an appeal with the IRS Appeals Office. Danduran's appeal was denied in September 2016.

On July 28, 2017, Danduran filed suit against the United States demanding a refund of the penalties assessed for the tax periods at issue. On October 19, 2017, the Government filed a third-party complaint against Cheryl Huntzinger seeking a judgment against her for any amounts it is required to refund to Danduran.

When determining if Danduran was a responsible party to meet the first prong of the penalty, the court looked to the facts that Danduran owned a 50% interest in Mill Pump, he invested $45,000 of his own money into Mill Pump to renovate the store, he jointly managed the day-to-day operations of Mill Pump when the store first opened, he had the authority to hire and fire employees, he was listed as a signatory on Mill Pump's bank account, and had access to the company's checkbook, he continued to come to Mill Pump most days to handle fuel management and maintenance even though he and Huntzinger had a falling out, he ensured that all payments from Mill Pump were made to the fuel vendor, he calculated amounts due to the fuel vendor and directed Huntzinger to make payments in the correct amount although sometimes Danduran would sign the checks. Based on these facts the court determined that Danduran was a responsible party. In the opinion, the court stated that it is important to remember that more than one person in a business may be considered a responsible person and delegating authority does not relieve a responsible person of liability under Section 6672. Last the court had to determine if Danduran met the second prong of the penalty and was willful.

Danduran claims he did not act willfully within the meaning of Section 6672 because Huntzinger never spoke about payroll or tax issues with him, and he had no knowledge of taxes being owed until he received a notice from the IRS. However, Huntzinger denied this version of events in her deposition when she stated Danduran was aware of the tax problems in late 2011 or early 2012. Huntzinger also testified Danduran never told her to cease paying other creditors and pay the taxes and Danduran received a monthly paycheck from Mill Pump of $2,200 throughout most of the time the store was in operation.

Based on the testimony of Huntzinger and the deposition notes, the court determined that Danduran was willful and as a result, denied the claim for refund.

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Note:

> It is important to note in this case the IRS did not originally pursue Huntzinger because Danduran paid the trust fund recovery penalties in full. However, when Danduran filed the claim for refund of the monies he paid and filed suit with the District Court, the IRS filed a third-party complaint against Huntzinger seeking judgement against her for any amounts that might have to be refunded to Danduran in the event the court determined that Danduran was not a responsible party who acted willful.

D. Law firm shareholder was liable for trust fund recovery penalty

A district court upheld the IRS's assessment of trust fund recovery penalties against a law firm's shareholders in a case that arose from financial decisions made by the law firm during an extended period of financial distress, where at least part of the difficulty was attributable to another shareholder's larcenous conduct.[11]

From 2009 through mid-September 2012, Spizz, Todtman, and Nachamie were the named shareholders of the law firm Todtman, Nachamie, Spizz & Johns, P.C., in which they each held a one-third interest. For most of the period from April 2009 through March 2012, the firm failed to pay trust fund taxes to IRS.

Todtman was the founder and President of the firm. He held a significant managerial role. He had authority to hire and fire employees and determine attorney compensation levels without the approval of other shareholders. He was responsible for running the day-to-day operations of the firm. He signed the firm's quarterly federal tax returns for the third and fourth quarters of 2009 and the first quarter of 2010. Spizz was Vice-President of the firm and had authority to sign checks from the firm's operating and payroll accounts. However, he stated that before June 2010, he only did so upon Todtman's authorization. From at least 2009 until the firm closed in April 2015, Spizz was authorized to and did guarantee loans on behalf of the firm. Spizz also had authority to review and sign the firm's corporate tax returns and quarterly tax returns, and he signed the firm's quarterly tax return for the second quarter of 2010.

On or before June 10, 2010, Spizz discovered that the firm had failed to pay the trust fund taxes it had been withholding. Soon thereafter, Spizz and Nachamie revoked Todtman's managerial responsibilities, and they began managing the firm's finances. Spizz initially assumed at least some responsibility for these tasks but claims to have passed these duties on to Nachamie around mid-2011.

In or around December 2013, Spizz noticed an inconsistency in one of the firm's client escrow accounts. Further investigation, with the assistance of a forensic accountant, revealed that Nachamie had embezzled almost $1 million from the firm's accounts. After Spizz reported Nachamie's misconduct, law enforcement authorities investigated the matter; Nachamie was eventually convicted of grand larceny and falsifying business records, sentenced to a term of imprisonment, disbarred, and ordered to pay restitution. Nachamie thereafter declared bankruptcy and the IRS accepted an Offer in Compromise to settle Nachamie's personal tax liabilities as well as the trust fund penalties against him. However, it was not the entire amount of the unpaid payroll taxes owed so the IRS pursued Todtman and Spizz.

The Court determined that Todtman was a responsible person because he not only founded the firm but was also President and one-third owner of that firm for the periods that the IRS assessed tax penalties against him. While Todtman asserted that he was denied independent access to the firm's checkbooks

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[11] *Spizz v. United States*, 120 AFTR2d ¶ 2017-5550 (DC NY 12/4/2017).

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and check authorization from 2008, the Court noted that he admitted that he could still sign checks when it was demanded of him by, or authorized by, the other partners. Further, Todtman's assertion as to his check writing limitations was undercut by his testimony that he would sign checks if other shareholders were unavailable. Todtman was found to be willful since he was aware that the payroll taxes were not being paid, signed checks to pay others, and signed the tax forms.

The Courts review of the facts for Spizz required a different analysis because Spizz presented sufficient evidence to establish his reasonable belief that the trust fund taxes were current before June 2010. Given this reasonable belief, the Court had to determine whether, at that time, the firm had unencumbered assets available to pay down the outstanding tax liability, in which case Spizz's failure to apply those assets toward the trust fund taxes would constitute willfulness. The record establishes not only that, on the date that Spizz became aware of the tax liability, the firm had funds available to pay trust fund taxes, but also that the firm diverted those funds to other creditors. The record negates Spizz's claim that the firm lacked unencumbered funds, and, by extension, his claim that he did not willfully fail to remit trust fund taxes accruing before June 10, 2010. Thus, after Spizz became aware of the firm's tax liabilities in June 2010, he could no longer maintain a reasonable belief that other members of the firm would timely remit trust fund taxes. To the contrary, "these problems gave rise to the duty to follow up and see that the taxes were paid," and Spizz's "failure to do so constitutes the reckless disregard that meets the willfulness requirement."

The district court therefore concluded that both Todtman and Spizz were responsible persons and that both willfully failed to remit trust fund taxes to the IRS while the firm was paying other creditors.

E. Co-owner of member managed LLC liable for trust fund recovery penalty

Trust fund recovery penalty against taxpayer, who was one of two co-owners of a member-managed woodworking LLC, was upheld on summary judgment. Taxpayer's responsible person status was clearly shown by his ownership status and facts that his approval was required for all company decisions and many financial transactions; that he had check signing authority; and that he had, and on occasion exercised, power to pay company's bills and sign paychecks. Taxpayer's argument that other co-owner, who was since deceased, had sole obligation for company's payroll taxes was disproven and did not change the fact of taxpayer's own status as a responsible person. Evidence that he paid employees and other creditors while knowing or having reason to know that taxes were going unpaid clearly showed willfulness or reckless disregard.[12] As a result of being a responsible person that was willful, taxpayer owed the $1,946,023.93 in unpaid payroll taxes and accrued interest.

F. Manager of nursing homes was liable for trust fund recovery penalty

The Court of Appeals for the Tenth Circuit, affirming a district court opinion, has determined that the temporary manager of several nursing homes was liable for the trust fund recovery penalty under Code Sec. 6672 and that the tax liens from assessing the penalty were valid.[13]

The facts of the case begin with the Oklahoma Department of Health appointing Rex Hodges, as temporary manager of four nursing homes in May 2000. Under Oklahoma law, as temporary manager, Hodges assumed operating control of the facilities and had sufficient power and duties to ensure that the residents of the facilities received adequate care. Hodges oversaw the day-to-day operations and was responsible for depositing the employees' payroll tax withholdings to the IRS and filing federal payroll tax

[12] *U.S. v. Commander*, 119 AFTR 2d ¶2017-620 (DC NJ).
[13] *Hodges v. United States*,119 AFTR 2d ¶2017-653, CA 10 4/10/2017.

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returns. He also had check-signing authority on the payroll account and had authority to hire and fire employees.

Although the nursing homes' payroll processor sent him biweekly reports detailing the amount of payroll taxes that had been withheld from the employees' paychecks and instructions for making the deposits to the IRS, Hodges failed to pay the employees' withheld payroll taxes to the IRS.

The IRS determined that Hodges was the responsible person who willfully failed to pay over the taxes. So, in February 2004 they began assessing the penalties personally against Hodges. They place Federal tax liens against his property as of the February 2004 date.

The Tenth circuit recognizes a reasonable cause exception, whereby the willfulness requirement "can be negated by showing the responsible person had reasonable cause for failing to pay withholding taxes held in trust for the IRS." A taxpayer can avoid liability only when the taxpayer has made reasonable efforts to protect the trust funds, but those efforts have been frustrated by circumstances outside the taxpayer's control. Hodges argued that he had such reasonable cause. He claimed to qualify for the reasonable cause exception because of the "urgent necessity of caring for the nursing home residents." Hodges stated he would have had to close the homes and that hundreds of employees would have been let go if he had paid over the taxes. He also stated that the owner of three of the four nursing homes for which he was appointed temporary manager promised he would pay the taxes. Lastly, Hodges stated he relied on an Oklahoma statute which states that a nursing homeowner is responsible for its costs and a lien can be placed against any and all assets of any owner. As a result, Hodges felt that he met the reasonable cause exception and should be liable for the unpaid payroll taxes.

The Court said that Hodges pointed to no evidence that could support a finding that he made reasonable efforts to protect the withheld taxes. It said, financial concerns do not constitute "circumstances outside the taxpayer's control" because virtually every violation of Code Sec. 6672 occurs due to the fact that a business is in financial trouble. The Court said that Hodges willfully failed to remit federal payroll taxes when he knew that the nursing homes had defaulted in its payment of employment taxes but nevertheless disregarded a known risk by relying on the assurances of others instead of doing more. The owners alleged promises to pay the taxes fell well short of evidence that Hodges attempted to protect the trust funds. Lastly, the Court stated that Oklahoma statute says nothing about taxes, nor does it attempt to preempt Code Sec. 6672. Even though an owner is liable for unpaid debt undertaken to meet expenses, the statute does not immunize a responsible person who, despite having the withheld payroll taxes available to pay the IRS, willfully fails to do so without reasonable cause. As a result, Hodges was a responsible party who acted willfully and therefore, owed the unpaid payroll taxes.

G. Company co-owner responsible party and reasonable cause exception not applicable

A district court found that the taxpayer, a 50 percent co-owner and chief executive officer (CEO) of the company, was liable for the Code Sec. 6672 trust fund recovery penalty and he did not satisfy the reasonable-cause exception to the reckless-disregard determination.[14]

IRC Section 6672(a) states that If an employer fails to properly pay over its payroll taxes, the IRS can seek to collect a trust fund recovery penalty equal to 100 percent of the unpaid taxes from a person who:

[14] *Hartman v. U.S.*, 120 AFTR 2d ¶ 2017-5158, (DC MI 8/16/2017).

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(1) is a “responsible person,” i.e., one who is responsible for collecting, accounting for, and paying over payroll taxes; and (2) willfully fails to perform this responsibility. In determining who is a responsible person, the courts generally look at several factors. In the Sixth Circuit, these factors include:

1. The duties of the officer as outlined by the corporate by-laws;
2. The ability of the individual to sign checks of the corporation;
3. The identity of the officers, directors, and shareholders of the corporation;
4. The identity of the individuals who hired and fired employees; and
5. The identity of the individuals who are in control of the financial affairs of the corporation.

Liability requires the existence of significant (as opposed to absolute) control of a corporation’s finances. A failure to pay over taxes is willful if a responsible person makes a deliberate choice to voluntarily, consciously, and intentionally pay other creditors rather than make tax payments. Willful conduct may also include a reckless disregard for obvious or known risks. More than mere negligence is required for willfulness. A person is not willful if, as a result of negligence, he or she is unaware of the default in the payment of payroll taxes. However, a reckless disregard of the facts and known risks that taxes were not being paid is sufficient to hold a responsible party liable.

In this case, Jon Hartman was a 50 percent co-owner and CEO of Spectrum Tool & Design, Inc. The company operated from April 2001 to October 2005. Dan Ott was a 50 percent co-owner and chief operating officer (COO) from April 2001 until Hartman laid him off in August 2005. Both Hartman and Ott had authority to handle money for Spectrum, open and close bank accounts in its name, and sign checks. Hartman signed employees’ paychecks, while Ott prepared the payroll tax deposit checks. Until December 2003, Spectrum used a third-party payroll service provider, ADP, to process its paychecks. But in December 2003, Spectrum was unable to remit the full amount of gross payroll, including employment taxes, due to ADP, and ADP terminated its contract with Spectrum. Spectrum was, however, able to pay employees their net payroll during this period. Hartman knew Spectrum could not timely pay its payroll taxes in December 2003, but he and Ott anticipated that they would be able to pay back the shortfall in January or February 2004. After being dropped by ADP, Spectrum began using an in-house software system for handling payroll, at Ott’s behest.

Hartman maintained that Ott was the sole person entrusted to ensure that Spectrum paid its employment taxes. Hartman contended that he did not learn that Ott was routinely failing to pay the payroll taxes until July 2004, at which time he arranged a meeting with the IRS to discuss the shortfalls. Going through Ott’s desk, Hartman discovered that despite Ott having regularly made out payroll tax checks, he had not paid the taxes. Up until that point, Hartman claimed that Ott’s regularly creating payroll tax checks had led Hartman to believe Ott was paying the taxes.

In May 2005, Hartman admitted that he first became aware of the delinquent taxes in December 2003 and that while the delinquent taxes were increasing, he authorized the payment of certain of Spectrum’s other financial obligations, including payroll, utilities, rent, supplies, operating expenses, loan payments, and equipment leases. In August 2005, Hartman laid off Ott for performance issues but still used him to pay Spectrum’s employment taxes.

The district court found that Hartman was a responsible person and that he failed to pay over the employment taxes. The Court found that Hartman conceded that, as early as July 2004, his suspicions were substantial enough to cause him to rifle through Ott’s desk where he discovered that, not only were taxes not being remitted, but Ott had manipulated the accounting software to reflect that the checks were,

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in fact, being remitted. Hartman then purported to have relied on the accounting software and Ott's assurances at a July 2004 meeting with the IRS, despite repeated reaffirmations that Ott was not paying the taxes. None of the mitigating circumstances, such as the reassurances of a CPA, or indicia that Ott's deception was well concealed (it clearly was not) were present here. By disregarding repeated red flags that Ott was not paying the payroll taxes, Hartman acted recklessly and, so, willfully, and therefore, he was responsible to pay the trust fund recovery penalty.

H. Taxpayer responsible party despite PEO contract

In a Chief Counsel Advice (CCA), the IRS held that, where a taxpayer contracted with a professional employer organization (PEO) to, among things, remit the taxpayer's employment taxes, and the PEO failed to remit those taxes, taxpayer was liable for the taxes.[15] The CCA rejected taxpayer's arguments that Code Sec. 3401(d)(1), which provides that a common law employer is not an employer for Federal income tax withholding purposes if he does not control the payment of wages, and §530 of the Revenue Act of '78, provided him relief from that liability.

Taxpayer is an S corporation which operates a business. In conducting its operations during the years in issue, Taxpayer hired workers to perform services in various capacities including accounting, administrative, marketing, and various other positions. Taxpayer filed Form 1120S, *U.S. Income Tax Return for an S Corporation*, for the years in issue and did not claim any deductions for officer compensation or salaries and wages. Instead, Taxpayer claimed deductions for "Employee Leasing" for its entire workforce.

Prior to the years in issue, Taxpayer entered into a contract entitled "PEO SERVICES AGREEMENT" with a third party. Under the contract:

1. Taxpayer assumed the responsibility for the day-to-day supervision and control of the individuals who the PEO retained to work at Taxpayer's location and the PEO did not and shall not have any liability, obligation, or responsibility therefore whatsoever.
2. Taxpayer must pay at least one (1) business day before each payroll date, an amount equal to all wages, salaries, and any all-other charges or payments to be paid to or with respect to the individuals who the PEO retains to work at Taxpayer's location.
3. Taxpayer must provide a security deposit or procure a letter of credit naming PEO beneficiary in the amount as determined by the PEO to cover wages, salaries, contributions, premiums, and any and all other charges or payments to be paid to or with respect to the individuals who the PEO retains to work at Taxpayer's location.
4. PEO may terminate the contract, immediately without notice, upon the occurrence of the Taxpayer's failure to pay any invoice in full in the amount and at the time specified when due or any breach or default of the contract by Taxpayer. In the event of termination for any reason whatsoever, the contract provides that Taxpayer is "responsible for payment of all wages, salaries, and employment related taxes."

The duties of the PEO under the contract included:

1. Administering Taxpayer payroll, designated benefits, and personnel policies and procedures related to the individuals who the PEO retains to work at Taxpayer's location.
2. Providing human resource administration and payroll administration.

[15] CCA 201724025.

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3. Furnishing and keeping workers compensation insurance covering the individuals who the PEO retains to work at Taxpayer's location in force.
4. Processing and paying wages from its own accounts to the individuals who the PEO retains to work at Taxpayer's location based on the hours reported by the Taxpayer.
5. Filing all employment tax returns (i.e., Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, and Form 941, *Employer's Quarterly Federal Tax Return*,) with the government and furnishing information returns (i.e., Forms W-2, *Wage and Tax Statement*) to the individuals who the PEO retains to work at Taxpayer's location.

Although the contract generally refers to the individuals who the PEO retains to work at Taxpayer's location as "co-employees," Taxpayer did not dispute that at all times during the years at issue it was the common law employer of the "co-employees" and had the right to direct and control all aspects of the employment relationship between itself and these individuals.

Taxpayer did not file any Forms 940 or Forms 941, or issue or file Forms W-2 with respect to any employees for any of the years at issue based on its contract with the PEO and took no steps to verify that the PEO filed and paid the employment taxes due or filed the appropriate returns. Taxpayer learned on audit that the PEO failed to remit applicable employment taxes to the government, and now asserts that it paid the amount in question in full to the PEO and is not liable for the unpaid employment taxes that the PEO failed to remit to the government.

The law dictates that for employment taxes to apply, an employer-employee relationship must exist. The existence of an employer-employee relationship generally is determined using the common law control test.

In the CCA, the IRS noted that the Taxpayer did not dispute it was the common law employer of the workers. Taxpayer also acknowledged that the common law employer has the responsibility to pay the underlying tax liabilities on wages it pays to employees. Taxpayer alleged, however, that it paid the requisite amount of wages, the employer share of FICA and the proper amount of FUTA taxes to the PEO, and that a PEO is "obligated by statute" under §3401(d)(1) to withhold employment taxes from those wages, and pay such taxes over to the government, making the PEO solely responsible for the payment of the employment taxes at issue.

The IRS determined that based on the provisions contained in the contract, the PEO is not considered to be in control of the payment of wages within the meaning of §3401(d)(1) because the PEO did not assume legal responsibility for payment of the wages to the employees. Under the terms of the contract, Taxpayer must pay the PEO an amount equal to the wages and salaries with respect to the workers in advance of the next payroll date. To ensure that the PEO will not be responsible for payment of wages to these workers, Taxpayer must provide a security deposit or letter of credit naming the PEO as beneficiary in the amount as determined by the PEO to cover the wages and salaries. Additionally, the PEO may terminate the contract immediately without notice and Taxpayer is "responsible for payment of all wages, salaries and employment related taxes." Thus, the PEO acted merely as a conduit for Taxpayer in making payroll and does not meet the standards in §3401(d)(1) and the regulations thereunder. Therefore, even though the Taxpayer paid all the payroll taxes to the PEO, the Taxpayer is still responsible for payment of the payroll taxes the PEO did not remit. In addition, §530 did not apply because it focuses on whether a worker is an employee not who is liable for the tax. Taxpayer agrees the workers were their employees.

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I. Nonprofit organization

A U.S. district court dismissed a complaint filed by the chairman of a nonprofit corporation's board seeking a refund of trust fund recovery penalties assessed against him after the corporation failed to pay its payroll taxes, finding that he failed to prove that he was not a responsible person who willfully failed to pay the taxes.[16] The taxpayer who becomes involved in running a financially distressed company exposes himself or herself to liability as a responsible person.

The Company, a nonprofit corporation that provided supportive living services, including transportation, nutrition, and care, for developmentally disabled clients, received funding from the Tennessee Department of Mental Retardation Services (DMRS). The director learned that third-quarter 2006 taxes were unpaid. He loaned the organization money to pay these taxes and the third-quarter taxes were paid. In December 2006, he learned of proposed raises for employees and voiced his objections to the other directors. No raises were given. On June 22, 2007, he became actively involved in the organization's financial affairs, assumed responsibility for writing its checks, and began operating the organization with the intent of making it a viable business. However, the organization ran into further financial difficulties. In mid-2007, DMRS began to withhold payments due the organization pending an investigation related to claims of lack of RN supervision and the organization could not meet payroll. The employees complained to the Tennessee Department of Labor (DOL). A DOL representative arranged for DMRS to release half of the funds to the organization to meet payroll. Although taxpayer claimed that DMRS released funds on the "express condition" that those funds be used for net payroll only, taxpayer failed to prove that. In fact, DMRS released more funds than were needed to meet payroll in July and August 2007. In March 2008, IRS assessed a trust fund recovery penalty against taxpayer. He made a payment to IRS for the second and fourth quarters of 2006 and all four quarters of 2007. He then sought a refund in the court.

1. Taxpayer had the status, as Chairman of the Board and a director, and the authority required to be a responsible person. The fact that he did not assume actual check writing authority until June 2007 only showed that he had the ability to assume that responsibility at any time. His actual ability to influence the organization was shown in his defeating the proposed pay raises in December of 2006.
   a. Although he had no ownership interest, did not hire or fire employees, and did not have check-writing authority, he clearly exerted significant and substantial control over the company's financial affairs by acting as a de facto line of credit, making start-up and bridge loans throughout its existence. In fact, he had the ability to force the organization out of business by simply withholding his periodic loans. Thus, if he chose, he could have exercised control certainly to the extent of assuring payment of trust fund taxes.
   b. He never asked for financial reports or inquired about the status of trust fund tax payments, despite knowing that the organization encountered financial difficulties about the middle of every month. He could have exercised his authority at any time. The fact that he chose not to exercise that authority or acquire available knowledge did not absolve him of his responsibility to see that the withholding taxes were paid.
   c. Organization had access to sufficient funds from which the delinquent taxes could have been paid. In fact, the amounts paid to taxpayer personally in repayment of his loans were more than sufficient to meet the organization's withholding tax liability.

[16] *Bunch v. Commissioner*; No. 2:10-cv-122 (E.D. Tenn. 2012).

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2. Even if taxpayer did not have actual knowledge of the tax delinquency, his conduct clearly constituted the requisite recklessness to meet the willfulness element. He should have known of the clear risk that withholding taxes were not being paid, not least because of the fact that he was required to loan money near the middle of each month for the organization to meet its financial obligations. He was thus fully aware of the organization's financial difficulties, and he had complete access to its books of accounts and the monthly financial reports to the board of directors. Even if these reports weren't provided him, he clearly had the authority to ask for those reports at any time.
   a. He had actual knowledge of the tax delinquency in December of 2006. If a responsible person subsequently learns that the company owes payroll taxes from a prior quarter, but nonetheless continues using company funds to pay other creditors, or allows funds to be disbursed to other creditors, the person's conduct is willful. Once a responsible person learns of the delinquent taxes, that person has an absolute duty to use all available corporate funds to pay off the deficiency. Failure to use available, **unencumbered** funds to pay the tax delinquency is willful conduct.
   b. Subsequent to his actual knowledge of a tax delinquency, the organization continued to expend significant sums of money to pay other creditors, to meet payroll, and to repay loans which taxpayer had made the corporation. He acquired complete access to, and control over, the financial records and affairs in late June 2007. In the months of July and August alone, corporate funds which exceeded the amount of the total tax delinquency were paid to employees, creditors, and to taxpayer himself.

J. Franchisee vice president liable for trust fund recovery penalties

A U.S. district court held the vice president of operations for a Golden Corral franchisee liable for trust fund recovery penalties, finding that he was a responsible person who willfully failed to remit employer withholding taxes for four tax quarters.[17] The company operated five Golden Corral restaurants. In the beginning of 1997, the owners decided to fire one of the company's two day-to-day managers. After consolidating the day-to-day operations under the remaining manager, the business continued to experience difficulties. In 1998, the owners decided to fire the day-to-day manager and hired taxpayer as a replacement. He had an extensive background in managing Golden Corral restaurants. He had worked for Golden Corral beginning in 1984, where he eventually attained the position of Regional Vice President. Taxpayer joined the company as the business's Vice President of Operations. In that position, he managed the business and was tasked with improving the restaurants' performance. He coordinated closely with one of the owners regarding all aspects of the business. In overseeing operations, taxpayer negotiated advertising contracts and worked closely with the owners in creating a payment plan for overdue invoices with its main grocery supplier. He had authority to hire and fire employees, as well as authority to write checks. One of his initial recommendations to help turn around the business was hiring two brothers to manage the business's accounting and payroll needs (the "Accountants"). Taxpayer worked closely with the Accountants in his role overseeing operations. He received and reviewed bills and invoices before forwarding them on to the Accountants. At some point, a signature stamp of taxpayer's signature was made and given to the Accountants, who had the authority to use the stamp on company checks and on tax returns. Taxpayer was aware of the financial difficulties from the beginning of his employment and was aware of the company falling behind on rent payments as well as payments to

[17] *Erwin v. United States et al.;* No. 1:06-cv-00059 (M.D. N.C. 2014).

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other vendors. Although he never looked at the company's tax returns, he did review individual stores' profits and losses statements, which indicated that the restaurants were losing money. He was aware throughout his tenure that the company generally did not have enough money to cover outstanding obligations and that the owners frequently had to make capital contributions. Shortly after he joined, the company began failing to pay its federal employee withholding taxes for the fourth quarter of 1998 through the third quarter of 1999.

1. Effective power or authority to pay taxes is the key factor in ascertaining whether an individual is a responsible person.[18] An individual's duty to collect, account, or pay taxes is considered "in light of the person's authority over an enterprise's finances or general decision making." The essential inquiry is whether a person has significant, but not necessarily exclusive, authority over corporate finances or management decisions.[19] The Fourth Circuit has developed a set of factors to assist in determining whether the circumstances indicate that a person was "responsible": whether the employee -- (i) served as an officer or director of the company; (ii) controlled the company's payroll; (iii) determined which creditors to pay and when to pay them; (iv) participated in the corporation's day-to-day management; (v) had the ability to hire and fire employees; and (vi) possessed the power to write checks.
   a. Although not an officer or director of the company, taxpayer was a high-ranking employee who worked closely with the owners and officers. While this first factor weighed in taxpayer's favor, his duties and level of responsibility indicated that he was a responsible person for §6672 purposes.
   b. Taxpayer argued that he did not control payroll. However, his ability to sign payroll checks and the corresponding tax returns coupled with the fact that his signature was apparently required on payroll documents illustrated that he was the party with ultimate authority and responsibility for running payroll. He could not, according to the court, now claim that he was not responsible for payroll duties simply because he delegated such tasks to others. The control of payroll factor skewed toward a finding that he was a responsible person.
   c. Taxpayer disputed whether he ever made determinations of which creditors to pay and which to not pay. He was handed an envelope of bills by his predecessor, who informed him that he needed to decide who would get paid. However, he recommended hiring the Accountants, he oversaw them, and he at a minimum participated in some contract negotiations for vendors. He received and validated invoices and bills before forwarding them on. When he received urgent calls from vendors demanding payment, he would inform the Accountants of such demands and that the vendor needed to be paid. Even if he did not explicitly direct the Accountants to pay such a vendor before or instead of another vendor, these actions nonetheless illustrated that he had the ability and authority to make decisions about payments to creditors. In his position as the head of all operations, his instructions were to the effect of "These guys need to get paid. They're yelling and screaming. Figure out what to pay them, okay?" These instructions were a form of prioritization, and they certainly provided a direction of when to pay creditors. He also participated in the decision-making process to develop a payment plan for past-due bills with the company's main

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[18] *Plett v. United States*, 185 F.3d 216 (4th Cir. 1999) (determining that responsible person status depends upon "whether [the taxpayer] had the actual authority or ability, in view of his status within the corporation, to pay the taxes owed" [internal quotations omitted]); *O'Connor v. United States*, 956 F.2d 48 (4th Cir. 1992).

[19] *Erwin v. United States*, 591 F.3d 313 (4th Cir. 2010).

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grocery vendor. Similarly, when it fell behind on rent payments, he joined the owners in negotiating with the company's commercial lessor. He made determinations about which creditors to pay and when to pay them. While this factor did not weigh overwhelmingly toward his being responsible, he failed to show that he did not effectively prioritize between creditors.

d. Taxpayer undoubtedly "participated in the corporation's day-to-day management" as the Vice President of Operations. He was never in charge of the financial side of the company; however, he had more than a threshold of participation in day-to-day operations, participating in coordinating with vendors, decision making with the owners, overseeing the Accountants, and managing the individual restaurants. He was indeed in charge of the majority of the day-to-day tasks. He validated bills and invoices. He worked with restaurant managers. His involvement was of a level that led to others perceiving him as president or CEO.

e. He had authority to hire and fire employees. Multiple individuals in a corporation may be a §6672 responsible person, and an individual need not have exclusive authority over management decisions.

f. Taxpayer possessed check-writing power. He argued that while he had official authority to write checks, such authority was only titular in nature. However, he had authority to sign checks, he did in fact sign checks, and he had given the authority to use his signature stamp in signing checks. This was not the case of a corporate employee who had check-writing authority but never signed checks with his or her name.

g. The majority of the factors supported a finding that taxpayer was a responsible person. Thus, the Court found that the totality of the circumstances established his responsible person status.

2. Knowledge of the unpaid taxes or reckless disregard for whether tax obligations are satisfied establishes the element of willfulness. A responsible person's intentional preference for creditors other than the United States establishes willfulness as a matter of law; such an intentional preference occurs when the responsible person knows of or recklessly disregards an unpaid deficiency. Once taxpayer was aware of the deficiency beginning in October 1999 and failed to rectify the situation, he willfully failed to pay the delinquent taxes for two months until his departure in December 1999. These tax deficiencies corresponded to tax quarters for which he was responsible. When a responsible person learns that withholding taxes have gone unpaid in past quarters for which he or she was responsible, he or she has a duty to use all current and future unencumbered funds available to the corporation to pay those back taxes.[20]

a. Taxpayer contended that his actions were not willful because the owners assured him that they would take care of the delinquent taxes. However, assurance from another person that taxes will be paid does not absolve the responsible person of his or her duty to pay the taxes.[21] As a responsible person, taxpayer had a duty to satisfy the outstanding tax obligation once he was aware of the problem, and he

[20] *Erwin v. United States*, 591 F.3d 313 (4th Cir. 2010).

[21] *Greenberg v. United States*, 46 F.3d 239 (3d Cir. 1994) (holding taxpayer acted willfully in not paying taxes despite taxpayer receiving assurances from his superior that tax delinquencies would be paid); *Denbo v. United States*, 988 F.2d 1029 (10th Cir. 1993) ("Denbo [the taxpayer] cannot escape liability by claiming that he relied on the assurances of others.").

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was not entitled to blindly rely on others' representations that they would resolve the situation.[22]

b. From October 1999, until December 1999, taxpayer had actual knowledge of the tax deficiencies. As a result, he had a duty to use unencumbered funds to pay the tax deficiencies. He failed to do so, despite having undisputed check-writing power and authority over incoming bills and invoices. His actions were willful within the meaning of §6672.

K. Company president denied refund of trust fund recovery penalties

A U.S. district court held that the sole shareholder and president of a company wasn't entitled to a refund of trust fund recovery penalties he paid, finding that he was a responsible person despite having delegated his authority to a manager who embezzled funds and failed to pay the company's taxes and that he willfully failed to pay over taxes.[23] Taxpayer owned real property (the "property") he leased to a farm equipment seller, until it closed. At the time it ended its lease with taxpayer, a representative for a line of tractors sold proposed that taxpayer start his own business on the property and become a dealer for the tractor company. Taxpayer was initially uninterested in starting a business because he was retired and lived far away from the property, but the tractor dealer then suggested that the manager of the closed farm equipment seller had 25 years of experience buying and selling tractors and could run the business.

They met and ultimately decided to form a company; the manager would run the business and would have the option to purchase the business at any time by repaying taxpayer's initial $150,000 investment in the company with interest. Pursuant to their verbal agreement, taxpayer hired the manager to manage every aspect of the business, including day-to-day operations, financial management, purchasing of product lines, payment of all of the company's bills, and other duties required to run an equipment sales business. The manager was responsible for supervising, hiring, and firing employees, as well as for submitting all tax forms and paying the company's payroll taxes. Taxpayer viewed his role as an investor, and essentially treated the company as if it belonged to the manager, but he never exercised the option to purchase the company. While taxpayer played a very limited role in the operation of the company, he signed the Articles of Incorporation as President; owned all of the shares; signed various contracts on behalf of the company as its president; and personally, guaranteed an operating line of credit eventually obtained by the company. He made telephone calls with the manager once or twice a month to discuss operations and made quarterly visits to check inventory and generally assess the business. He also reviewed balance sheets and annual statements. Prior to incurring the payroll tax liability at issue, taxpayer noticed and directed the manager to satisfy unpaid payroll obligations from 2005 and ensured the payroll obligations from 2005 were paid by the January 2006 deadline. Finally, taxpayer had authority to sign checks on the bank account, though he did not write any checks on the account and was listed on the check signature card as "owner."

Taxpayer later received notice from an Internal Revenue Service Agent that there were some serious issues with employment taxes for 2006 and 2007, the first-time taxpayer became aware that such payroll taxes had not been paid. Taxpayer subsequently learned that the manager had been embezzling, failing to pay creditors or pay payroll taxes, and stealing company assets. Upon discovering the fraud, he fired the manager and took over management. He ultimately decided to close because he believed he could not pay all of the liabilities and contribute sufficient working capital to keep the company going. Before

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[22] See, e.g., *Morgan v. United States*, 937 F.2d 281 (5th Cir. 1991) ("Reckless disregard includes failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid.").

[23] *Shore v. United States*; No. 1:13-cv-00220 (Ida. 2014).

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closing the company, however, taxpayer allowed more than $120,000 from the checking accounts to be paid to unsecured creditors other than the United States. Although he believed he should not be held liable for unpaid payroll taxes because he was not a responsible party and did not willfully ignore tax obligations, he ultimately paid $101,583.09 in trust fund recovery penalties to the United States, and later filed the suit to obtain a refund.

1. Taxpayer delegated full authority for handling finances and management to the manager, and for so long as he remained at the company taxpayer did not take an active role in financial matters. For purposes of §6672, responsibility is a matter of status, duty, and authority. Authority turns on the scope and nature of an individual's power to determine how the corporation conducts its financial affairs; the duty to ensure that withheld employment taxes are paid overflows from the authority that enables one to do so.[24] That an individual's day-to-day function in a given enterprise is unconnected to financial decision making or tax matters is irrelevant where the individual has the authority to pay or to order the payment of delinquent taxes. Similarly, delegation of authority to pay taxes will not relieve a person of responsibility.
    a. Courts have looked to a number of non-exclusive factors common in the §6672 case law, such as whether the taxpayer served as an officer of the corporation or a member of its board of directors, owned a substantial amount of stock in the company, participated in day-to-day management of the company, determined which creditors to pay and when to pay them, had the ability to hire and fire employees, or possessed check writing authority.[25] The Court must consider the totality of the circumstances to determine whether taxpayer had the "effective power" to pay the taxes owed.[26]
        - Taxpayer was the company's president. While the company did not have corporate bylaws delineating his specific corporate authority, and he did not exercise any of the traditional duties of a corporate president, taxpayer signed contracts on its behalf as its president, including inventory agreements the company needed in order to obtain the farm equipment it sold, and he also personally guaranteed such contracts. Taxpayer also signed on the company's behalf and as its president when the company opened a line of credit at a bank, and personally guaranteed the bank line of credit.
        - Taxpayer was the sole shareholder and had the effective power to change the company's employees and thereby direct the business of the corporation. He also possessed, but did not utilize, check writing authority on the company's account.
        - He did not manage the day-to-day operations of the company or, at least while the manager served, determine which creditors to pay and when to pay them. However, he had monthly telephone calls with the manager to discuss the business, made unannounced visits to assess inventory, and reviewed financial statements.

[24] *Purcell v. United States*, 1 F.3d 932 (9th Cir. 1993).
[25] See, e.g., *Conway v. United States*, 647 F.3d 228, 233 (5th Cir. 2011); *Johnson v. United States*, 734 F.3d 352, 361 (4th Cir. 2013); *United States v. Jones*, 33 F.3d 1137, 1140 (9th Cir. 1994).
[26] *Erwin v. United States*, 591 F.3d 313 (4th Cir. 2010).

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- With respect to the 2005 unpaid tax liabilities, taxpayer had the authority to order the payment of delinquent taxes.[27] Although taxpayer delegated financial management to the manager, as well as the authority to determine which creditors to pay and when to pay them, the cases are clear that delegation of such authority does not relieve a party of responsibility under §6672. A taxpayer may be a "responsible person" if he or she had the authority required to exercise significant control over the corporation's financial affairs, regardless of whether he or she exercised such control in fact. Despite delegating his authority and permitting the manager to run the daily affairs, taxpayer remained a "responsible person" because he had effective control of the corporation and the effective power to direct the corporation's business choices, including the withholding and payment of trust fund taxes.
- Taxpayer was also ultimately responsible for hiring and firing the manager. Although the manager was responsible for hiring and firing employees, taxpayer, in his capacity as president, obviously possessed enough authority over corporate affairs to independently investigate manager and ultimately force him out of the company. Within two months of learning of the tax deficiencies, taxpayer took complete control of the financial operations, which also established his authority to do so.

b. The Court found taxpayer a responsible person as a matter of law.[28]

2. A long line of decisions in the Ninth Circuit have defined willfulness as a voluntary, conscious, and intentional act to prefer other creditors over the United States.[29] In order to satisfy the willfulness prong, no bad motive need be proved, and conduct motivated by reasonable cause, such as meeting the payroll, may be willful.[30] If a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, even to meet the payroll out of personal funds he or she lends the corporation, the Court's precedents require that the failure to pay withholding taxes be deemed willful.

   a. A taxpayer may act willfully even though he or she does not learn about unpaid taxes until after the corporation has failed to pay them. When a responsible person learns that withholding taxes have gone unpaid in past quarters for which he or she was responsible, he or she has a duty to use all current and future unencumbered funds available to the corporation to pay those back taxes. If the taxpayer instead knowingly permits payments of corporate funds to be made to other creditors, a finding of willfulness is appropriate.

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[27] See *Denbo v. United States*, 988 F.2d 1029 (10th Cir. 1993) (although "it was Allred...who controlled the day-to-day operations of the corporation and made decisions concerning the payment of creditors and disbursement of funds," Denbo remained responsible where he had "significant, as opposed to absolute, control of the corporation's finances."); *McDermitt v. United States*, 954 F.2d 1245 (6th Cir.1992) ("[a]lthough not an officer of the corporation," plaintiff was responsible because "[h]e had the power and the authority to direct the payment and non-payment of the corporation's liabilities.").

[28] *Erwin v. United States*, 591 F.3d 313 (4th Cir. 2010) (affirming finding plaintiff was responsible person as a matter of law where plaintiff owned one-third interest in company and served as a corporate officer and director, selected business sites, hired and fired employees, and, within months of learning of the company's tax deficiencies, took complete control of the company's financial operations); *Jefferson v. United States*, 546 F.3d 477 (7th Cir. 2008) (board president was a responsible person as a matter of law because he secured loans and directed past payment of taxes for the corporation, reviewed financial reports, and had check-signing authority); *Kinnie v. United States*, 994 F.2d 279 (6th Cir. 2993) (corporate vice president and fifty-percent shareholder was a responsible person as a matter of law because he had check-signing authority, hired an accountant to review the books, and eventually took control of the business).

[29] *Davis v. United States*, 961 F.2d 867 (9th Cir. 1992).

[30] *Buffalow v. United States*, 109 F.3d 570 (9th Cir. 1997) (citing *Phillips v. United States IRS*, 73 F.3d 939 (9th Cir.1996); *Jones v. United States*, 60 F.3d 584 (9th Cir.1995); *Klotz v. United States*, 602 F.2d 920 (9th Cir.1979); *Teel v. United States*, 529 F.2d 903 (9th Cir.1976)).

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b. Since he learned of the unpaid tax liability in August 2007, taxpayer paid more than $120,000 to unsecured creditors. His failure to remedy the payroll tax deficiencies while subsequently allowing corporate payments to be made elsewhere, including to unsecured creditors, constituted "willful" conduct.[31]

3. The Supreme Court held that new management of a corporation was not personally liable for a §6672 penalty upon using after-acquired revenue to satisfy creditors other than the United States, provided the new management assumes control when a delinquency for trust fund taxes already exists and the withheld taxes have already been dissipated by prior management.[32] To hold a taxpayer personally liable to the extent of after-acquired funds for taxes owed during a time in which he or she was not a responsible person would be to discourage new investors from attempting to salvage a failing business -- which, if the salvage effort were successful, would enable the government to collect more in delinquent taxes than if the business failed.

   a. Taxpayer did not have responsibility for management at the time the tax delinquency was incurred, and the company's debts exceeded its available assets when taxpayer took over management of the company, but taxpayer was a responsible person at the time the 2006 and 2007 tax liability accrued. Taxpayer was not a new purchaser but was instead a responsible person when the tax liability for 2006 and 2007 went unpaid. As such, holding him personally liable for an amount based on after-acquired funds would not discourage new investors from attempting to save the failing business. He already was an investor and had the authority to handle the company's finances (though he delegated this authority to the manager) at the time the tax liability was incurred.

   b. The Ninth Circuit expressly declined to extend the exception to a case where a company president delegated authority to run a corporation to a manager but resumed control of the corporation upon learning of the manager's embezzlement. It does not apply in cases where existing, but inactive, management takes control of a business after learning of unpaid tax liability.[33]

   c. A company president who was unaware the company's taxes had not been paid until after they were due, and who, once he learned that the company was not paying employees' withholding taxes, assumed a more active role in supervising corporate disbursements, could not apply the exception.[34] Transfers in responsibility internal to the corporation cannot be equated with the accession of new management that occurred in the Supreme Court case. Where an individual is a responsible person both before and after tax liability accrues, there is a duty to use **unencumbered** funds acquired after the withholding obligation becomes payable to satisfy that obligation.[35] Once he became aware of the tax liability in August 2007, taxpayer had a duty to ensure that the taxes were paid before any payments were made to other creditors.[36] That he failed to do so established willfulness as a matter of law.

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[31] See *Phillips v. United States*, 73 F.3d 939 (9th Cir. 196) (where a responsible person is aware that trust fund taxes are unpaid but permits the business to continue its operation and pay other creditors, the willfulness prong is satisfied).

[32] *Slodov v. United States*, 436 U.S. 238 (1978)

[33] *Purcell v. United States*, 1 F.3d 932 (9th Cir. 1993).

[34] *Davis v. United States*, 961 F.2d 867 (9th Cir. 1992).

[35] A taxpayer does not act willfully by paying funds to a secured creditor over the government because such funds are encumbered and thus unavailable to satisfy tax liability, *Nakano v. United States*, 742 F.3d 1208 (9th Cir. 2014).

[36] *Mazo v. United States*, 591 F.2d at 1157 (5th Cir. 1979).

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L. Accountants hit with trust fund penalty tax for failure to remit client's payroll taxes

A district court has concluded that two brothers in an accounting firm were each liable for over $325,000 in trust fund recovery penalties due to their failure to remit a financially troubled client's unpaid withholding taxes to the IRS.[37] The IRS sought to have them held responsible for the penalties even though they were not owners, principals, or directors of the taxpaying corporate client. The Fourth Circuit, the court in this case, had developed a non-exhaustive list of factors to examine in determining whether a taxpayer is a responsible person. It looked at whether the employee: (1) served as an officer or director of the company; (2) controlled the company's payroll; (3) determined which creditors to pay and when to pay them; (4) participated in the corporation's day-to-day management; (5) had the ability to hire and fire employees; and (6) possessed the power to write checks.[38]

1. The accounting firm ("Accounting") managed payroll and accounts payable, calculated employee withholding tax liability, prepared federal Forms 941, and made federal withholding tax deposits for an unrelated company ("Client"). Accounting would get the payroll information from each of Client's individual stores and input it into the software system, issue employee payroll checks, and calculate Client's withholding tax deposit. Accounting initiated this process by accessing the computer servers for each store and retrieving the relevant employee information. Shortly after Client began experiencing financial problems its federal withholding taxes went unpaid, either in whole or in part.
    a. During this time, Accounting knew that the company owed, and was not paying over to IRS, withholding taxes, including the amount owed for any particular pay period, and the amount accruing over time. Accounting repeatedly informed management that the withholding taxes were due and owing, and that Client did not have enough money to pay employee payroll, vendor, and creditor obligations, and the withholding taxes in full. In addition, on two separate occasions, Accounting met with members of management to discuss Client's outstanding tax liability and to come up with a proposed payment plan. After each meeting, Accounting sent the proposed plan to the IRS on behalf of Client.
    b. However, management instructed Accounting to continue issuing payroll checks and checks to certain vendors and creditors during the time period when the company owed federal withholding taxes to the IRS. On a number of occasions, Accounting received instructions to issue checks directly to management members in amounts that Accounting knew would limit or prohibit payment of the withholding taxes owed to the Service. No one at Client expressly instructed Accounting not to pay the employee withholding taxes at any point; however, Accounting did not remit the full amounts owed in federal withholding taxes to IRS during the time period relevant to this case.
2. IRS assessed trust fund recovery penalties against Accounting's owners that totaled over $325,000 each. The district court ruled that the principals of Accounting were jointly and severally liable for the trust fund recovery penalty because they both met the requirements to be responsible persons.
    a. The court noted that even though Accounting's owners were not Client's officers or directors, it was clear that they had **substantial control over** its **payroll operations**. Accounting's owners were the first people to know the amount of

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[37] *Erwin v. United States*, No. 1:06-cv-00059 (M.D. N.C. 2013), 111 AFTR 2d ¶2013-426.
[38] *Plett v. United States*, 84 AFTR 2d 99-5403 (4th Cir. 1999).

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withholding taxes owed for each pay period and the amount of unpaid taxes accruing over time, and were the persons tasked with paying over the appropriate tax amounts owed.

b. Accounting's owners had seemingly unfettered access to the company operating account and general authority to draw from that account to complete an electronic transfer of funds directly to the IRS at the end of each pay period. In addition, for purposes of paying employees and various company vendors and creditors, Accounting's owners had the authority, and the responsibility, to write and issue checks on behalf of Client.

c. There was no evidence that anyone actually prevented Accounting from timely paying the withholding taxes, or that Accounting's owners were under any threat from management regarding the payment of the taxes owed.

3. Accounting's owners willfully failed to perform their responsibility because they issued thousands of checks to Client employees, knowing that the money issued through these checks could have been used to satisfy the amounts owed to the IRS. Accounting's owners intentionally preferred other creditors over the IRS.

Question to Ponder:

With the increased emphasis by the IRS on collecting delinquent payroll taxes from anyone associated with a company's payroll taxes, discuss strategies a CPA might use to combat such an assessment.

M. Office manager

A U.S. district court denied cross-motions for summary judgment regarding an office manager's liability for a company's unpaid employment tax liabilities in her suit for a refund of trust fund recovery penalties, finding that it was unclear whether she was a responsible person who willfully failed to pay the company's tax liabilities.[39] Taxpayer's brother-in-law owned the company, and in 2004 taxpayer became the company's office manager. She answered phones, opened mail, typed, and proofread estimates for jobs, and organized the company's files. She also helped the company process payroll. Each pay period, all of the company's painters and other staff members submitted time sheets to her brother-in-law. Once he had reviewed and approved them, she entered the hours worked into QuickBooks, and then used the program to generate payroll checks that either she or her brother-in-law signed. Plaintiff could sign these checks because he had given her full check signing authority on both of the company's bank accounts. She also used QuickBooks to generate reports showing the company's outstanding bills that she gave to her brother-in-law, who told her which bills to pay. She used QuickBooks to generate the checks for those bills and either she or her brother-in-law signed them. In addition to these duties, she helped prepare and file the company's federal employment tax returns. She used QuickBooks to complete the company's employment tax returns. She gave the returns to him to review, and, once he had approved them, she signed and filed them. Taxpayer claimed that she signed tax returns and checks merely as a convenience to her brother-in-law because he was frequently out of the office at job sites and that she did not help him make financial decisions, which was corroborated by him. He maintained full control over the day-to-day operations of the company.

1. The company began to have cash flow problems because several of its customers declared bankruptcy and were unable to pay their bills. It became impossible for taxpayer to balance the company's checkbook, and, in July 2006, she noticed that the employment

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[39] *Arndt v. United States*; No. 2:11-cv-00546 (E.D. Wis. 2013).

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tax return for the previous quarter showed that it had failed to pay its taxes. The tax returns that she submitted for the third and fourth quarters of 2006 and the first quarter of 2007 showed similar deficiencies. She asked about these tax debts and her brother-in-law reassured her that he was taking care of the taxes. In August 2007, the company shut down. After the shut-down, the IRS assessed a tax penalty against both taxpayer and her brother-in-law for the 2006 and 2007 unpaid taxes.

2. Taxpayer had full check-signing authority, paid many of the bills, and filled out and signed the company's employment tax returns. These duties are usually performed by someone with the authority to decide which creditors will be paid.[40] However, this is not always the case.[41] She maintained that her duties were purely ministerial. The Service maintained that taxpayer acted willfully, knew the company was having financial problems and was behind on its employment taxes but taxpayer claimed that she did not know the taxes were not being paid because her brother-in-law told her he was taking care of them, and he supported this assertion. The court found these issues to be questions of fact to be decided by a jury.

N. Manager liable

A district court held an office manager liable for $2.9 million in trust fund recovery penalties plus interest, finding she was a responsible person at her company and arranged to pay the company's creditors over a four-year period even though she knew the company had not paid employment taxes.[42] Taxpayer was a responsible person for the Company for each quarter of 2006 through 2010. She was the Company's Officer Manager throughout that time period. She had substantial authority over payroll because she prepared and signed the Company's payroll checks. Because she was charged with preparing checks to creditors, she necessarily determined which creditors to pay. She participated in day-to-day management of the Company, including making decisions about employee compensation, maintaining the Company's books and records, and preparing financial information to be presented at shareholder meetings. At all relevant times, she had authority to, and did, sign checks drawn on the Company's bank account. She participated in decisions regarding the hiring and firing of employees. From 2006 to 2010, she was aware of the Company's unpaid employment tax liabilities as they accrued. However, she continued to prepare and sign checks to pay other creditors in preference over the United States. She acted willfully in failing to pay over to the Service the taxes withheld from the wages of the Company's employees.

O. Court refuses to abate trust fund recovery penalties

A U.S. district court refused to abate trust fund recovery penalties assessed against the vice president and construction manager of a construction company because the court could not determine based on the facts presented that he did not willfully fail to pay over the company's trust fund taxes.[43] Company was a construction company owned 100% by a third party who also served as the president; taxpayer served as the company's vice president and construction manager. The company went out of business in 2009 and the third party filed for bankruptcy. When the company began to experience cash flow problems, it was forced to choose between paying its subcontractors to keep its projects moving forward lest "the jobs shut down and everything implodes" or pay its payroll taxes. Taxpayer was vice president and had check signing authority, but he had no significant role in the company's tax planning. The company's comptroller

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40 See *Jefferson v. United States*, 546 F.3d 477 (7th Cir. 2008) (finding taxpayer responsible because his involvement in the company's financial affairs was "significant" and "included more than simply writing checks")

41 *Godfrey v. United States*, 748 F.2d 1568 (Fed. Cir. 1984) ("The mechanical duties of signing checks and preparing tax returns are . . . not determinative of liability under § 6672.").

42 *Miller v. United States et al.*; No. 3:13-cv-00728 (E.D. Va. 2014).

43 *Moser v. United States*; No. 4:12-cv-00607 (E.D. Ark. 2014).

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stated that taxpayer did not have authority to decide independently that the company funds should be disbursed for any purpose except for projected related expenses. All invoices were reviewed and approved for payment by a project manager and sent to the accounting department for future checks to be issued and that these checks were signed by taxpayer as a convenience and as an audit function. Taxpayer did not prepare any payroll tax returns or discuss any payroll tax issues with the IRS, he never participated in a formal company strategy session about the payroll tax liability, and that in his role in the company, he did not have the authority to fail willfully to disburse any funds in avoidance of the payroll tax obligations. The third party likewise testified in his deposition that taxpayer did not have the authority to make the call on not paying the taxes after August 2008, when the third party's outside Certified Public Accountant (CPA) notified him that there was a payroll tax issue and taxpayer was not in a position to direct the company not to pay its taxes. Taxpayer remained vice president, all his other responsibilities remained intact, he had the authority to prioritize which of the company's creditors were paid when money was tight, and taxpayer was part of the decision process of deciding to pay the company's subcontractors instead of paying the company's payroll taxes (at least prior to August 2008).

1. A "responsible person" under §6672 is someone who has the status, duty, and authority to avoid the corporation's default in collection or payment of taxes. Signs of a "responsible person" in this context include holding a corporate office, control over financial affairs, the authority to disburse corporate funds, stock ownership, and the ability to hire and fire employees. "[W]here a person has authority to sign the checks of the corporation, or to prevent their issuance by denying a necessary signature, or where that person controls the disbursement of the payroll, or controls the voting stock of the corporation, he will generally be held responsible." To trigger liability, a person must have significant decision-making authority over the corporation's tax matters, and a person's technical authority to sign checks and duty to prepare tax returns are not enough to make the person responsible under §6672.[44]
2. A responsible person acts willfully if he or she acts or fails to act consciously and voluntarily and with knowledge or intent that as a result of his [or her] action or inaction trust funds belonging to the government will not be paid over but will be used for other purposes, or by proceeding with a reckless disregard of a known or obvious risk that trust funds may not be remitted to the government.[45]

P. Company president liable for trust fund penalty despite taking action upon learning of deficiency

A district court found the taxpayer, who was the CEO, president, and treasurer of a company of which he had no ownership interest was liable for the trust fund recovery penalties.[46] Taxpayer's positions in company plus the facts that he managed daily operations, had hiring/firing and check-writing authority, and made decisions regarding creditor payments clearly showed he was responsible person, even if he was not person primarily responsible for paying taxes; and facts that he paid his own and other employees' salaries as well as other creditors while knowing taxes were unpaid clearly showed willfulness. Although he claimed to have been deceived about the tax situation by the former finance director during earlier quarters, such was irrelevant and did not change the willfulness finding.

44 See *Kenagy v. United States*, 942 F.2d 459 (8th Cir. 1991).
45 *Ferguson v. United States,* 484 F.3d 1068 (8th Cir. 2007) (quoting *Keller v. United States,* 46 F.3d 851(8th Cir. 1995) (quoting *Honey v. United States,* 963 F.2d 10837 (8th Cir. 1992)).
46 *Arriondo v. U.S.*, 118 AFTR 2d 2016-5205 (DC TX 2016).

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Taxpayer ran the business along with other employees and was part of the group that handled the day-to-day operations of the company, but he was focused on increasing sales. He met with company executives weekly and was informed about operations. At these weekly meetings, taxpayer always asked the financial director or controller if there was enough money to buy steel and to cover employee salaries.

Taxpayer had authority to hire and fire employees, the authority to enter into contracts on behalf of American Steel, and input into employee salary amounts. He had access to the company's books and records and was always an authorized check signer. American Steel received monthly bank statements, and taxpayer could therefore see how much money American Steel was receiving and spending after he knew of the unpaid taxes. He also had the authority to purchase and sell assets for American Steel during the period in question.

American Steel faced financial challenges due to the economic downturn in 2008. Taxpayer was aware of that American Steel's finances were in trouble and that the company always had a challenge financially and struggled with cash.

In April of 2009, the State of Texas sent American Steel a notice of levy for unpaid excise tax. Ms. Latiolais, a CPA, and American Steel's director of finance assured the taxpayer that the state tax issue was a timing issue related to a tax return, and she was able to work out a payment schedule fairly easily. Taxpayer did not investigate further or inquire about other potential tax issues.

Throughout the period in question, taxpayer was aware of the requirements to withhold and pay payroll taxes and to pay taxes quarterly. American Steel paid payroll taxes without incident for over a year after taxpayer began working there. However, American Steel's quarterly federal tax return forms (the "Forms 941") for the fourth quarter of 2008 and the first quarter of 2009 show taxes were still due when the returns were filed, with partial tax deposits for the fourth quarter of 2008 and no tax deposits for the first quarter of 2009.

Latiolais abruptly left American Steel in early 2009. She prepared, signed, and filed the tax return for the fourth quarter of 2008. She prepared the return for the first quarter of 2009 but left the company before filing it. She did not present taxpayer with the returns for his review and had not done so in the past. Taxpayer did not follow up with Latiolais regarding payment of employment taxes, did not ask to see payroll tax deposits, and did not ask to see any evidence that the taxes were being paid. He had relied on Latiolais and the "sufficient, sophisticated" procedures that had been in place and effective since before he began working at American Steel even after learning of the delinquent state excise taxes.

On May 18, 2009, Mr. Dawson, who began acting as controller after Latiolais's departure, informed taxpayer that Latiolais had been using employee payroll tax trust fund money to pay creditors rather than the IRS. That was the first-time taxpayer learned of the unpaid taxes. On the same day, Dawson told taxpayer that American Steel did not have enough money to pay the taxes owed to the IRS, that Latiolais had lied to him about American Steel's finances, and that she had instructed her employees not to pay federal withholding taxes to the IRS.

Taxpayer met with a bankruptcy attorney approximately one week after learning of the unpaid taxes. The bankruptcy attorney told taxpayer to complete the shutdown of the company and to gather the necessary information for bankruptcy. American Steel filed for bankruptcy protection on June 5, 2009, 18 days after Dawson informed taxpayer of the unpaid taxes. Taxpayer approved other payments and checks to

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employees and other creditors after he learned of the unpaid taxes. He received compensation from American Steel after he learned of the unpaid taxes because he continued to perform necessary functions to prepare the company for bankruptcy on the advice of the bankruptcy attorney. The bankruptcy attorney told him he was entitled to be paid for his services in shutting down the company because he was not an owner. He continued paying employee wages, paying certain creditors, and in an attempt to complete a large order to raise money for the taxes, he paid $9,000 for raw materials to begin a new customer project.

Taxpayer admitted he was a responsible party. However, he believed that Latiolais had primary responsibility for paying taxes and he should therefore be absolved from the liability. The Court stated the statute applies to any responsible person, not just the person most responsible for paying taxes.[47] The Court concluded that taxpayer should not be absolved from the liability as he was a responsible person, notwithstanding the actions by Latiolais.

The Court then moved onto the willfulness standard. The Court said that willfulness is proved by evidence that the responsible person paid other creditors with knowledge that withholding taxes were due at the time. “Willfulness only requires a voluntary, conscious, and intentional act, not a bad motive or evil intent.” Taxpayer contends that Latiolais’ deception prevented him from taking action earlier and that no payments to creditors of American Steel were made after he learned of the failure to pay. However, a responsible person who learns of the underpayment of taxes must use later-acquired unencumbered funds to pay the taxes; failure to do so constitutes willfulness.[48] It is undisputed that taxpayer and Dawson agreed to attempt one more job to earn the money to pay the taxes, and that they spent at least $9,000 attempting to buy steel after learning of the unpaid taxes. In addition, he paid salaries, including his own after he knew the liability existed. The Court found that even if there was not enough money to fully satisfy the back taxes owed to the IRS on May 18, 2009, taxpayer allowed deposits for new steel to be paid out of what limited funds the company had. He thus used unencumbered funds to be used for something other than the taxes after discovering the unpaid taxes. As a result, and in light of this authority, the Court concluded that taxpayer acted willfully.

Q. Taxpayer was responsible person who acted willfully when he loaned money to business to make payroll

A U.S. district court held that the doctor, who was the medical practice founder, was liable for the trust fund recovery penalties because he was indisputably the responsible person who acted willfully when he loaned money to the practice to make payroll, knowing the taxes were going unpaid.[49] Taxpayer’s preferential lending arrangement, where he expressly restricted that funds be used for payroll, was not encumbrance legally sufficient to excuse him from liability and his claim that he acted morally and generously in using his own funds to cover payroll was not reasonable cause for nonpayment of taxes since he consciously used those funds to pay creditors other than government.

Taxpayer founded Family Practice Associates of Houston, a medical-services provider, in 1979. In 1995, Family Practice hired Richard Stephen, Jr., as its Chief Financial Officer. By 2009, Family Practice owed over $10 million in unpaid payroll and other withholding taxes. Taxpayer learned that these taxes were unpaid on May 11, 2009. Stephen pleaded guilty to three counts of felony theft of money that he embezzled from Family Practice.

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47 *Barnett v. I.R.S*; 71 AFTR 2d 93-1614 [988 F.2d 1449, (citing *Howard*, 711 F.2d at 73)].

48 *Barnett*, 988 F.2d, 1449 (citing *Mazo*, 591 F.2d at 1157; *Turnbull*, 929 F.2d at 179-80; *Wood*, 808 F.2d at 416).

49 *McClendon v. U.S.*, 118 AFTR 2d 2016-6549 (DC TX, 11/17/2016).

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Family Practice stopped operating and remitted its remaining receivables to the IRS to pay toward the tax liability. Taxpayer made a $100,000 personal loan to Family Practice for the restricted purpose of using the funds to pay the May 15, 2009, payroll. Family Practice used that loan to pay its employees. He was assessed a total of $4,323,343.70 in trust fund recovery penalties. He paid a small part, then sued for a refund and abatement of the remaining penalty amount.

Taxpayer concedes that he was a responsible person within the statute. The only issue was whether he willfully failed to collect, account for, or pay taxes that Family Practice owed to the IRS. The Court determined that once an assessment of penalty taxes is made and it is established that the taxpayer is a responsible person, the burden of proving lack of willfulness is on the taxpayer.[50] A responsible person has a duty to ensure that a taxpayer's unencumbered funds are used to pay back taxes it owes the IRS, rather than to pay other creditors. Willfulness requires only a voluntary, conscious, and intentional act, not a bad motive or evil intent.[51] A considered decision not to fulfill one's obligation to pay the taxes owed, evidenced by payments made to other creditors in the knowledge that the taxes are due, is all that is required.[52] Willfulness is normally proved by evidence that the responsible person paid other creditors with knowledge that withholding taxes were due at the time to the U.S. Payment of wages to employees counts as a payment to a creditor for purposes of this principle.[53] If a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, *even to meet the payroll out of personal funds he lends the corporation*, has acted willfully within the meaning of the statute.[54] The Fifth Circuit has made clear that a taxpayer who consciously decides to use unencumbered funds to pay a creditor other than the government cannot benefit from the reasonable-cause defense.[55] The Court found that the taxpayer and had no basis for a different result and therefore was found to meet the willfulness requirement. As a result, he was liable for the trust fund recovery penalties.

R. Business owner's wife was not responsible person despite bank signatory authority

The Tax Court concluded that the taxpayer lacked the authority to control the financial affairs of the business or exercise any significant authority over the disbursement of Dey Corp.'s funds. Notwithstanding taxpayer's signatory authority and her spousal relationship to one of the corporation's owners, the substance of taxpayer's position was largely ministerial, and she lacked actual authority.[56] Taxpayer's husband and his business partner, Mr. Stamps, jointly purchased franchise rights and opened a restaurant and wine bar named "The Grape" in Florida. Mr. Stamps ran the day-to-day operation of the restaurant while the role of taxpayer's husband was that of a silent partner and investor. When Dey Corp. was incorporated, Mr. Stamps was listed as an officer and director. Taxpayer had no ownership interest in the business. In addition, she had no time to devote to a business venture because during the years at issue, taxpayer's primary responsibility was that of care giver to her disabled son. Shortly after Mr. Stamps and taxpayer's husband began engaging in preliminary business matters, Mr. Stamps was unexpectedly hired for a short-term job elsewhere. As a result, most of the pre-opening responsibilities fell upon taxpayer's husband. Because of his busy schedule, taxpayer's husband directed her to carry out some of those responsibilities. Pre-opening responsibilities involved checking the site premises during

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50 *Mazo v. United States*, 591 F.2d 1151, (5th Cir. 1979).
51 *Barnett*, 988 F.2d, 1449.
52 *Howard v. United States*, 711 F.2d 729, 736 (5th Cir. 1983).
53 *Logal v. United States*, 195 F.3d 229, (5th Cir. 1999).
54 *Phillips v. U.S.*; I.R.S., 73 F.3d 939, (9th Cir. 1996).
55 *Logal v. United States*, 195 F.3d 229, (5th Cir. 1999).
56 *Christina M. Fitzpatrick v. Commissioner*, TC Memo 2016-199.

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construction, resolving permitting issues, and opening the bank account, which she had full signature authority on. Dey Corp. engaged Paychex as their full-service payroll support. In addition to preparing employee paychecks and determining payroll tax liability, Paychex would debit the business' bank account; directly deposit Federal payroll taxes; and electronically file Forms 941, *Employer's Quarterly Federal Tax Return*. Dey Corp. hired Mr. Chislett as the general manager of the restaurant. Mr. Chislett was responsible for carrying out the day-to-day business operations. He managed the employees, paid creditors, and oversaw purchases from vendors. He was responsible for hiring and firing personnel. He was also Paychex's main contact during the periods at issue, and he maintained control over the payroll process. Taxpayer did not have a significant role at the restaurant. While she was directed to establish the business' bank account and contract with Paychex during the pre-opening phase of the business, she became decidedly less involved once the business was operational. Her main responsibilities were delivering checks, relaying electronic bank account balances to Mr. Chislett, and delivering the business' mail that was sent to her private mailbox. She occasionally transferred funds to and from the corporate bank account at the direction of Mr. Stamps or her husband. She issued checks at the direction of Mr. Stamps or her husband for some of the business' recurring monthly expenses. She made no operational decisions. She did not have the proper education, training, or experience to hold a management position at the restaurant. Because the restaurant had no business location at the time Paychex was first contracted, the payroll checks were initially delivered to taxpayer's home address. Later, once the business formally opened, Paychex began delivering the payroll checks directly to the business location. However, employees were rarely onsite to receive the payroll checks on Tuesday mornings because the business would not open until later in the day. Therefore, the parties reverted to having the checks delivered to taxpayer's petitioner's residence. Upon delivery, taxpayer was directed to sign the checks and deliver them to the business premises on Tuesday afternoons. She was not responsible for and did not review statements included in the Paychex package.

Within a year the business was losing money. As a result, Mr. Chislett became responsible to find ways to increase sales. Unfortunately, the ideas he implemented were very costly and as a result, checks issued to vendors began to bounce. As a result of the bounced checks, vendors began to lose faith in the business' ability to pay its bills, and many demanded cash on delivery or certified checks. Mr. Chislett therefore began to pay creditors by first using cash received from daily operations. When the cash balance at the restaurant was exhausted, he would resort to using standard checks (if the creditor still accepted standard checks) or certified checks. The owners limited the number of checks available to Mr. Chislett at any one time, presumably in an effort to reign in his spending. Taxpayer was directed to deliver to Mr. Chislett a small number of blank non-payroll checks when she delivered the weekly payroll checks. In 2008, the bank account became frozen, so taxpayer was directed to open a new bank account, which she did. Four months later, in November 2008, Paychex tried to withdraw money from the new bank account to pay the taxes and an invoice. The electronic withdrawals were rejected. This was the last time Paychex attempted to debit any taxes from a Dey Corp. bank account. Paychex continued to produce payroll checks and **reference copies** of Forms 941. The **reference copies** of Forms 941 prepared by Paychex reflected that there was no balance due and owing and that there was no need to file Forms 941. The signature blocks were printed with the following words: "REFERENCE COPY PREPARED BY PAYCHEX" and "DO NOT FILE." Furthermore, the payroll checks and Paychex invoices for payroll services continued to be debited from the corporate account. However, Paychex did not debit the payroll tax portion from the account, make payroll deposits on the business' behalf, or file Forms 941. Taxpayer was unaware these services had been canceled. The restaurant continued to operate until early 2011 when the operations were turned over to the franchisor.

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Several months after the operations were turned over to the franchisor, the IRS visited the corporate accountant regarding unpaid payroll taxes. The CPA sent the taxpayer and her husband an e-mail notifying them that a representative of the IRS had visited his office investigating unpaid payroll taxes. This e-mail was the first time they had knowledge that Federal payroll deposits had not been made for various quarters and that Forms 941 remained unfiled. The IRS investigation led to the assessment of the trust fund recovery penalties against taxpayer, her husband, Mr. Chislett, and Mr. Stamps. However, the taxpayer's assessment letter never reached her but was instead returned by the post office to the IRS. Since the taxpayer did not respond, the IRS assessed the taxes against her and filed a federal tax lien.

The Court first had to determine if the failure to deliver the assessment letter to the taxpayer absolved her of the liability. Issuance of the assessment letter 1153 by certified mail, which was sent to taxpayer at her last known address, satisfies the notice requirements and therefore the trust fund recovery penalty assessments made against her were valid. The next issue the Court had to decide was if she was responsible for the liabilities.

The statute provides that an employer has the duty to duty to withhold income and employment taxes from their employees' wages.[57] The statute also provides a collection tool allowing the Commissioner to impose penalties on certain persons who fail to withhold and pay over trust fund taxes.[58] However, the liability for the trust fund recovery penalty is imposed only on: (1) a responsible person who (2) willfully fails to collect, account for, or pay over the withheld tax.

The IRS argued that taxpayer possessed all the recognized indicia of responsibility and was therefore a responsible person. In addition, the IRS further asserted that she exercised substantial financial control over Dey Corp. and that at all times was a de facto officer of the corporation because she opened two corporate bank accounts, had signatory authority on both accounts, and signed checks on behalf of the corporation.

Taxpayer argued she lacked decision making authority and did not exercise significant control over corporate affairs. She further asserted that despite her signatory authority, she was not a responsible person within the meaning of the statute because she had a limited role in the business' payroll process and merely signed payroll checks for the convenience of the corporation. She claimed that Mr. Stamps and Mr. Chislett were responsible for running the corporation day-to-day and that her duties were ministerial. The Court noted that one of their responsibilities was determining the credibility of the parties' witnesses and they found Mr. Chislett and Mr. Stamps to be less than credible. However, they found the taxpayer's spouse and CPA to be honest, forthright, and credible. Based on a preponderance of the evidence, the Court found that the taxpayer's role was ministerial and that she lacked decision making authority. As a result, the taxpayer was found not to be the responsible party.

The Court stated the taxpayer lacked the authority to control the financial affairs of the business or exercise any significant authority over the disbursement of Dey Corp.'s funds. Notwithstanding that she had signatory authority and her spousal relationship to one of the corporation's owners, the substance of her position was largely ministerial, and she lacked actual authority. The credible testimony and the documentary evidence introduced at trial demonstrated that Mr. Stamps and Mr. Chislett exercised control over the financial affairs of the corporation and that the taxpayer served only support functions. The Court noted they were puzzled how Mr. Stamps, the president of the corporation and a hands-on

[57] I.R.C. §3102 (a) and I.R.C. §3402(a).
[58] I.R.C. §6672.

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owner, and Mr. Chislett, the day-to-day manager, successfully evaded in the administrative phase for any personal liability for the trust fund recovery penalties.

Taxpayer had a high school education. She has never completed or even enrolled in any college-level courses. While she developed strengths in sales and marketing during the course of operating her rental real estate business, she did not have experience in accounting, finance, tax, or management. The IRS, however, went to great lengths to characterize petitioner as a savvy businessperson whose actions and prior work experience made her a de facto director. On the basis of the record, the Court stated they did not agree. They stated it was clear from the testimony and other evidence that taxpayer was not an officer, director, owner, or employee of the corporation at any time. With the exception of a few weeks during the pre-opening phase, she had no involvement in the day-to-day affairs of the corporation. In fact, she spent most of her time taking care of her disabled son. Consequently, she usually visited the corporation only once a week, on Tuesdays, for less than an hour each time. Sometimes she did not visit the business for periods of several months. She had no authority to hire and fire employees of the corporation. She had no responsibility to oversee or ensure the payment of payroll taxes on its behalf. She was not its bookkeeper or accountant. She did not reconcile the bank statements. Even though she wrote and signed roughly 4 percent of the non-payroll checks to pay some of the corporation's recurring operating expenses, such as rent, she was merely doing so at the direction of others and for the convenience of the corporation. Moreover, even though she signed most of the payroll checks prepared by Paychex, the duty was ministerial and done only for the convenience of the corporation. She had no duty to, and did not, oversee the employees, collect payroll information, compile payroll information, or remit the payroll information to Paychex on behalf of the corporation. Mr. Chislett was responsible for carrying out those duties. Accordingly, because she did not hold corporate office, did not control financial affairs, had no ownership interest, had no authority to hire and fire employees, and otherwise had little or no decision-making power beyond ministerial duties, she was not a responsible person.

Having determined that the taxpayer was not a responsible person, the Court need not determine whether taxpayer willfully failed to collect, account for, or pay over the trust fund taxes at issue. However, for the sake of completeness, the Court choose to do so. The willfulness requirement is satisfied if there is evidence that the responsible person had knowledge of payments to other creditors after he or she was aware of the failure to remit the withheld taxes. The Court found the taxpayer did not willfully fail to collect, account for, or pay over the trust fund taxes at issue for the following reasons:

1. Mr. Chislett was Paychex's main contact and therefore responsible for ensuring Paychex provided adequate services. Taxpayer merely delivered the Paychex package and any mail she received at her private mailbox to Mr. Stamps or Mr. Chislett at the business location. She neither reviewed nor was responsible for reviewing the mail or the contents of the Paychex package. Therefore, she had no knowledge as to whether the IRS was contacting the corporation regarding delinquent payroll taxes or whether the statements in the Paychex package reflected that payroll taxes were unpaid.
2. Taxpayer did not have the responsibility to scrutinize the bank statements closely. She did not reconcile the bank statements and had no oversight responsibility for the financial books and records of the corporation. She was merely directed to relay electronic bank account balances to Mr. Chislett and Mr. Stamps. Therefore, she did not act with reckless disregard in the course of carrying out her ministerial duties.
3. It was not until the CPA contacted the taxpayer and her husband, several months after the business had been turned over to the franchisor that she first learned that the corporation had not been making its payroll tax deposits. Consequently, she could not

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have willfully preferred another creditor over the U.S. because she did not have the requisite knowledge that payroll taxes were unpaid. Accordingly, the Court found that petitioner did not act willfully in failing to collect, account for, or pay over the trust fund taxes at issue.

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Audit Techniques Guides, Practice Units, and Cash Intensive Businesses

Learning objectives ***1***
I. Audit Techniques Guides, Practice Units, and Compliance Campaigns ***1***
A. Cash intensive businesses **5**
1. In general *5*
2. What is a cash intensive business? *6*
3. Books and records *8*
4. Analysis of the tax return *9*
5. Comparative analysis and ratio analysis *10*
6. Interview *11*
7. Examination *13*
B. Business consultants **16**
1. Introduction *16*
2. Internal control *17*
3. Income *17*
4. Shifting or the assignment of income *19*
5. Tax years *21*
6. Travel *22*
7. Independent contractor vs. employee *23*
8. Meals *25*
9. Personal service corporation *26*
10. Activities not engaged in for profit -- IRC §183 *28*

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Audit Techniques Guides, Practice Units, and Cash Intensive Businesses

Learning objectives

Upon reviewing these materials, the reader will be able to:

- Identify the Audit Techniques Guides and Practice Units issued by the IRS;
- Define a cash intensive business and the special problems with books and records; and
- Explain the role that ratio analyses play in the examination of a cash intensive business.

I. Audit Techniques Guides, Practice Units, and Compliance Campaigns

Audit Techniques Guides (ATGs) help IRS examiners during audits by providing insight into issues and accounting methods unique to specific industries. While ATGs are designed to provide guidance for IRS employees, they are also useful to small business owners and tax professionals who prepare returns. They are issued and maintained by the Small Business Self-Employed Division (SBSE) of the IRS.

ATGs explain industry-specific examination techniques and include common, as well as, unique industry issues, business practices, and terminology. Guidance is also provided on how the IRS will examination income, the interview techniques they will use, what type of documentation they will request, how they will evaluate evidence, and check sheets developed for use by the examiners in their audits. The Audit Techniques Guides are the playbook for the IRS for specific types of examinations and can be useful for business and tax planning purposes as well as what can be expected in an examination. They can be found on the IRS website at www.irs.gov/businesses/small-businesses-self-employed/audit-techniques-guides-atgs. They are listed by topic in alphabetic order. Topics include:

- **Aerospace** – This ATG focuses on the particular unique aspects of the industry and provides examiners tools and tests to utilize in evaluating and auditing research credit.
- **Architects and Landscape Architects** – This ATG focuses on issues in the architect and landscape architect service industries.
- **Art Galleries** – This ATG focuses on issues surrounding Artists and Art Galleries.
- **Attorneys** – This ATG focuses on attorneys and law firms as well as worker classification issues in the industry.
- **Business Consultants** – This ATF focuses on issues relating to business consultants as well as employee versus independent contractor issues.
- **Capitalization of Tangible Property** – This ATG focuses on issues involving capitalization and dispositions of tangible property under the final 236A regulations. It discusses what is a unit of property, what the total amount is to acquire or produce property, the de minimis rules for expensing, safe harbor rules for small taxpayer's expensing improvements for real property, safe harbor rules for expensing routine maintenance and repairs, rules for expensing materials and supplies, general asset account rules and change of accounting methods associated with capitalization versus expensing.
- **Cash Intensive Businesses** – This ATG focuses on cash intensive businesses including bail bonds, beauty shops, car washes, check cashing establishments, coin operated amusements, laundromats, scrap metal, some convenience stores, and taxicabs.

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- **Child Care Provider** – This ATG focuses on tax related issues pertaining to the childcare providers industry. It provides guidance on accounting for income and deductions.
- **Coal Excise Tax** – This ATG focuses on issues relating to domestically produced coal.
- **Conservation Easement** – This ATG focuses on charitable contributions of conservation easements.
- **Construction Industry** – This ATG focuses on the construction industry including a glossary. It discusses types of contracts; types of contractors; methods of accounting; and joint ventures. This ATG includes the filing locations for Rev. Proc. 92-29 elections, contractor square footage costs and common errors in look-back interest filings. It also includes procedures for look-back interest and interest computations under the look-back method for completed long-term contracts.
- **Continuation of Employee Healthcare Coverage** – This ATG focuses on coverage, issues, and guidance regarding COBRA coverage.
- **Cost Segregation** – This ATG focuses on preparing g cost segregation studies and how the IRS will evaluate these studies for depreciation deductions.
- **Credit for Increasing Research Activities** – This ATG focuses on qualifying research expenses, qualifying research activities, and computations for the research credit.
- **Entertainment Audit Technique Guide** – This ATG focuses on common issues in the entertainment industry. It includes issues common and unique in the industry as well business practices and industry terminology. It is pertinent for performers, songwriters, actors, directors, musicians, publishers, writers, and managers
- **Equity (Stock)-Based Compensation** – This ATG focuses on issues related to equity (stock)-based compensation. The term “equity-based compensation” includes any compensation paid to an employee, director, or independent contractor that is based on the value of specified stock.
- **Excise Tax on Indoor Tanning Services** – This ATG focuses on indoor tanning services and the excise tax associated with the services.
- **Fishing** – This ATG focuses on the issues in the fishing industry.
- **Golden Parachute** – This ATG focuses on issues relating to golden parachute payments on both individual and corporate returns.
- **Hardwood Timber Industry** – This ATG focuses on the hardwood timber industry and as information for taxpayers and practitioners associated with the hardwood timber industry.
- **IC-DISC Audit Guide** – This ATG focuses on F-1120IC-DISC and its related shareholders.
- **Inland Waterways** – This ATG focuses on industries related to coastal and inland waterways. There is also a Port Project ATG that includes these issues.
- **IRC §42, Low-Income Housing Credit** – This ATG focuses on issues for taxpayers owning IRC §42, low-income housing projects.
- **IRC §162(m): Salary Deduction Limitation** – This ATG focuses on different methods for compensating a company’s executives to avoid the §162(m) limitations.
- **IRC §183: Activities Not Engaged in For Profit** – This ATG focuses on the application of IRC §183 hobby loss rules.
- **Lawsuits, Awards, and Settlements** – This ATG focuses on the taxability of lawsuits, awards, and settlements.

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- **Ministers** – This ATG focuses on who is a minister, parsonage issues, business expenses, retired ministers, self-employment income, employee versus independent contractor, and other income issues.
- **New Vehicle Dealerships** – This ATG focuses on new vehicle dealership issues.
- **Non-Qualified Deferred Compensation** – This ATG focuses on non-qualified deferred compensation. A nonqualified deferred compensation (NQDC) plan is any elective or nonelective plan, agreement, method, or arrangement between an employer and an employee (or service recipient and service provider) to pay the employee compensation sometime in the future.
- **Oil and Gas Industry** – This ATG focuses on basic operations and terminology in the Industry as well as discussion on royalty owners and financial products.
- **Passive Activity Losses** – This ATG focuses on IRC §469 passive loss rules. It includes audit issues, lead sheets, and job aids that examiner's use when conducting an audit.
- **Real Estate Property Foreclosure and Cancellation of Debt** – This ATG focuses on real estate foreclosures and cancellation of debt income.
- **Rehabilitation Tax Credit** – This ATG focuses on the rehabilitation tax credit. It includes issue check sheets, pro forma Information Document Request, and standardized audit reports that examiners will use when auditing the issues.
- **Retail Industry –** This ATG focuses on issues unique to the retail industry.
- **Veterinary Medicine** – This ATG focuses on issues relating to veterinary medicine. It includes discussions of types of business entities (especially personal service corporation); cash vs. accrual method of accounting; and inventory vs. supplies.

Practice Units are issued by the LB&I to assist agents in developing more complex business issues. The Units are in the PowerPoint format and explain the issue, what the examiners should look for and what documents should be requested to enhance issue development. Many of them lean towards international taxation for individuals and businesses. Since LB&I concentrate on F-1065, F-1120S and F-1120 whose assets exceed 10 million dollars many tax practitioners believe they only apply to very large entities, but this is not true. The issues they tackle in many instances are the same as in the SBSE arena just on a larger scale. They can be found on the IRS website at www.irs.gov/businesses/corporations/practice-units. They are listed by topic and by the date they were issued. Although the list of topics is not identified below in full, some areas that might be of interest to small businesses and individuals are:

- Allocation Methods for Personal Use of an Aircraft
- Concepts of Global Intangible Low-Taxed Income
- Foreign Tax Redeterminations
- Partner's Outside Basis
- Liquidating Distributions of a Partner's Interest in a Partnership
- Reasonable Cause and Good Faith
- Liquidating Distributions of a Partner's Interest in a Partnership
- Sale of a Partnership Interest
- Recourse vs. Nonrecourse Liabilities in a Partnership
- Property Distributions for S Corporations
- IRC 481(a) Adjustments for IRC 263A Accounting Method Changes
- How to Compute the AMT FTC
- Interest Capitalization for Self-Constructed Assets
- Examining a Taxpayer Electing a Partial Disposition of a Building
- Source of Income for Nonresident Alien Individuals

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- Land Developers and Subcontractors -Proper Method of Accounting
- Tax Home for Purposes of IRC Section 911
- Self-Employment Tax and Partners
- IRC 179D Energy Efficient Commercial Buildings Deduction
- Identifying a Taxpayer Electing a Partial Disposition of a Building
- Determining an Individual's Residency for Treaty Purposes
- Losses Claimed in Excess of Basis
- General Deductions of a Foreign Corporation Engaged in U.S. Trade or Businesses
- Reduced Foreign Taxes Under Treaty Provisions
- Valid Shareholder Debt Owed by S Corporation
- Adjustments to Debt Basis
- Stock Basis Ordering Rules
- U.S. Territories - Self-Employment Tax
- Initial Stock Basis
- Employee Share of Employment Taxes - U.S. Citizens and Resident Aliens Working Abroad
- U.S. Persons Residing Abroad Claiming Additional Child Tax Credit
- Adjustments to Stock Basis
- Overview of Entity Classification Regulations (a/k/a Check-the-Box)
- Failure to File the Form 5471 – Category 2 and 3 Filers – Monetary Penalty
- Creditable Foreign Taxes
- Sourcing of Income
- Physical Presence Test for Purposes of Qualifying for IRC 911 Tax Benefits
- FTC General Principles
- Summary of Foreign and Domestic Loss Impacts on the Foreign Tax Credit
- Self-Employment Taxes - U.S. Citizens and Resident Aliens Working Abroad
- Calculating Foreign Earned Income Exclusion – Partner in a Partnership with Foreign Earned Income
- FDAP Payments – Source of Income
- Foreign Housing Exclusion (IRC § 911)
- Interest Expense Limitation Computation under §163(j)
- Allocation and Apportionment of Deductions for Nonresident Alien Individuals
- Defining the Entity – Foreign Trusts
- Foreign Grantor Trust Determination – Part II – Sections 671-678
- Foreign Grantor Trust Determinations – Part I – Section 679
- Foreign Partnership – Taxation
- Overview of Subpart F Income for U.S. Individual Shareholders
- Failure to File the Form 5471 – Category 4 and 5 Filers – Monetary Penalty
- Determination of U.S. Shareholder and CFC Status
- Identification of a U.S. Trade or Business of a Nonresident Alien
- U.S. Persons Residing Abroad Claiming Additional Child Tax Credit
- Calculating Foreign Earned Income Exclusion - Self-Employed Individual
- Sourcing of Fringe Benefits for FTC Limitation
- U.S. Territories – Determining Bona Fide Residency Status
- Sourcing of Salary and Compensation
- Calculating Foreign Earned Income Exclusion - Employee

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Compliance Campaigns address significant compliance and resource challenges for the LB&I Division. IRS identifies campaigns in areas of the tax law where taxpayers might be non-compliant. They provide a synopsis of the issue and how the transactions should be treated. Although the list of topics is not identified below in full, some areas that might be of interest to small businesses and individuals are:

- Allocation Methods for Personal Use of an Aircraft
- Expatriation of Individuals
- FATCA Filing Accuracy
- High Income Non-Filers
- Individuals Employed by Foreign Governments & International Organizations
- Individual Foreign Tax Credit
- Individual Foreign Tax Credit Phase II
- IRC 965 for Individuals
- Loose Filed Form 5471
- Nonresident Alien Individual Tax Credits
- Nonresident Alien Rental Income from U.S. Real Property
- Related Party Transactions
- S Corporation Distributions
- S Corporation Built-in Gains
- Sale of a Partnership Interest
- SECA Tax
- Taxable Asset Transactions - Matching Buyers and Sellers
- Tax Cuts and Jobs Act
- Virtual Currency

A. Cash intensive businesses

1. In general

There has been, for those taxpayers with the ability to determine their own reported income, an increasing underreporting of income. Of particular interest are businesses and individuals who receive most of their income in cash. Cash transactions are anonymous, leaving no trail to connect the purchaser to the seller, which may lead some individuals to believe that cash receipts can be unreported and escape detection.

a. There are three main ways to misappropriate cash from a business.
   - (i) It can be skimmed from receipts, for example, pocketed before it is recorded. If this happens it will not be discovered by auditing the books.
   - (ii) It can be stolen after it has been recorded, for example, cash removed from the cash register or goods stolen from the shelf for future resale.
   - (iii) A fraudulent disbursement can be created, for example, a payment to a vendor that is actually cashed by the owner's son.

b. The most significant indicator that income has been underreported is a consistent pattern of losses or low profit percentages that seem insufficient to sustain the business or its owners. Other indicators of unreported income include:
   - (i) A lifestyle or cost of living that cannot be supported by the income reported.
   - (ii) A business that continues to operate despite losses year after year, with no apparent solution to correct the situation.

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(iii) A Cash T shows a deficit of funds.

(iv) Bank balances, debit card balances, and liquid investments increase annually despite reporting of low net profits or losses.

(v) Accumulated assets increase even though the reported net profits are low or a loss.

(vi) Debt balances decrease, remain relatively low, or do not increase but low profits or losses are reported.

(vii) A significant difference between the taxpayer's gross profit margin and that of their industry.

(viii) Unusually low annual sales for the type of business.

Note:

> If an examiner wants to find income, they must actively look for income. Unlike examining expenses, which can either be verified or not, hidden income is harder to find and requires a proactive approach. There are several techniques that can be used successfully when working with cash intensive businesses.
>
> First, a financial status analysis including both business and personal financial activities should be done. This is a required minimum income probe. If it shows an imbalance in the cash flows indicative of underreported income, the examiner will request clarification or explanation from the taxpayer before beginning the use of an indirect method. Indirect methods, such as a percentage mark-up, source and application of funds, or bank deposit and cash expenditures analysis, can then be used to confirm the amount of any understatement.

c. The examiner must gather information about how the taxpayer conducts business, document cash inflows and outflows, and conduct a detailed interview with the owner of the business relating to business and non-business cash receipts and cash expenditures.

d. The examination of income is a mandatory audit issue. Examiners must determine whether the taxpayer reported the correct amount of income. The depth of the examination of income and the techniques used are dependent on the facts and circumstances of the case.

2. What is a cash intensive business?

A cash intensive business is one that receives a significant amount of receipts in cash. This can be a business such as a restaurant, grocery store, or convenience store that handles a high volume of small dollar transactions. It can also be an industry that practices cash payments for services, such as construction or trucking, where independent contract workers are generally paid in cash.

a. A business with a large number of cash transactions probably uses a cash register. Sales are entered into the register, using different keys for different sales. This is done so the owner can determine the cost of sales in each product area, for example, beer sales, dairy sales, soda sales, grocery sales, etc. A product line that is not profitable will soon be refined or eliminated because these stores are usually small, and every inch of space must be productive.

(i) The workers will ring up every sale on the cash register and provide a cash register tape receipt to each customer. If cash is taken out of the register for small purchases, to cash checks, or for the owners use, a note is made and is retained in the drawer.

(ii) The cash register will produce a detail tape locked in the register, which is a continuous record of each transaction recorded that day, with a total (**X total**).

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This tape will identify the type of purchases keyed into the register, for example, grocery, liquor, coupons, etc., and what type of payment was received, for example, cash, check, etc.

(iii) The cash register will also provide, under a separate key control, the accumulated total amount of sales **(Z total)** that is carried forward for a longer time period, until authorized to be reset at zero.

(iv) The detail tape (X total) should not be accessible to the person using the register, and the reset key (Z total) should only be accessible to senior management. In a small proprietorship or closely held business this control may be impossible.

(v) At the close of the business day, the supervisor will unlock the register and read the X total. The supervisor then clears the cash register for the following day, thus automatically recording on the Z tape the transaction total (X total) of the current day's cash receipts. The detail tape (X total) should then be removed from the register and retained for subsequent comparison with the total cash turned in from the register.

(vi) Sales from the cash register are totaled at least daily, usually at the end of a worker's shift. The employee will count the cash in the drawer, less the beginning balance which is retained in the drawer for the next shift's use. The worker may count the cash while a supervisor is present or may count the cash and enclose it in an envelope for deposit in the business safe. The worker will also total the checks and credit card payments received.

(vii) A designated person will open the envelopes containing the shift cash, count total cash, and prepare deposit slips. A copy is made of the deposit slip and retained by the designated person. The supervisor, or another individual, will take the cash to the bank, returning with the deposit receipt, which is matched to the copy of the deposit slip. This is an important internal control -- the same person must not prepare the deposit and take the cash to the bank.

(viii) The supervisor will determine sales for the day (or shift) by printing the Z tape total on the register. The Z tape records the total transactions, such as sales by type, the number of customers and the number of items rung in for the period. This is another important internal control -- the same person does not count the cash and total the sales, otherwise, all overages could go into the pocket of the counter.

(ix) The total sales for the period are reconciled by comparing sales recorded on the Z tape to the income in the drawer (cash, checks, credit card purchases, and cash paid out). All differences between receipts and the cash register tapes must be reconciled and a record kept of cash overages and shortages.

(x) Once this important reconciliation is complete, the total sales for the day or period can be entered on a daily sheet. The cash register Z tape and all reconciliations, discrepancies, and notes are retained and attached to the daily sheet.

(xi) The total daily sales amount (from the daily sheet containing all reconciliations) is entered on a sales sheet that generally records all sales for the month. This is usually the document that goes to the bookkeeper to record monthly sales. The daily detail tapes (X totals) are source documents that must be retained by the business.

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(xii) The sales made by check and credit card can be subtracted from the total sales for any period to determine the amount of cash received. This can be compared to cash deposited to the bank.

b. Businesses that have fewer transactions will usually issue sales invoices or receipts to each customer, rather than use a cash register.

(i) At the end of each workday, the worker may count the cash received while a supervisor is present or may count the cash and enclose it in an envelope for deposit in the business safe. The worker will also total the checks and credit card payments received. These will be entered on a daily sheet.

(ii) A designated person will open the envelopes containing the shift cash, count total cash and prepare deposit slips. A copy is made of the deposit slip and retained by the designated person. The supervisor, or another individual, will take the cash to the bank, returning with the deposit receipt, which is matched to the copy of the deposit slip.

Note:

This is an important internal control for the protection of cash reporting -- the same person must not prepare the deposit and take the cash to the bank.

(iii) The supervisor, or designated individual, will total sales invoices for comparison with the cash collected (plus cash paid out). If there is any discrepancy between sales invoices and payments received, a reconciliation must be made, and notes are retained with the daily sheet.

Note:

This is another important internal control -- the same person does not count the cash and total the sales. A good indication of whether this happens is whether overages are shown. If cash shortages appear periodically, but cash overages are never recorded, that is a good indication this internal control is missing -- the same person reconciles cash and sales.

(iv) The business will record each individual receipt separately in the sales journal, retaining the invoices, reconciliations, and deposit slips as back-up documents.

3. Books and records

Every business has its own procedures and internal forms, but, at a minimum, must document the flow of each receipt or revenue from the customer's hands to the business, to the final end in the business bank account or as payment for a business expense.

a. The examiner can expect to see the summary Z tapes and the detail X tapes (if a cash register is used), sales invoices, or receipts (if no cash register is used), daily reconciliation sheets, monthly sales sheets (that will match the Statement of Profits and Losses) and bank deposit detail. Any deviation from these elementary steps should be recorded by the examiner and may indicate a disregard for recordkeeping rules and a lack of internal controls.

b. The books and records of a cash intensive business may not be kept in any particular industry standardized format. When these entities are small businesses or the taxpayers are not sophisticated with respect to record keeping or the tax law, the only way to understand the bookkeeping system is to have the taxpayer explain it.

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c. If the taxpayer has a representative (the return preparer, generally), the examiner may have to walk through the taxpayer's books with the taxpayer to the point at which they submit their figures to the representative. The same walk through with the representative will then be conducted in order to determine the audit trail from the source documents, through the original books of entry, to the tax return/tax reconciliation workpapers.

4. Analysis of the tax return

Regardless of what techniques the examiner employs to examine a return, a thorough pre-audit analysis is essential to discover potential audit adjustments and fraudulent situations. The beginning of any examination is a pre-contact analysis, which is a review of the tax return to identify potential issues and data needed to plan the examination. The analysis should cover all aspects of the return, including, but not limited to:

a. With respect to page one and two of Form 1040: Filing status, family size, address, wage income, interest income, business income, capital gain or losses, rental or farm income, miscellaneous income, credits claimed, other taxes paid, and taxpayer's occupation, the examiner will consider.
   - (i) Is the taxpayer's address in a high value area, disproportionate to reported income?
   - (ii) Is the occupation a position that could have indirect sources of additional income?
   - (iii) Will reported income support the size of family reflected?
   - (iv) Is the foreign accounts question answered?

b. With respect to Schedule A, the examiner should determine if total deductions indicate expenditures in excess of net income reported.
   - (i) Real estate taxes should be compared with taxpayer's address. Do the taxes suggest that other property is owned by the taxpayer? Does the real estate tax deduction show additional properties not commensurate with reported income?
   - (ii) Do the interest expenses indicate loans or property holdings? Does the interest deduction show indebtedness on purchases not commensurate with reported income?
   - (iii) Are there any unusual items, such as large gambling losses reported as miscellaneous deductions?

c. With respect to Schedule B, the examiner will check the amounts for accumulation of funds; number of accounts; or lack of interest or dividends. Are the interest and dividend income and the corresponding investments consistent with reported income?

d. With respect to Schedule D: During the audit, consider, when properties are purchased and sold, note the source of funds used and where the proceeds were reinvested. Review Form 1099 information received.

e. With respect to Schedule C or F, the examiner must compare the business to similar type business with respect to net income, interest expense accounting method, and gross profit percentage
   - (i) Does the taxpayer pay cash or finance the purchase of business assets?
   - (ii) Does the depreciation schedule indicate that the taxpayer purchased assets during the year and any unusual items?
   - (iii) Are there any capital items purchased?
   - (iv) Does the sales tax deduction indicate any purchases not commensurate with reported income?

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f. The examiner focuses on:

   (i) What are the internal controls on income?

   - Are all receipts deposited? Are most by currency or check?
   - Who controls the collection and deposit of receipts?
   - Who records the receipts into the records?
   - What other regulatory agencies audit receipts (i.e., sales tax, franchisor)?
   - Does the accountant verify gross income?
   - How does the owner or stockholder draw living expenses?
   - Check the controls on employees handling receipts.
   - Are numbered sales invoices used?

   (ii) What should the business be earning? Consider:

   - The location. (Is it accessible to a large market?)
   - The number of operating units (cash registers, machines, trucks, chairs, etc.).
   - The number of employees (and their duties).
   - The age of the business. (Is goodwill established?)
   - The gross profit percentage for the industry.

   (iii) Is “other income” possible? For example:

   - Can the operation produce a saleable by-product (scrap, farm products, and rebuilt items)?
   - Can the goods or services be traded (construction, repairs, personal services, money orders between merchants)?
   - Are there vending or pinball machines?
   - Check for potential “sub-operations” created by the business (snack bar, repairs, appraisals, installation, and accessories, or towing business not listed).
   - Are there sub-leases or rentals (land, storage spaces, and tools)?
   - Could kickbacks or rebates be paid or received (construction jobs, coupons)?

   (iv) Unusual situations warranting answers:

   - High profits, but no savings or investments.
   - Low profits, but many investments and expenditures.
   - Increasing assets, but small deductions for interest paid.
   - Decreasing liabilities and low profits.

g. Examiners use an estimated Cash T and/or source and application of funds in the pre-plan stage of the examination to get an idea of the taxpayer’s finances. The analysis will be more thoroughly developed as the examination progresses and more information is obtained. From these indicators and the initial Cash-T, examiners should form a financial picture of the taxpayer. One of the key indicators is an accumulation of assets and/or incurring of expenses in excess of available net income and borrowings. When examiners see a return with a large asset accumulation, low net income, and small interest expense, examiners need to resolve how this occurred.

5. Comparative analysis and ratio analysis

Ratio analyses are extremely important in evaluating the reasonableness of reporting in a cash intensive business or in a business that carries inventory. A successful business will continually analyze its costs by

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using operating ratios. This ensures that all areas remain profitable and allows owners to make adjustments to product lines that report sluggish gains.

a. The cash business, as reported on the tax return, should be evaluated through the use of ratios. This is because relationships exist between income and expenses that creates a balance. The balance can be evaluated by using a vertical analysis of the tax return.

b. Similarly, trends and practices are usually consistent over time, and these can be evaluated by using a comparative analysis between three or more years of tax returns. When someone is misappropriating cash, it causes the relationships to become unbalanced, and this can be discovered by analyzing ratios.

   (i) The first step in determining the reasonableness of the reported income and expenses is a vertical analysis that expresses each expense in terms of gross receipts. This is the method companies use to compare one business to another.

   - A vertical analysis is a comparative analysis within a given tax year of certain expenses relative to gross receipts. Thus, all expenditures will be expressed as a percentage of gross receipts. This is done by dividing the amount of the expense by the amount of gross receipts.

Note:

Creating a benchmark: The Service has used Bizstats.com, which offers free business statistics and financial ratios, by type of entity (sole proprietor, corporation, partnership), by industry (retail, beverage store, construction, etc.) and by amount of gross receipts. By entering the amount of gross receipts from the return into the Bizstats customized P&L report for the proper industry, Bizstats will prepare a benchmark vertical analysis that can be **compared to the tax return**. This analysis will tell the examiner how the business under audit compares with the industry as a whole. This does not indicate there is unreported income but may raise some questions about the expenses that should be asked of the taxpayer.

   (ii) In a retail business the markup percentages usually remain constant from year to year. If goods are marked up 50 percent when the cost is $12, the goods sell for $18, and the business earns a profit of $6 on each sale. When the supplier increases the cost of goods to $14, the business, keeping the 50 percent markup percentage, sells it for $21 and earns a profit of $7 on each sale. This way, any supplier increases are passed on to the consumer.

   (iii) When a supplier increases cost, it is usually an increase to all of the supplier's customers. Therefore, all retailers will increase their prices. For example, when the price of gasoline goes up, all stations increase their prices to maintain their individual profits. The examiner should not accept self-serving statements that a retailer did not raise prices in order to be competitive. If the retailer's prices do not increase with cost increases, the retailer will be undercutting the competition and the examiner can expect to see increased sales.

6. Interview

The initial interview of the taxpayer sets the stage for the rest of the examination. The primary purpose of the interview is to secure, by conversation with the taxpayer, facts which will present the taxpayer's overall financial picture, an understanding of the operations, and an overview of the recordkeeping practices (that is, type of records maintained and the accounting controls).

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In a cash intensive business there may be very few tangible records, so the examiner will perform a detailed and meticulous interview. The oral testimony of the taxpayer at this point may turn out to be the only evidence provided. A proper interview for a cash intensive business may take two or more hours.

a. The taxpayer will be asked to explain every step from the time cash and other income is received until it is deposited to a bank or spent. Only by taking the time to write down every step in the cash process and noting the name of every person who handles cash, can an examiner find weaknesses in the system if they exist.

b. The taxpayer must explain the mechanics of how cash is handled in the business. It is important during the interview to have the taxpayer explain every step of cash handling, beginning with the collection of gross receipts from every source. The Service encourages examiners to prepare a flow chart of the cash flow from the time it is received until it is placed into a third party's hands and ask the taxpayer if the flow chart is correct. The examiner will solicit a similar explanation for cash that is paid out as expenditures, including who is authorized to pay cash and where the cash comes from.

c. Examiners must ask about **cash-on-hand** that the taxpayer has access to, including funds available from friends or relatives. Cash includes pocket money plus cash in a safe or other safe location, and cash held in trust by others. If examiners are working with the return preparer or other representative, the taxpayer will be required to appear for the interview so the availability of cash funds can be discussed.
   (i) Examiners will press on establishing the amount of cash on hand and accumulated funds and verify the taxpayer's statements of cash accumulations during the initial interview. This is necessary because:
      - Cash-on-hand and accumulated funds can explain Financial Status Analyses that appear to identify a potentially significant imbalance.
      - Examiners should ask the taxpayer to make an affirmative statement regarding the existence or nonexistence of cash-on-hand and accumulated funds.

d. The taxpayer's business history and related businesses will be explored.
   (i) The taxpayer must provide the amount of accounts receivable, loans receivable, inventories, and a general statement of how the inventories are valued and method used.
   (ii) If a comparative analysis shows losses or consistently low profits, the taxpayer must explain what has caused the problem and what is being done to improve the situation. The taxpayer will be knowledgeable about the industry and can explain any market fluctuations.

e. Taxpayers often commingle business bank accounts and personal accounts of the immediate family. The examiner will:
   (i) Request detailed information about bank loans, personal loans, accounts payable, and other borrowed funds. This will focus on loans made outside the business, which do not appear in the regular books.
   (ii) Determine the taxpayer's security holdings in stocks, bonds, mutual funds, real estate holdings, the personal residence, and monthly payments.
   (iii) Request a record of personal loans made to others – members of the family, a friend, or someone else.
   (iv) Inquire about the availability of financial statements, independent audit report, applications for loans, and workpapers.

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f. Is there any other income, such as a gift, inheritances, loans, and other non-taxable sources?

7. Examination

a. The examiner must ask the following questions.
- Principal products?
- How long in business?
- Who are the principal customers?
- Any other source of income?
- How are sales handled?
- Method: Cash or accrual? If accrual, does he have a list of accounts payable and receivable?
- How are prices set?
- What is the markup percentage? (Ask for markup percentage on each major product.)
- How often is inventory taken, by whom?
- Who keeps the books? How did they learn recordkeeping?
- What bank accounts maintained?
  - (i) Do they deposit everything? Who deposits?
  - (ii) How do they get cash to spend?
  - (iii) Check to cash?
  - (iv) Personal withdrawals – how handled?
- Safe deposit box?
- How are expenses recorded? How were the return figures arrived at? How are the expenses paid?
- Cash-on-hand: How much? Where located?
- Non-taxable income. Pensions, loans, gifts, inheritances? Investments? Stock? Real Estate? Major personal property?
- Major Expenses: Loan repayments? Asset acquisitions? When? How?

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Note:

Since many businesses in this industry are cash oriented, have weak internal controls, lack an audit trail, and have inadequate books and records, the examiner's audit should focus on probing for unreported income.

The business owner is responsible for maintaining the documents needed to verify the reported income. When the source documents are available, there will be more than one way to test income and other transactions, because different documents will have the same information (a bill of lading and a sales invoice, for example) to check for consistency. When the source documents are not available the examiner must look for ways to discover if all income is reported.

(i) The most likely method for a cash intensive business that does not report their full income is to skim cash prior to its entry in the accounting system with the result that the books will reconcile to the return and the bank deposits, but income will be missing. This can be done:
  - By failing to deposit all of the funds;
  - By failing to use a cash register to record sales; or
  - By failing to report an income stream.

Skimming can be discovered through excess expenditures or when markup percentages are corrected.

(i) Someone with access to incoming checks can remove a check before it is recorded. Later the check can be added to a cash register in exchange for cash in the same amount. If a check for $500 is taken from the mail, it can later be substituted into the cash register for $500 in cash. This way the total receipts will match the amount deposited. However, when the examiner checks the amount of cash received and the cash deposited, a discrepancy will be evident. The examiner should follow up with the person who worked the register and ask about the check included in that drawer. If necessary, follow up with the payer and find out how it was delivered to the business.

(ii) The examiner can look for a purchase that will reveal sales. For example, when a smog certificate is required on each vehicle sold, the number of smog certificates purchased will equal the number of vehicles sold. Once the examiner knows the correct number of items sold, either the taxpayer can produce the missing data or sales can be determined by multiplying the number by the average of the reported sales.

(iii) When workers wear uniforms, the uniform service invoices can be inspected. They usually list the number of pants and shirts laundered and include the worker's name embroidered on the shirt. The examiner will compare the names on the uniform invoices to the names on the W-2's to determine if there are more people wearing uniforms than working. The employer usually does not pay for the uniform to determine so the examiner will check payroll deductions for the amount paid by the employee.

(iv) When a vehicle is towed to a repair shop, the shop initially pays the tow truck, and then passes the cost on to the customer. The examiner should use the tow receipts as a sample to ensure each vehicle's repairs are reported on a sales invoice. If necessary, the examiner can locate the customers and contact them to provide their work invoices that were never reported in the shop's sales.

(v) If the taxpayer does not produce contracts, but it is unlikely the particular industry would do business without them, the examiner will request the deposit slips, deposit sources, and cancelled checks to reveal customers and suppliers. The suppliers, identified through the taxpayer's cancelled checks, can be contacted to obtain their invoices. In the building industry, the invoices will reveal the delivery addresses and can identify specific homes that were built.

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b. When employees or workers in the business are extended family members or fellow immigrants, there can be diverted profits in the form of unreported benefits. A convenience store owner who pays very little to employees may also allow the worker to remove inventory for personal use. The examiner should be alert to store owners offering workers:
   (i) Free or low rent in their residential rental properties;
   (ii) Payment of personal expenses; or
   (iii) Removal of inventory for personal use.

c. A check cashing service may refer to a large or small company that will cash personal or payroll checks for a fee. The check cashing service earns its income by charging a percentage of the amount of the check.
   (i) Some convenience stores will offer this service, typically charging a 3 percent to 5 percent fee. For example, cashing a $1,000 payroll check at a local convenience store may cost between $30 to $50.
   (ii) As with a bank, the check casher will require identification, and may not accept certain types of checks, based on their experience. A business that has been in operation for several years will not usually have losses from check cashing. Whenever losses or bad debts are claimed, the examiner must determine that sufficient efforts were made by the business. Contact should be made with the customer to ensure the funds were not repaid to the business in cash and the collection was not recorded.

d. Before beginning any examination of income, the examiner must determine what is included in income on the books and tax return, and how the amount was determined. Only then can adjustments be made.
   (i) To the extent possible, examiners should attempt to identify the source and nature of deposits or receipts that were omitted. For example, if examiners only add total business bank deposits and compare the total to the receipts on the return, no consideration is given to the taxpayer's method of payment of business and personal expenses. (Cash expenditures must be added to bank deposits.)
   (ii) When the taxpayer has a double entry set of books, the cash accounts must be reconciled, and the other accounts must tie into the balance sheet. In this case, if all income is believed to be included, the examination will concentrate on an analysis of the cash accounts and a review of the taxpayer's withdrawals from the business and personal living expenses.

e. The percentage of markup method is an indirect method that can overcome this weakness in reconstructing taxable income. It is similar to how state sales tax agencies conduct audits. The cost of goods sold is verified and the resulting gross receipts are determined based on the actual markup. A percentage of markup method permits examiners to use a common denominator within the business records to identify unreported income. The denominator should be verifiable through a third party such as a supplier, if necessary. Examiners apply a multiplier to the common denominator to establish gross receipts. The markup method is especially effective in businesses where the supply chain is regulated or limited.

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(i) The percentage of markup method should be considered in the following cases:
- Inventories are the principal income producing factor;
- Cost of goods sold or merchandise purchased are from a limited number of suppliers;
- Suppliers can be ascertained with reasonable certainty; and,
- Per unit sales price can be determined with reasonable consistency.

(ii) Where gross profit percentages are fairly uniform for a specific trade or industry, an acceptable gross profit percentage may be used to determine if the taxpayer’s gross profit compares with similar businesses. Problems to be considered here are the type of merchandise, size of operation, locality, period covered, general merchandising policy, and the influence these factors might have on the percentage. Where a percentage relationship between a business expense, such as commissions and gross income, is established early in the audit, such percentage could be used to verify gross income.

(iii) Where agents know the number of units handled or produced by the taxpayer and know the price or profit per unit, they can recompute gross income. This method can be used in both service industries and in the manufacture or sale of goods or property.

Example: If the examiner has confidence that a restaurant's reported labor costs of $150,000 is accurate and the normal labor burden for the establishment is 30 percent, then gross receipts should be $500,000 ($150,000 / .30 = $500,000).

Question to Ponder:

How long are examinations currently taking and what appears to be driving the length of these examinations?

B. Business consultants

1. Introduction

Employment related expenses are extremely costly to most business. They include FICA, Medicare, FUTA, SUTA, workers compensation, and fringe benefits. As a result, the trend has been to hire these workers as independent contractors. These workers are part of a growing industry now known as “consulting;” the Service needed to address business consulting where some of these former employees are now contractors who are engaged by the same company and/or industry that previously employed them. This audit techniques guide is based on examinations of sole proprietors, corporations, and partnerships completed by revenue agents.

a. What is "consulting"? The dictionary defines it as being employed in giving professional advice, either to the public or to those practicing a profession, while the tax regulations define the field of consulting as "the provision of advice and counsel," but exclude sales and brokerage services, "or economically similar services."[1]

(i) The distinction between the two is based on the facts and circumstances, but a significant factor is whether the taxpayer’s compensation is contingent on the outcome of a particular transaction. Thus, an economic analyst, data processing consultant, management consultant, or financial planner is performing "consulting" activities; while a securities broker, computer sales agent, recruiter,

[1] Temp. Regs. §1.448-1T (e) (4) (iv).

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advertising agent, or insurance broker is not, although these activities may include some element of "advice and counsel."

(ii) Many people call themselves a consultant, when in reality they may be a broker, a salesperson, a retailer, or engaged in a business that is a hybrid. One of the issues facing the industry is an influx of new entrants, many of them managers and executives who have been downsized. They open up shop independently or in collaboration with others. For many displaced workers, consulting is something they say they are doing in the interim while searching for a job.

2. Internal control

As part of every examination, the examiner needs to evaluate and document the internal control of the business. This is important in determining the agent's **level of reliance on the taxpayer's books and records for the scope and depth of the examination**.

3. Income

An examination of income is conducted to determine whether taxable income has been accurately reported on the tax return. Examinations of income for all business tax returns should incorporate industry-based audit techniques. Many consulting businesses are closely held and as a result, internal controls may be inadequate. This provides an opportunity for inaccurate reporting of income.

a. Every examiner will seek to determine that the taxpayer has reported all of the income required to be reported and that the income was reported in the proper period by the proper entity. The examiner should be alert for the following:
   - The lack of internal controls;
   - The types of books and records the taxpayer maintains particularly in the area of electronic software;
   - The taxpayer's use of bartering;
   - The shifting or assignment of income by a taxpayer to a related entity;
   - The taxpayer's use of the internet. Examiners should use a search engine to check for an internet presence and ask the taxpayer about internet use;
   - The taxpayer's use of a fiscal year-end in order to defer income;
   - Complete the minimum income probe lead sheet including the section for ecommerce audit procedures;
   - Where applicable, request YK1 printouts; and
   - If consultant is a sole proprietor, secure Integrated Data Retrieval System (IDRS) income information.

b. Minimum income probes are required for individual and corporate business returns. The minimum income probes include an evaluation of internal controls. The examiner is instructed to determine the reliability of the books and records, regardless of the sophistication of the record-keeping method.

c. It has been estimated up to 75% of small- and medium-sized businesses use electronic accounting software to maintain their books and records. Most accounting software programs can generate a large number of pre-set reports. Each report can be modified to fit the examiner's needs. When working with these reports within the accounting software program, the examiner can "drill down" to the underlying data and documents to further investigate items, as appropriate. In the majority of audits, examiners should request a copy of the taxpayer's original accounting software backup file as reviewing the electronic records should make the audit more efficient.

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d. In every case, examiners will use a search engine to check for an internet presence and ask the taxpayer about internet use. Tips on effective web searching can be located on the internet by using the advanced search features of popular search engines to narrow results.

Note:

(i) Question the taxpayer regarding business policies and practices for:
- Billing rates and billable hours per year;
- Explanation of how retainer fees are determined in contract agreements;
- Explanation of how and when consulting fees are earned and billed;
- When the taxpayer provides consulting services without a signed contract;
- When customers enter into consulting agreements with the taxpayer in which customer requests the services of a specific employee;
- When the consulting agreements have cancellation provisions if a consultant dies; and
- Whether the taxpayer has employment contracts with all of its consultants.

(ii) Question the taxpayer as to website addresses.

(iii) Question the taxpayer as to whether deductions have been claimed on the return that are common to e-commerce businesses, such as depreciation for networking equipment or high telecommunications expenditures, or payments to an Internet Service Provider (ISP) or an Application Service Provider (ASP).

e. In audit, identification of e-commerce business, reviewing and saving websites, and interviewing the taxpayer with questions tailored to the taxpayer are the objectives.

Note:

The internet has brought about resurgence in bartering exchanges. Bartering exchanges are required to file form 1099-B including payments to corporations with limited exceptions. A small proportion of this bartering activity is reported to the IRS. Taxpayers may encounter cash flow problems. Bartering for internet service allows a taxpayer to preserve precious cash for rent, utilities, and salaries. If services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income as compensation.[2] If any payment required to be reported on Form 1099-MISC is made in property other than money, the fair market value of the property at the time of payment is the amount to be included on such form.[3] One-on-one corporate bartering (the exchange of property and services) between corporations is not subject to the information-reporting requirement. Barter transactions that are "facilitated" directly or indirectly by middlemen, organizations, or individuals (that do not rise to the definition of "barter exchange broker") between corporations, individuals, or other entities are not subject to information reporting. There is a significant probability that no Forms 1099-MISC were filed for bartering transactions. This is an area of high noncompliance.

(i) Detecting bartering is a part of the income probe. The first step is to review the information that is readily available.
- Does the Information Reporting Program (IRP) transcript indicate any Form 1099-B (*Proceeds from Broker and Barter Exchange Transactions*) for the tax year under examination?
- If the taxpayer has a website, does the site indicate that the business is a member of a barter exchange or accepts bartering trades for services or goods? (Look for links, banners, and logos.)

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2 Treas. Regs. §1.61-2(d)(1).
3 Treas. Regs. §1.6041-1(g).

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- During the tour of the business, is there an indication that the business is a member of a barter exchange or accepts bartering trades for services or goods? For example, taxpayers often have signs, logos, or plaques regarding achievements, credit cards accepted, memberships, etc. Some of these may indicate barter organizations.

Note:

The IRS has partnered with Internet Reciprocal Trade Association (IRTA) and National Association of Trade Exchanges (NATE) to educate their members regarding bartering and taxes. The following websites provide useful information regarding how bartering works, its members, etc.: www.irta.com; and www.barternews.com.

Businesses that choose to participate in modern trade and barter will become a client of an IRTA Member Company. As clients when they sell their goods and services to other clients in the system, they earn trade credits that are deposited into their accounts. They then have the ability to purchase goods and services from other member clients utilizing trade credit in their accounts.

(ii) During the course of the examination of the books and records be alert for fees paid to or invoices from a bartering exchange. If bartering was not detected, document the case file. If bartering was found, the next step is to determine if the issue should be pursued in terms of compliance value and time to develop. Consider the dollar amount, volume, and nature of the transaction(s). Remember to consider the basis of the item bartered (goods only).

(iii) On the other hand, if the taxpayer exchanged a single item, such as business asset for a personal item, such as a two-week timeshare at a vacation resort, it would be worthwhile to pursue.

- Exchange of services is another example of an issue that generally should be pursued. There is no basis and both income tax and self-employment tax may apply.
- Once you have determined that the issue is worthwhile, it is suggested that you walk through one or two barter transactions with the taxpayer or representative. You need to determine if the transaction is properly reported as income, the expense is a legitimate business expense, and if so, that it was deducted only once.

Note:

(i) Ask about barter memberships and barter activity during the initial interview.
(ii) Did the taxpayer receive any Forms 1099-B?
(iii) If you have a participant in a barter exchange, inquire:

- What does the taxpayer trade?
- How often are trades made?
- Are the trades reflected in the books and records?
- How and when are the trades reflected in the books and records?
- Does the exchange provide statements to the taxpayer?
- How often are the statements received?

4. Shifting or the assignment of income

Closely held or one-man personal services corporations, including business consultants, have assigned, or shifted income earned by themselves, as individuals, or their closely held corporations, to another entity in order to reduce their income and/or self-employment taxes. The taxpayer may shift income

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earned by one entity to a related entity in order to offset net operating losses of a related entity or in some cases to circumvent the Roth IRA limitations. Subsequent to this shifting of income, the taxpayer may take a relatively small salary from the entity (that received the assigned income) in relationship to the amount of income shifted.

a. A review of the taxpayer's consulting agreements/contracts should be conducted. The following are a list of items the examiner should search for in the agreement/contract:
   (i) To whom is the client/customer contracting the services? Is the Taxpayer an S corporation or a partnership and yet the contract requires the services of a particular employee/owner?
   (ii) Is the contract voided upon the death of a particular employee of the Taxpayer?
   (iii) Do the terms of the agreement call for services that only one employee/owner is capable of performing?
   (iv) The examiner should trace the consulting fees per the contract to the Taxpayer's books and records.
   (v) Request copies of all tax returns that are considered related returns of the Taxpayer because the Taxpayer has control. The examiner should evaluate copies of tax returns of significant shareholders or partners (greater than 20% direct or indirect ownership) for:
      - Examination potential (including issues unrelated to the corporate or partnership return);
      - The proper treatment of related transactions with the corporation or partnership, including losses from related parties; and
      - The likelihood of diverted funds.

b. The shifting of income or the assignment of income can be addressed by the examiner under the common law assignment of income issue under IRC §61 and/or the assignment of income under IRC §482.
   (i) In cases involving closely held or one-man personal services corporations, a tension exists between the principle that income is taxed to the person who earns it and the principle that corporations are separate and distinct taxpayers from their owners. In deciding whether an individual rather than his corporation is taxable with respect to income earned through his performance of personal services, the courts have held that the relevant inquiry is which of the two parties controls the earning of the income.[4] In this case, two elements must be present before a corporation, rather than its service-performer employee, may be considered the controller of income. These two elements are as follows:
      - First, the service-performer employee must be an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense. The examiner should determine where the individual performing the service had a **contract or employment agreement between himself and the corporation** that would indicate the corporation had the right to control or direct the individual.
      - Second, there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position.

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[4] *Johnson v. Commissioner*, 78 T.C. 882 (1982), aff'd. without published opinion 734 F.2d 20 (9th Cir. 1984), cert. denied 469 U.S. 857 (1984).

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(ii) The question under §482 to be raised by the examiner is whether parties would have entered into their financial relationships had they been unrelated parties dealing at arms-length. Although it has been held that a corporation is not required to pay a salary to an officer who performs services on its behalf,[5] particular scrutiny is necessary when an individual incorporates an existing service profession and the corporation's only business activity is effectuated solely through the efforts of the individual as an employee of the corporation.

c. How a transaction is taxed depends upon its substance. A transaction must be viewed as a whole, and each step from the beginning of negotiations to final consummation is relevant. The true nature of a transaction cannot be disguised by a mere outward appearance that exists solely to alter tax liabilities. The substance over form or economic substance doctrine requires a determination of whether what was done, apart from the tax motive, was the thing that the statute intended.[6] When a step in a transaction is a mere "ritualistic incantation" in order to meet the words of the statute, that step will be ignored, and the final result achieved will govern the tax consequences.

(i) In applying this doctrine of substance over form, the courts look to the objective economic realities of a transaction rather than to the particular form the parties employed. In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding.

(ii) In contrast, taxpayers are generally bound by the form in which they choose to cast their transactions. While a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not.

(iii) The Health Care and Education Reconciliation Act codified the economic substance doctrine and imposes a strict liability penalty on any underpayment attributable to a noneconomic substance transaction. The amendments are generally effective for transactions entered into after March 30, 2010. A transaction will only have economic substance if: (1) The transaction changes the taxpayer's **economic position in a meaningful way** (apart from federal income tax effects); and (2) The taxpayer has a **substantial purpose** (apart from federal income tax effects) for entering into the transaction.

5. Tax years

A taxpayer may have improperly selected a fiscal tax year other than a calendar year-end in order to defer income. Sole proprietorships must use the tax year of the individual owner. A partnership must use the same tax year as its partners, unless a **business purpose** for using a different tax year is established. A corporation is generally permitted to choose from among a calendar year, a fiscal year, or a 52-53 week year. A personal service corporation must generally use a calendar year unless the corporation can establish to the satisfaction of the Secretary a business purpose for having a different period.

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[5] *Gross v. Commissioner*, 23 T.C. 756 (1955), aff'd. 236 F.2d 612 (2d Cir. 1956).
[6] *Gregory v. Helvering*, 293 U.S. 465 (1935).

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Note:

In certain circumstances, a partnership, S corporation, or personal service corporation that cannot establish a business purpose for using a fiscal year may be able to select a fiscal year if it makes the required election under IRC §444. A partnership, S corporation, electing S corporation, or PSC generally can elect under §444 to use a taxable year other than its required taxable year, but only if the deferral period of the taxable year elected is no longer than the shorter of three months or the deferral period of the taxable year being changed. A partnership and an S corporation with a §444 election must make required payments under §7519 that approximate the amount of deferral benefit. Form 8752 is used to calculate the payment due or the refund to be received. The payment or refund should be recorded as either an asset or a liability on the company's books. If it is not, the taxpayer may have reported the payment or refund as an expense or income. If that is the case, the examiner should look for an M-1 adjustment for the amount of the payment or refund. A PSC with a §444 election is subject to the minimum distribution requirements of §280H. A taxpayer may automatically adopt, change to, or retain a taxable year permitted under §444 by filing a Form 8716.

If the taxpayer intends to choose a fiscal year, adequate books of account must be established before the end of the first accounting period.

Generally, the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's required taxable year, ownership taxable year, or natural business year. In the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners, will not be treated as a business purpose. A taxpayer is deemed to have established natural business year through the use of a mechanical test if it satisfies the "25-percent gross receipts test."

In order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128.

a. If the Taxpayer is a personal service corporation, partnership, S corporation, or personal service corporation, determine if the Taxpayer established that it had a business purpose for having a tax period other than a required year-end. Request the Taxpayer's computation of its natural business year if the Taxpayer is relying on the mechanical test (Revenue Procedure 2006-46) to determine its fiscal year-end. Determine if the Taxpayer filed Form 1128 in order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period.
b. If the Taxpayer did not establish a natural business year through the use of the mechanical test and did not otherwise establish a business purpose for the use of a tax year other than the required tax year, determine if the Taxpayer filed an election under IRC §444 with Form 8716.
c. If the Taxpayer did make an IRC §444 election, determine if the Taxpayer made the required payments under IRC §7519. Review the books and records for asset or liability representing the payments calculated from Form 8752.

6. Travel

There is extensive travel inside and outside the United States within the consulting field. This industry lends itself to significant travel because many consultants have a specialized niche and a broad geographical client base. Potential areas of concern are spousal/family travel and personal travel, particularly out of the United States.

a. When an examiner is performing a pre-audit analysis, he or she should expect to see a separate line item for travel. If no travel expense is reflected on the return, the examiner

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may want to follow up to determine if travel expense may be incorrectly characterized on the return. The taxpayer may fail to allocate between the personal and business nature of the expense, as required under §274. The examiner will also need to prepare pertinent interview questions and request specific documentation on the Information Document Request.

b. A thorough interview is very important to find out **where the taxpayer's client base is located** and **how often the taxpayer travels**. The examiner should be alert to companion/family travel in and outside of the United States. The examiner can focus on extended travel beyond the actual business purpose and companion travel by testing the large, unusual, or questionable items and sampling a time frame (i.e., one month).

Note:

- Who are your major clients?
- Where is your client base located geographically?
- How often do you or your employees travel?
- Who travels for the company?
- Are they allowed to bring a companion? If so, who and why?
- Do employees receive a monthly flat fee or per diem for travel?
- Are employees required to account to their employer for their travel?

Reimbursed expenses:

- How are reimbursed expenses run through your accounting records?
- The examiner will ask the taxpayer to walk them through a transaction.

7. Independent contractor vs. employee

a. **A former employee coming back to a company as an independent consultant with a minimal break in service** --This has evolved from the downsizing taking place in the business world over the past decade. Many employers, in an effort to lower costs, have terminated specialized employees and then hired them back as independent consultants. This allows the employer to lower their costs in payroll and employee benefits.

b. **The continued use of the same strategic alliances** -- This has arisen when a consultant obtains a client for which they do not have all the resources themselves to fulfill the contract. To meet the needs of their client they form business relationships with other individuals. This can lead to an employee/employer relationship.

<u>**Pre-audit**</u>

a. During the pre-audit phase, this issue may not be apparent from the face of the return. If the return being examined is an individual return, the examiner will want to determine the source of the gross receipts from consulting. The examiner will also want to prepare interview questions to address this potential area. The examiner needs to be alert to large consulting or contract expenses, or expenses for other services. If the individual incurs significant unreimbursed expenses, this would be a factor in determining an employer/employee relationship. When the examiner decides to pursue this issue, the first step is to determine if the individual has a safe haven as an employer under §530. If the individual does not qualify for the §530 relief, the examiner may go forward with the development of this issue.

(i) This issue is a facts and circumstances issue. The examiner will need to analyze the individual's answers to the interview, as well as the contract (written or oral) between the individual and his or her major client to see if an employee/employer

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relationship exists. The examiner will want to be alert to behavioral control, financial control, and the relationship of the parties.

(ii) This issue is also a facts and circumstances issue which the examiner will want to develop based upon behavioral control, financial control, and the relationship of the parties.

b. The purpose of §530 is to shield employers who had a reasonable basis for treating workers as independent contractors from employment tax consequences arising from employment status reclassification by the Service. Section 530 should be addressed as early as practical where the employment status of a consultant is at issue. Discuss with the individual the reasons why he or she believes they were treated as either an independent contractor or as an employee. Failure to correct an individual's improper treatment of their "employee" during an examination provides the taxpayer a "safe haven."

c. For employment tax purposes, an individual will be deemed not to be an employee unless the employer had no reasonable basis for treating the individual as an independent contractor. To qualify for relief under §530, an individual must meet three general requirements:

(i) All federal tax returns required to be filed by the individual, with regards to the treatment of individuals as independent contractors, must be filed timely.

(ii) Consistent Treatment –

- The treatment of an individual as an independent contractor must be consistent with the treatment by the employer of any individual holding a substantially similar position.
- A substantially similar position exists when the job functions, duties, responsibilities, the party controlling functions, and the exercise of the duties and responsibilities are substantially similar.

(iii) Reasonable basis is established if the individual can show reasonable reliance on one of the following:

- Judicial precedent, published ruling, technical advice with respect to the individual, or a ruling issued to the individual.
- Reliance on a past Internal Revenue Service audit, if that audit entailed no assessment attributable to the individual's treatment of those holding positions substantially similar to that held by the individual whose treatment is at issue.
- Reliance on a private letter ruling issued to the taxpayer.
- A long-standing recognized practice of a significant segment of the industry based on the geographical location in which the individual does business.

Audit

The determination of whether a consultant is an employee or independent contractor is a factual question to be determined upon the consideration of the facts and the circumstances and the application of the law and regulations to a particular case. In general, the common law rules must be applied in determining the employer-employee relationship.

a. In determining whether an individual is an employee under the common law rules, the most important question is the amount of control the person or entity has over the

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individual hired to perform the services. This control question has been broken down into three areas of inquiry:

(i) Behavioral control;

(ii) Financial control; and

(iii) Relationship of the parties.

b. Within these areas of inquiry, there are certain factors that indicate the level of control over the individual employed. These factors have been developed based on the examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and factual context in which the services are performed. Having determined the relevant factors, consideration must be given to the relative weight of these factors in determining the consultant's status. The auditor will then need to weigh the facts and circumstances of each case and determine a consultant's status accordingly.

Note:

Determination of employee vs. independent contractor status is relevant with respect to the following federal tax issues: (i) whether an individual is liable for the employee's share of the FICA tax; (ii) whether business expenses must be itemized and are subject to the two-percent floor on miscellaneous itemized deductions or are subject to the adjusted gross income additions and the itemized deduction limitation; (iii) whether the firm's qualified pension plan must treat the individual as an employee for qualification purposes; and (iv) whether the individual has a right to continuing health care coverage after termination for purposes of COBRA.

In addition, employee status is also relevant for purposes of determining coverage under or liability for workers' compensation benefits, federal and state civil rights laws, the Fair Labor Standards Act (regulating minimum wage and overtime pay), the national Labor Relations Act (providing employees with the right of collective bargaining), the Occupational Safety and Health Act (regulating safety in the workplace), and the Americans with Disabilities Act (requiring employers to make special accommodations for disabled employees).

8. Meals

Introduction

Given the considerable travel usually required in this industry, there may be a sizeable expense for meals. Potential areas of concern include: (i) Personal (i.e.: lack of business purpose); (ii) Is the applicable percentage limitation being applied properly (50-percent limitation or 100% limitation for 2021 and 2022 for restaurant meals); (iii) Travel-status meals should be limited if not being reimbursed by client; and (iv) Meals in non-travel status.

Pre-audit

The examiner will pay particular attention to the limitation of meals while in travel status (because many taxpayers are unaware that the limitation applies to meals while in travel status). If no meals expense is reflected on the return, the examiner may follow up to determine if the expense may be incorrectly categorized on the return. The taxpayer may have failed to apply the appropriate percentage limitation. During the pre-audit analysis, the examiner will want to prepare pertinent interview questions and request specific documentation on the Information Document Request.

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Audit techniques

Sample to verify that the taxpayer is complying with §274. When the examiner reviews the sample, he or she should inspect for substantiation purposes, and verify that the taxpayer has properly applied the limitation to all unreimbursed meals and entertainment.

a. No deduction shall be allowed for meal or entertainment expenses unless the taxpayer substantiates these expenses by adequate records or by sufficient evidence corroborating his or her own statement. To deduct such expenses, the taxpayer must record:
   - The amount of the expense and a description of each separate expenditure;
   - The time and place the meal was provided;
   - The business purpose of the activity, including a description of any business benefit derived or expected; and
   - The nature of the business discussion.

b. The elements of any expenditure must be recorded "at or near the time" when the expense was incurred. Although not required, it is contemplated that the taxpayer will maintain a diary, travel log, or similar documentation while the taxpayer has current knowledge of the travel expenditure. The taxpayer may rely on "other sufficient evidence," but that evidence must be as specific and detailed as to the elements of the expense as the "adequate records" provision.

c. Certain expenses of traveling away from home may be deemed substantiated. The amount of meal expense deemed substantiated by employees, who are reimbursed by their employers (or another payor) is the lesser of the payor's allowance for meals for the day or the amount computed at the M&IE rate for the locality for such day. The amount that may be deducted on an employee's or self-employed individual's income tax return (after including any reimbursement received) is the amount computed at the M&IE rate for the locality of travel for the day of travel.

d. Generally, the amount of an otherwise allowable deduction for the cost of business entertainment and meals must be reduced by a flat 50 percent, unless these expenses are being reimbursed by a client.

9. Personal service corporation

Introduction

Consulting is a qualifying field within the meaning of personal service corporations. Many businesses that describe their services as consulting may not necessarily meet the definition of consulting outlined in the Regulations. The definition states that the performance of services in the field of consulting means the provision of advice and counsel. This does not include services such as sales or brokerage services, or economically similar services.

a. As a significant area of concern, does a C corporation meet the definition of a qualifying personal service corporation?

b. As a reason for some concern: Some C corporations may want to be considered a personal service corporation in order to be able to use the cash method of accounting; but some C corporations may not want to be considered a personal service corporation in order to take advantage of the graduated tax rates.

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Pre-audit

Examiners are aware that consultants can be anything. Many businesses use the word consulting to describe their services when, in fact, they are not only providing advice and counsel, but are also providing other services. This potential issue is driven by the facts and circumstances. As a result, a thorough interview is vital.

Audit techniques

Review the stock record book to verify stock ownership. Review contracts to verify the facts and circumstances that have been obtained in the interview.

Note:

> If a determination is made that the taxpayer is a personal service corporation other issues to consider may include:
> - Passive activity rules (there is an audit techniques guide available).
> - Taxable year (generally a calendar year).
> - Employee-owner compensation deduction limitation (if an election has been made to use a taxable year, other than a calendar year).
> - Personal service corporation formed to avoid or evade income tax.

a. The use of the cash method of accounting is denied to corporations, but a "qualified personal service corporation" is an exception. To qualify as a qualified personal service corporation, the corporation must meet a "function test" and an "ownership test."
   (i) The "function test" requires that 95 percent of the entity's activities involve the performance of services in one of the areas listed in the regulations, which includes consulting, defined as "services performed in the field of consulting" as the provision of advice and counsel and excludes performance of sales or brokerage services, or economically similar services.
   (ii) The "ownership test" requires that 95 percent of the entity's stock be owned directly or indirectly by active or retired employees engaged in providing such services, their estates, or any other person acquiring the stock by reason of their death. Indirect ownership may be held through a partnership, S corporation, another personal service corporation, or a grantor trust and community property laws are disregarded. No other attribution rules apply.

b. The passive activity loss limitations apply to personal service corporations to ensure that passive losses may not be offset against active income. The definition of "personal service corporation" is generally the same as above, with certain modifications. To determine whether the corporation is a personal service corporation, one must determine whether any "employee-owners" owned more than 10 percent of the stock, by value of the corporation on the last day of the testing period, which is generally the preceding taxable year.
   (i) The examiner will determine if the performance of personal services was the principal activity during the testing period. This determination depends on whether more than 50 percent of the corporation's compensation costs during the testing period were attributable to personal service activities.

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(ii) The final determination is whether the personal services provided by the personal service corporation are "substantially" performed by employee-owners. This determination is made by determining if more than 20 percent of the corporation's compensation costs were attributable to services performed by employee-owners. If all these criteria are met, the corporation is a personal service corporation and is subject to the passive loss limitations.

(iii) In general, for a personal service corporation, the calendar year is required for the taxable year for all taxable years beginning after 1986.

c. The deduction allowed for amounts paid by a personal service corporation to employee-owners is limited if the corporation has made an election to use a taxable year other than the required taxable year for a personal service corporation and has failed to meet minimum distribution requirements for the taxable year.

d. The Service has the power to allocate income, deductions, credits, exclusions, and other allowances between a personal service corporation and its employee-owners. Three conditions must be satisfied before reallocation may be made.

(i) These requirements are: 1) substantially all of the services of a personal service corporation are performed for or on behalf of one other corporation, partnership, or other entity; 2) the principal purpose of using the personal service corporation is the avoidance or evasion of federal income tax by reducing income or increasing deductions that would not otherwise be available; and 3) the allocation is necessary to prevent the avoidance or evasion of federal income tax or clearly reflect the income of the personal service corporation or any of its employee-owners.

(ii) A "personal service corporation" means a corporation the principal activity of which is the performance of personal services, and such services are substantially performed by employee-owners. Generally, "employee/owners" is any employee of the corporation who on any day during the taxable year owns more than 10 percent of the outstanding stock of the corporation. For purposes of determining "employee-owners," the constructive stock ownership rules apply, with certain modifications.

(iii) Generally, a personal service corporation will be deemed not to have been formed or availed of for the principal purpose of avoiding or evading federal income taxes if the reduction in federal income tax liability of each employee-owner does not exceed certain amounts.

10. Activities not engaged in for profit -- IRC §183

<u>Introduction</u>

Examiners also consider the activities not engaged in for profit issue when examining business consultants. The use of the word "consultant" in a business title provides an air of legitimacy to the business purpose. The taxpayer may be deducting expenses while having little or no revenue. The §183 activities not engaged in for profit rules apply to: (i) individuals; (ii) S corporations; (iii) partnerships; and (iv) trusts and estates. They do not apply to C corporations. Due to the suspension of the Schedule A miscellaneous itemized deductions under the Tax Cuts and Jobs Act of 2017, being reclassified from a trade or business to a not-for-profit hobby means the reporting of all income but no deductions for expenses as that was done on Schedule A.

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Pre-audit

It is not always easy to determine from looking at the return if an activity is not engaged in for profit. Examiners are alert to see if there is a "reasonable" indication that there is a "likelihood" of an activity not engaged in for profit in the pre-audit stage of the examination. The amount of pre-plan time spent will vary with the complexity of the case. Examiners consider the following in their pre-audit analysis:

- Are there activities with large expenses and little or no income?
- Are losses offsetting other income on the return?
- Does the activity result in a large tax benefit to the taxpayer?
- Does the history of the activity show that it is generating any profit in any years?

If the examiner suspects that the Taxpayer may be involved in an activity not engaged in for a profit, examiners should review the IRC §183 Audit Technique Guide.

Reimbursed expenses

Reimbursed expenses are expenses that the taxpayer will recoup directly from their client. These are very common in the consulting industry. They can include travel, meals, products, and advertising, among others. Examiners may find one or more of the following scenarios in the taxpayer's accounting system:

- The taxpayer will reflect the reimbursed funds as income and then take a corresponding deduction.
- The taxpayer will net the income and the associated expense through one account.
- The taxpayer will not record the income but will deduct the related expense.
- Reimbursements provided under non-accountable plans are taxable wages subject to employment taxes. Reimbursements provided under accountable plans that are in excess of substantiated expenses are taxable wages subject to employment taxes if excess is not returned within a reasonable period of time.

Note:

> Based on these scenarios, the examiner will want to be alert to the tax effect of reimbursed expenses given the taxpayer's method of accounting. Since reimbursed expenses are very common in this industry, the examiner needs to determine who is responsible for the 50-percent limitation on business meals and entertainment. If the taxpayer is not being reimbursed, the limitation applies to the taxpayer.

Reimbursed expenses may be reflected on the tax return in various ways. Some taxpayers differentiate reimbursed expenses as a separate line item, while others include the deduction on the return under the specific expense.

- The scenario of most concern is the deduction of the expense without the inclusion of the reimbursement as income.
- The other area of importance is who is responsible for the 50-percent limitation on business meals and entertainment.
- During the pre-audit analysis, the examiner should prepare interview questions pertaining to reimbursed expenses.

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Audit techniques
The examiner will select a sample of invoices or contracts and trace the income and reimbursed expenses to the books. This analysis will verify that the income is reported and that a corresponding expense may be deducted. Additionally, while sampling invoices or contracts, the examiner can verify that the taxpayer has properly applied the percentage limitation to all unreimbursed meals and entertainment.

The reporting and substantiation of certain reimbursements of persons other than employees includes reimbursement arrangements with a client or customer.[7] Generally, the amount of an otherwise allowable deduction for the cost of business entertainment and meals must be reduced by a flat 50 percent, unless these expenses are being reimbursed by a client.

[7] Treas. Regs. §1.274-5T(h).

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