# Tax Enforcement: Reading Tea Leaves in a Tax Gap Environment

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Limited IRS enforcement resources typically focus on areas of perceived noncompliance, whether by taxpayers or practitioners. Effective client representation requires a detailed knowledge of relevant tax authorities and current IRS enforcement priorities and intiatives, together with a healthy respect for the applicable professional and ethical responsibilities. Mutual respect between government representatives and private practitioners for these responsibilities and efforts enhance our system of tax administration and should improve compliance.



The IRS directly interacts with more Americans than any other public or private organization while administering the code as enacted by Congress. Its mission is ''to provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.'' Positions maintained by the IRS administratively and in litigation should be objectively pursued based on the applicable law and facts involved. However, the IRS is an agency made up of people who, much like those of us on the outside, come to the office with their personal viewpoints and life experiences intact. Although we might try, few of us are truly objective.

The commissioner of the IRS has been delegated the authority to administer and enforce the internal revenue laws, and he has the final administrative authority concerning substantive interpretation of the tax laws as reflected in legislative and regulatory proposals, revenue rulings, letter rulings, and technical advice memorandums. The IRS is an administrative agency attempting to interpret and apply tax law to simple situations as well as to complex circumstances that Congress never contemplated when enacting the code.

Although the IRS is unequivocally the best administrative tax agency in the world, its efforts are highly dependent on a responsible tax practitioner community.[1]

Effective client representation requires a detailed knowledge of relevant tax authorities and current IRS enforcement priorities and initiatives, together with an understanding of all applicable professional and ethical responsibilities. Future columns will attempt to highlight and analyze recent developments and relevant enforcement priorities, and suggest responsive techniques and strategies. A discussion of specific enforcement priorities must be framed by a general understanding of IRS operations and the current tax environment.

## A. The IRS Strategic Plan

Operating in a complex and constantly changing environment, the IRS administers the world's most effective system of voluntary tax compliance. It must monitor and react to increasing globalization, the constant development of new business models, and explosive technological advancements. Tax laws have become increasingly complex, and the role of tax practitioners and other third parties in the system is constantly expanding. To remain focused, the IRS routinely develops five-year strategic plans for its operating divisions. The 2009-2013 strategic plan includes two primary goals, each defined by separate objectives:

> Goal 1: Improve service to make voluntary compliance easier
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> > Objective 1: Incorporate taxpayer perspectives to improve all service interactions
> >
> > Objective 2: Expedite and improve issue resolution across all interactions with taxpayers, making it easier to navigate the IRS

[1]More than 80 percent of all federal individual income tax returns were prepared by paid preparers or by taxpayers using consumer tax preparation software, resulting in approximately 86.6 million federal individual income tax returns being prepared by paid tax return preparers. The actual number of paid preparers is difficult to determine without some type of registration process, but the IRS estimates that there are between 900,000 and 1.2 million individual paid preparers of tax returns. Recent studies show that 94 percent of taxpayers who use paid preparers generally follow their advice. Sixty-two percent of taxpayers said they follow their preparer's advice all the time. IRS, ''Return Preparer Review'' (Dec. 2009), *Doc 2010-85*, *2010 TNT 2-62*. *See* IRS Office of Program Evaluation and Risk Analysis, ''Paid Preparer Review for National Public Liaison'' (Sept. 2007). The return preparer population is believed to consist of approximately 42,896 active enrolled agents, 646,520 CPAs (as of 2006), 1,180,386 attorneys, 123 enrolled retirement plan agents, and 82,653 volunteers. The number of unenrolled return preparers is unknown. IRS, ''AES2 Taxpayer Survey,'' Question 13 (2009); IRS, ''Taxpayer Assistance Blueprint, Phase 2'' (2007); Jane K. Dokko and Michael Barr, ''Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence from a New Survey,'' *IRS Research Conference Proceedings* (2006).

**(Footnote continued in next column.)**

Objective 3: Provide taxpayers with targeted, timely guidance and outreach

Objective 4: Strengthen partnerships with tax practitioners, tax preparers, and other third parties to ensure effective tax administration

Goal 2: Enforce the law to ensure everyone meets their obligations to pay taxes.

Objective 1: Proactively enforce the law in a timely manner while respecting taxpayer rights and minimizing taxpayer burden

Objective 2: Expand enforcement approaches and tools

Objective 3: Meet the challenges of international tax administration

Objective 4: Allocate compliance resources using a data-driven approach to target existing and emerging high-risk areas

Objective 5: Continue focused oversight of the tax-exempt sector

Objective 6: Ensure that all tax practitioners, tax preparers, and other third parties in the tax system adhere to professional standards and follow the law[2]

Note the objectives' emphasis on practitioners. Practitioners provide leverage for limited tax administration resources. Most practitioners work within a zone of reasonable interpretations of the tax law. Some do not. For those who seem a bit confused about their ethical responsibilities and the relevant authorities, the IRS must proceed cautiously when using its enforcement resources. However, it must proceed and do so with authority in a clear and effective manner. Practitioners intentionally operating outside the zone of reasonableness do a disservice to us all. Practitioners operating inside that zone deserve the respect and admiration of the IRS for their dedication to a career of long hours toiling in the complex trenches of the code on behalf of sometimes marginally thankful clients who feel their representative is actually working for the government.

### B. Tax Gap Enforcement

Partially as a result of strong, ongoing congressional interest, the IRS is aggressively attempting to increase its tax enforcement activities to reduce the tax gap — the difference between the amount of tax imposed on taxpayers for a given year and the amount that is actually paid voluntarily and timely.[3] The tax gap represents, in dollar terms, the *annual* amount of noncompliance with our tax laws. However, because the tax gap represents unpaid taxes, any estimate is a ballpark figure at best. The federal gross tax gap is estimated at $345 billion per year (based on IRS tax gap data for 2001).[4] IRS enforcement activities, coupled with other late payments, recover about $55 billion of the gross tax gap, resulting in a net federal tax gap of approximately $290 billion and a noncompliance rate of 15 to 16 percent.[5] Few other countries can boast of a tax compliance rate of approximately 84 percent! However, all agree that a noncompliance rate of 15 to 16 percent amounting to several hundred billion dollars is unacceptable in our self-assessment tax system.

The tax gap is thought to be made up mostly of underreporting of income, underpayment of reported taxes, and the nonfiling of returns. It is believed that 82 percent of the estimated gross tax gap of $345 billion consists of underreporting on filed returns ($285 billion); that 8 percent is associated with nonfiling ($27 billion); and that 10 percent is associated with the nonpayment of tax ($33 billion).[6] The majority of the tax gap appears to be composed of individual income tax ($197 billion or approximately 57 percent — principally nonbusiness income and business income) and employment tax ($39 billion or approximately 11 percent — principally self-employment tax).[7] The balance comprises corporate tax, estate tax, and excise taxes. Taxes on illegal activities are excluded from these estimates. Having identified the primary sources of the tax gap, it should not be overly difficult to anticipate future IRS enforcement actions.

The percentage of underreported individual income varies significantly depending on the degree of information reporting and whether withholding is required. For example, tax gap data suggest that only 1.2 percent of the wages, salaries, and tips were underreported in 2001, whereas 57.1 percent of nonfarm proprietor income was underreported.[8] As such, increased information reporting and withholding would seem certain to reduce the tax gap. Any increased revenue would have to be weighed against higher administrative costs of the IRS and higher compliance costs of individuals.

Recently released enforcement results for fiscal 2009 demonstrate that the IRS has been able to leverage limited enforcement resources to remain a viable threat to those who believe a tax return merely represents an offer to negotiate with the government. Total IRS enforcement revenue increased from $33.8 billion in fiscal 2001 to $48.9 billion in fiscal 2009.[9] (Based on fiscal 2005 data, it costs about 44 cents for each $100 collected by the IRS.[10]) The increase in enforcement revenue was achieved with a substantially similar number of total IRS enforcement personnel (20,203 in fiscal 2001 and 21,059 in fiscal

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[2]IRS Strategic Plan 2009-2013 (Apr. 28, 2009), *Doc 2009-9611*, *2009 TNT 80-44*.

[3]IRS and Treasury Department, "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," p. 6 (Aug. 2, 2007), *Doc 2007-18004*, *2007 TNT 150-15*.

[4]For tax gap data for 2001, see "IRS Updates Tax Gap Figures," IR-2006-28 (Feb. 14, 2006), *Doc 2006-2947*, *2006 TNT 31-6*.

[5]*Id.*

[6]*Id.*

[7]*Id.*

[8]*Id.*

[9]IRS, "Fiscal Year 2009 Enforcement Results" (Dec. 22, 2009), *Doc 2009-28017*, *2009 TNT 244-40*.

[10]*See* Dustin Stamper, "Audits Up, Costs of Tax Collection Down, IRS Data Book Reveals," *Tax Notes*, Mar. 27, 2006, p. 1377, *Doc 2006-5341*, or *2006 TNT 53-2*.

2009).[11] From fiscal 2001 to 2009, audits of individual returns increased from 529,241 to 1,099,639 (with a corresponding increase in the audit coverage rate from 0.58 percent to 1.03 percent); liens increased from 674,080 to 3,478,181; levies increased from 482,509 to 965,618; and seizures increased from 234 to 581.[12] In fiscal 2009, there were more than 266 million visits to the IRS Web site![13]

With the number of individual return filings increasing from 127 million to more than 138 million between fiscal 2001 and 2009 (coupled with a corresponding increase in the filings of nonindividual returns),[14] the IRS must remain vigilant in its enforcement efforts regardless of budget constraints. The Small-Business/Self-Employed Division (SB/SE) has approximately 28,000 total employees, including 4,000 new employees (approximately half of whom have previous experience in tax or accounting) and is contemplating 13,000 random audits to update data and formulas. The Large and Midsize Business Division has approximately 6,200 total employees, including 750 new employees (approximately half of whom are from outside the IRS). Appeals has approximately 2,000 total employees, of which approximately 1,000 are appeals officers or settlement officers, including 400 new employees. And the Office of Chief Counsel has approximately 1,600 total lawyers, including 226 recently hired lawyers (approximately 170 having prior experience and 56 hired through the Honors Program, with 47 being designated to LMSB and 90 being designated to SB/SE). Because six of the nine LMSB Tier I priority examination issues include some international tax component, substantially every LMSB counsel lawyer will be trained in the fundamentals of international tax law. Hopefully, the patience of taxpayers and practitioners will not be overly tested as these new employees are integrated within the IRS operations.

Many have emphasized increased tax enforcement to reduce the tax gap. However, much of the tax gap for individual income tax filers is due to types of unreported income that are difficult to detect during an examination. Even if liabilities are detected, many taxpayers are simply unable to pay, and many detected tax liabilities are so small relative to enforcement costs that it is not cost effective to pursue collection. As such, enhanced compliance requires a strong enforcement mechanism combined with other methods of encouraging taxpayers and their representatives to improve tax compliance. Practitioner penalties serve as a unique reminder of the diligence required in the return preparation process and the potential pitfalls associated with rendering unsupported advice outside the zone of reasonableness.

### C. Consideration of Practitioner Penalties

Congress and the IRS have long focused on tax practitioners in an effort to leverage limited enforcement resources — ''Attorneys and accountants should be the pillars of our system of taxation, not the architects of its circumvention.''[15] The return preparer represents the fine line between increasingly demanding government inquiries and client desires to remain off the government radar screen. The government wants transparency — if a taxpayer and his representative believe in the positions set forth within a tax return, the government believes the positions should be fully disclosed. Taxpayers believe that the whale only gets harpooned when it comes up for air. Preparers believe that whatever they do, neither the government nor the client will be fully satisfied.

Modifications to the return preparer penalty provisions in section 6694 (and the regulations thereunder) and the increased visibility of the IRS Office of Professional Responsibility (OPR) in overseeing perceived violations of Circular 230[16] have received the attention of the practitioner community. OPR, formerly known as the Director of Practice, enforces Circular 230 governing the practice before the IRS of attorneys, CPAs, enrolled agents, enrolled actuaries, and appraisers. As described in the recently announced ''Return Preparer Review,''[17] the responsibilities of OPR will drastically increase as it receives the authority to govern the practice of unenrolled, registered preparers.[18]

''It is no surprise that a knowledgeable tax attorney would use numerous legal entities to accomplish different objectives. This does not make them illegitimate. Unfortunately such 'maneuvering' is apparently encouraged by our present tax laws and codes,'' the Eleventh Circuit remarked in 2008.[19] However, ''maneuvering'' does not occur in a vacuum or without the attention of the IRS. Practitioners who choose not to comply with established standards of conduct are subject to a broad range of coordinated actions to effectively address their misconduct — for example, the assessment of economic penalties, disciplinary penalties, and sanctions imposed under Circular 230; suspension of electronic filing privileges; pursuit of injunctive action; and, when warranted,

[11] *Supra* note 9.
[12] *Id.*
[13] *Id.*
[14] *Id.*

[15] Remarks by former IRS Commissioner Mark Everson at his nomination hearing before the Senate Finance Committee (Mar. 18, 2003), *Doc 2003-7606*, *2003 TNT 59-55*.

[16] Regulations governing practice before the IRS are in title 31, Code of Federal Regulations, part 10, and are published in pamphlet form as Treasury Department Circular 230. The regulations prescribe the duties and restrictions relating to that practice and the disciplinary sanctions for violating the regulations. A copy of Circular 230 is *available at* http://www.irs.gov.

[17] *See supra* note 1.

[18] The IRS is to be commended for the time-consuming process, including public hearings and solicitation of comments, before determining that unenrolled paid preparers should be subject to oversight and should have some degree of continuing education (without any implication that unenrolled preparers might not already pursue considerable, ongoing continuing education). All tax practitioners should welcome the opportunity to enhance their tax knowledge and expertise through some process of continuing education. Mandatory continuing education requirements are the equivalent of state helmet laws for motorcycle riders. Some people don't always recognize the obvious.

[19] *See Ballard v. Commissioner*, 522 F.3d 1229 (11th Circuit, Apr. 7, 2008), *Doc 2008-7664*, *2008 TNT 68-16*.

criminal prosecutions by the Justice Department. ''Supreme excellence consists in breaking the enemy's resistance without fighting,'' Sun Tzu observed.[20] The IRS's focus on preparers has been constant and significant.

**1. Examination letter.** The SB/SE examination program letter for fiscal 2008 defined the operational goals of the SBSE and stated:

- ''Return preparers are a critical component of Tax Administration and provide a unique opportunity to impact taxpayer behavior and compliance with the tax law. We will develop and implement a Service-wide return preparer strategy to actively identify and address egregious preparers. We will identify preparers that promote overly aggressive positions for appropriate action. We will fully develop and coordinate preparer penalty issues, consider initiation of projects, and refer practitioners to the Office of Professional Responsibility, when appropriate.''
- ''Penalties should be considered during every examination. Examiners must properly develop and document actions taken to determine the appropriateness of all applicable penalties. The reasonable cause provisions will be considered on a case-by-case basis taking into account all the pertinent facts and circumstances.''
- ''Return Preparer penalties should also be considered. Coordination with Area Return Preparer Coordinators will take place to determine if the initiation of Program Action Case procedures is appropriate.''
- ''In FY 2008, our audit coverage will include cases representing the most egregious forms of noncompliance. The identification and development of fraud should be considered in all examinations.''
- ''Areas are encouraged to identify egregious activities through Compliance Initiative Program (CIP) and Return Preparer Program cases. Inclusion of these types of cases supports our strategy for addressing egregious non-compliance and our efforts to provide balanced coverage. Increased emphasis will be placed on returns with Schedule C activity that directly correlates to the Tax Gap. This is in recognition that $109 billion of the overall Tax Gap is due to underreporting on the part of individual business taxpayers.''

**2. January 2008 LMSB memo.** The LMSB memorandum, ''Procedures on Tax Return Preparers,'' described the return preparer program:

- ''The purpose of the return preparer program is to bring noncompliant return preparers into compliance. . . . PACs [Program Action Cases] are preparer investigations where clients of questionable preparers are examined to determine whether preparer penalties and/or injunctive actions against the preparers are warranted.''
- ''The expectation for LMSB is that most of the potential cases will be referrals from LMSB field agents.''[21]

**3. April 2008 LMSB memo.** The LMSB memorandum ''Procedures for Tax Return Preparer Penalty Cases,'' provided the following comments and procedures for LMSB examiners:

- **Taxpayer Audit.** The purpose of asserting penalties on return preparers is to increase compliance. When examining a return prepared by a tax return preparer, it is an examiner's responsibility to ensure that the identification and conduct provisions of the code were followed. If the provisions are not followed, it is the examiner's responsibility to assert the penalties. During every field examination, examiners should determine if return preparer violations exist. This determination will be made based on oral testimony and/or written evidence during the examination process.
- **Gather Pertinent Information from Audit.** Each income tax examination is separate and distinct from the return preparer violation case relating to the income tax examination. Therefore, examiners will not propose or discuss conduct penalties per se in the presence of the taxpayer.
- **The Interview.** Interviews of the taxpayer should serve a dual purpose: 1) to further the tax examination and 2) to identify violations by a tax return preparer. During the initial interview and throughout the examination process, the examiner should ask questions regarding the return preparation as appropriate to the case and issues being developed:

  Whether through the interview process or other documentation, the examiner will need to determine whether tax violations may have been committed by a person who for compensation prepared all or a substantial portion of a return.

  Questions should be tailored to the individual taxpayer and situation. Examples of questions which may be appropriate to a given situation include:
  - Did you meet with the preparer?
  - What documentation was provided to the preparer?
  - Did you receive a copy of the return or claim?
  - How was the preparer compensated?
  - Are you aware of any errors, omissions, or mistakes on the return under examination?
  - Did you disclose this transaction on your tax return? Why? Why not?
  - Were there any concerns about how the transaction was reported?
  - What sort of process is used to address those concerns and on what basis are decisions made?
  - Was there any discussion regarding potential penalties?

[20]Sun Tzu, *The Art of War*.

[21]LMSB-04-1207-079 (Jan. 14, 2008), *Doc 2008-2350, 2008 TNT 24-62*.

- Was there any discussion regarding whether the transaction is subject to disclosure?

  Disclosure or the lack of disclosure under Revenue Procedure 94-69 impacts the consideration of preparer penalties. If a dubious transaction is disclosed on the tax return, the transaction will have to be more egregious to warrant the imposition of preparer penalties. However, disclosure of the transaction does not in itself prohibit imposition of preparer penalties.

  When interviewing the taxpayer or preparer ask if any other services are provided by the preparer's firm and how long the preparer has been preparing returns for the taxpayer? These simple questions will give you an idea of the extent of the preparer's knowledge regarding the taxpayer's financial situation/status and alert you as to the applicability of penalties. A tax return preparer who has been preparing a client's return for a number of years is more knowledgeable than a firm that is preparing a client's return for the first time.

- **Documentation of the Facts.** The examiner should document the case file following the conversation with the taxpayer and/or Power of Attorney. While each examiner has their own interview style, examiners should be vigilant in documenting statements made during these interviews.
- **Caution:** In the workpaper files examiners should only document the fact that the required inquiries on the return preparer issues were completed. The taxpayer's answers to these inquiries should not be included in any workpapers in the taxpayer's case file. All information on the return preparer's activities and the applicability of any penalties relating to the return preparer should be separated from the taxpayer's case file. This information is then included in the return preparer penalty case file.[22]

**4. Excise tax memo.** The December 2008 SB/SE excise tax memorandum, ''Interim Guidance Return Preparer Procedures for Excise Tax,'' states:

> For each excise examination involving a return that was prepared by a paid return preparer, the examiner must enter comments in the work papers, preferably Form 4318 *Examination Work papers Index*, regarding the appropriateness of a return preparer penalty.[23]

**5. Employment tax memo.** The February 2009 SB/SE memorandum, ''Interim Guidance for Preparer Penalty Procedures for Employment Tax,'' set forth the following comments and procedures for employment tax examiners:

- ''During all field and office examinations, a determination will be made as to whether the facts and circumstances of the examination give rise to the development of a penalty issue. This determination will be made based on oral testimony and/or written evidence obtained during the examination process. Examiners are required to comment on preparer penalties on all cases examined.''
- ''Examiners will not propose or discuss preparer penalties in the presence of the taxpayer. All information regarding the return preparer's activities and the applicability of any penalties relating to the return preparer should be separated from the taxpayer's case file.''
- ''When a IRC section 6694(a), IRC section 6694(b), or IRC section 6695(f) penalty is asserted against an attorney, CPA, enrolled agent, or enrolled actuary and is closed agreed by the examiner or sustained in Appeals, or closed unagreed without Appeal contact, a referral to the Director, Office of Professional Responsibility is mandatory.''[24]

**6. Appraiser penalties memo.** An August 2009 SB/SE memorandum, ''Procedures for Implementing the Penalty for Substantial and Gross Valuation Misstatements Attributable to Incorrect Appraisals Under IRC Section 6695A,'' states: ''During the related tax examination, examiners will inquire, as warranted, to develop facts and circumstances to determine whether or not an IRC section 6695A appraiser penalty case should be opened.''

As stated, practitioners are a critical component of tax administration and provide a unique opportunity to affect taxpayer behavior and compliance with the tax law. The IRS will continually monitor practitioner behavior to improve compliance. Most preparers have a high degree of pride in their work and do not get up in the morning intending to do the wrong thing. All spend significant amounts of otherwise personal time attending continuing professional education conferences and seminars to enhance their professional knowledge and expertise. Many far exceed whatever continuing professional education requirements exist to maintain their professional licenses. The vast majority of preparers spend long hours struggling with uncertain facts, complex statutory authorities, and ever-changing case law, trying to do the right thing. They are a critical, well-respected component of tax administration.

Experienced government representatives recognize the difference between those attempting to work within the system and those attempting to circumvent it. Unfortunately, through attrition, there are fewer experienced government representatives toiling away in the tax trenches. Most practitioners have little to no experience with the questionable preparers who the government must routinely tackle. Preparer penalties and sanctions are important for those who ignore their responsibilities to reasonably comply.

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[22]LMSB-04-0308-009 (Apr. 13, 2008), *Doc 2008-9607*, *2008 TNT 85-8*.

[23]SBSE-04-1208-068 (Dec. 31, 2008), *Doc 2009-2372*, *2009 TNT 22-20*.

[24]SBSE-04-0209-008 (Feb. 3, 2009), *Doc 2009-2371*, *2009 TNT 22-19*.

### D. SB/SE in a Recessionary Economy

Recent economic trends have resulted in more bankruptcy filings and significantly more taxpayers unable to satisfy their tax obligations in a timely manner. The recession has also brought increased efforts to resolve liabilities through offers in compromise and installment agreements (IAs) — with a corresponding increase in defaulted OICs and IAs — and many more taxpayers who have not historically had tax-related issues. SB/SE is responding with an effort to work more closely with delinquent taxpayers.

SB/SE is coordinating a process to provide an additional review of real estate valuations before rejecting OICs based on valuation and to be flexible in payment arrangements involving OICs and IAs.[25] Revenue officers have been advised to postpone enforced collection actions if the taxpayer becomes unemployed or incurs some other financial hardship or a devastating illness, etc. When the liabilities have been satisfied, the levies are to be released on an expedited basis.

When first learning of a potentially adverse situation for a taxpayer, the representative must contact the IRS. It is not reasonable to await an IRS contact at some uncertain future date. The representative should be proactive and explain the entire situation (financial, health, etc.) for the taxpayer. The national taxpayer advocate has long advocated fewer liens when the taxpayer has insignificant assets.[26] Contact the IRS before a lien is filed and request consideration of collection alternatives. Remember, IRS employees and their families may have similar issues. Everything is relevant in this economy.

### E. LMSB Global High-Net-Wealth Industry Group

It is not unusual for a single high-net-wealth individual to have actual or beneficial ownership of several related entities, either alone or with family members or business associates. Recognizing that it is impossible to effectively examine the activities of high-net-wealth individuals by simply reviewing their individual returns, the LMSB recently formed a global high-net-wealth industry group to centralize and focus IRS compliance expertise on high-wealth individuals and their related entities (initially those having more than $10 million in assets or income in the aggregate). It involves the pursuit of a holistic approach to the entire web of business entities controlled by a high-net-wealth individual and a better understanding of the economic picture of the overall enterprise to assess its compliance. Examinations will include an enterprise analysis of related trusts, private foundations, flow-through entities, real estate investments, and privately held corporations. Australia, Canada, Germany, Japan, and the United Kingdom, have similar groups.

The ''wealth squad'' will be made up of flow-through specialists, international examiners, economists to identify economic trends, appraisal experts to advise on valuation issues, and technical advisers to provide industry or specialized tax expertise. Each return will be reviewed as an integral part of the overall enterprise, with a focus on sophisticated domestic and overseas financial, business, and investment arrangements having complicated legal structures (trusts, real estate, royalty and licensing agreements, and partnerships) and tax consequences. Although part of the LMSB, the wealth squad will be responsible for related private foundations and retirement plan assets, which would normally fall under the jurisdiction of the Tax-Exempt and Government Entities Division.

Representatives of high-net-wealth individuals should recognize the limitations on their personal expertise and the issues that may require the engagement of outside specialists. We are fortunate to live in a country where it is not overly difficult to locate a practitioner who knows how many angels are in fact dancing on the head of that pin (that is, practitioners having considerable knowledge and experience in a narrow area of tax law). The LMSB wealth squad is good for the IRS. Hopefully it will expedite examinations by allowing the IRS specialist to quickly recognize when issues do not exist rather than having an IRS generalist get lost in the documentation. Practitioners must be prepared to respond in a similar manner.

### F. LMSB Transfer Pricing Practice

Transfer pricing has become one of the most significant tax issues, if not *the* most significant tax issue, in the international arena. Taxpayers operating in multiple jurisdictions assume taxpaying obligations in each jurisdiction. Transfer pricing determines the proper allocation of income between jurisdictions. Given competing interests between other jurisdictions, the IRS, and the taxpayer, the Service recently established a transfer pricing practice within the LMSB to strategically and systematically administer transfer pricing issues. The practice will coordinate the efforts of a group of transfer pricing experts to identify emerging issues and trends and to provide consistency in the resolution of transfer pricing cases. Practitioners must be prepared to respond in a similar manner. Determinations of the proper income allocation among competing jurisdictions are not for the faint of heart: When facing a transfer pricing issue, find the expert.

### G. Disclosures of Uncertain Positions

The IRS recently announced a proposal that would require some business taxpayers to report uncertain tax positions when a return is filed.[27] The proposal would affect companies with assets exceeding $10 million that have a financial statement prepared under Financial Accounting Standards Board Interpretation No. 48, ''Accounting for Uncertainty in Income Taxes,'' or similar accounting standards. These taxpayers would be required to annually disclose uncertain tax positions in the

[25] *See* SBSE-05-0110-004 (Jan. 15, 2010), *Doc 2010-1738*, *2010 TNT 16-23*.

[26] The national taxpayer advocate's annual reports to Congress are on the IRS Web site, *available at* http://www.irs.gov/advocate/article/0,,id=97404,00.html.

[27] *See* IR-2010-13 (Jan. 26, 2010), *Doc 2010-1887*, *2010 TNT 17-15*; and Announcement 2010-9, 2010-7 IRB 408, *Doc 2010-1882*, *2010 TNT 17-14*.

form of a concise[28] description of those positions and the maximum amount of income tax exposure if the taxpayer's position is not sustained.

The taxpayer is not required to disclose its risk assessment or tax reserve amounts but must provide a list of issues that it has already prepared for financial reporting purposes. The IRS is attempting to improve the efficiency and effectiveness of tax examinations so it can effectively allocate its examination resources. The affected taxpayers are required to establish tax reserves for uncertain tax positions in determining their financial statement income under U.S. or foreign accounting standards, such as FIN 48.

The IRS has indicated that it could require more disclosure, but that the agency would otherwise retain its long-standing policy of restraint regarding tax accrual workpapers. Taxpayers are not required to disclose their risk assessment or tax reserve amounts, even though the IRS could otherwise compel the production of that information through a summons.[29] While the IRS intends to require the reporting of uncertain tax positions, it proposed to otherwise continue its existing policy of restraint.[30]

Large corporate taxpayers generally respect their responsibility to file accurate returns. In many large corporate audits, the IRS audit team makes reasonable inquiries about potentially uncertain positions near the commencement of an examination. Those inquiries are often more detailed than what would be disclosed in a few sentences. Will the IRS exam team feel pressure to limit the examination to a prompt disallowance of the (material) disclosed uncertain positions and move on to the next taxpayer? Do we need field agents, or have we now asked the large corporate taxpayer to effectively fall on its sword in an effort to preserve the IRS's limited enforcement resources? Will the IRS expand this disclosure practice to individuals, small businesses, partnerships, estates, and trusts? Does a return that fails to attach the disclosure schedule still qualify as a return? The IRS has reaffirmed its commitment to the policy of restraint regarding audit workpapers, but it has mostly eliminated the need for the workpapers by requiring that the taxpayer disclose the uncertain positions with the return. Where's the beef?

The IRS is evaluating various options for penalties associated with an inadequate disclosure.[31] It is interesting that the IRS is considering efforts to promote new legislation imposing a penalty for failure to file the disclosure schedule or for an inadequate disclosure when there are already some 130 penalties in the code and most of the tax community have called for penalty reform (and tax simplification). Penalty reform must be considered on an equal basis with an enhanced disclosure regime. Is it clear that positions disclosed on the new schedule will not be subjected to penalties?

### H. Anticipated Enforcement Procedures

Expect the IRS to expand use of soft notices and other nonaudit contacts while aggressively targeting areas of perceived significant noncompliance. Nonaudit contacts preserve resources in a manner similar to visibly parking an empty police car in a busy intersection. Drivers tend to stop twice when they notice a police presence.

The IRS has been revising its case selection procedures to better identify high-risk transactions, with a continued focus on corporations, high-income individuals, business income, and flow-through entities. This focus includes an effective nonfiler program, increased criminal investigations of existing and emerging high-risk areas, and pursuit of tax scheme promoters and of those who misuse tax-exempt organizations.

### I. Enforcement Priorities

The international arena will continue to test the IRS's enforcement resources for years to come. There will be ongoing, enhanced coordination with treaty partners and international organizations. (Six of the nine LMSB Tier I issues involve international components, and LMSB counsel lawyers have been trained in the fundamentals of international taxation.) The IRS is attempting to develop a protocol to conduct joint audits with treaty partners, ensuring that the taxpayer provides the same information to both tax authorities, reducing opportunities for arbitrage. In a joint audit conducted with a foreign tax authority, the corporate taxpayer will not have to go through a similar exercise twice but will be unable to play the jurisdictions against each other.

Issues regarding undeclared foreign-source earnings and financial accounts[32] will continue to generate considerable interest from the IRS and the Justice Department. The IRS has long encouraged participation in the voluntary disclosure process for all taxpayers — those with interests in offshore accounts and otherwise. Justice has a somewhat similar policy regarding the nonprosecution of taxpayers who have made a timely voluntary disclosure. The IRS policy provides that a taxpayer's voluntary disclosure is a factor that ''may result in prosecution not being recommended.''[33] To obtain this qualified benefit, the disclosure must be truthful, timely, and complete; the taxpayer must demonstrate a willingness to cooperate (and actually cooperate) in determining the tax liability; and the taxpayer must make ''good faith arrangements'' to fully pay the tax, interest, and any penalties.[34]

Those with interests in foreign accounts that have not previously been disclosed should immediately consult competent counsel. They likely remain eligible for the benefits of the long-standing IRS voluntary disclosure program, which would lessen the possibility of a future criminal prosecution. The IRS is expected to at least

[28]''By concise, we mean a few sentences that inform us of the nature of the issue, and not pages of factual description or legal analysis.'' IR-2010-13.

[29]*See United States v. Arthur Young*, 465 U.S. 805, 815 (1984).

[30]Announcement 2002-63, 2002-2 C.B. 72, *Doc 2002-14466*, *2002 TNT 117-12*, and Internal Revenue Manual section 4.10.20.

[31]Announcement 2010-9, *supra* note 27.

[32]The filing deadline for Form TD F 90-22.1, ''Report of Foreign Bank and Financial Accounts'' (commonly known as an FBAR) is due June 30 for the prior calendar year.

[33]*See* IRM 9.5.11.9.

[34]*Id.*

temporarily continue its current procedures for criminal preclearance and for disclosures made according to the three-page letter.[35] However, it is difficult to determine the potential administrative resolution of civil penalties for those who did not participate in the framework set forth in the penalty memorandums.[36] Undeclared foreign accounts present a rich target for the government. The IRS is committed to enforcement concerning offshore accounts, and the changing environment concerning bank secrecy may lead the government to many taxpayers with undisclosed interests in foreign financial accounts. For those with undeclared foreign accounts, now is the time to come into compliance — waiting is not a viable option.

Other examination priorities based on a perceived degree of noncompliance include:

- potential abuse of mortgage interest limitations[37] through claimed deductions exceeding limitations in multiple years;
- abuse of section 1031 like-kind exchanges, such as through the backdating of documents to circumvent the 45-day rule;[38]
- real estate dispositions in which the taxpayer is unable to adequately support the amount realized and the adjusted basis, or those in which the taxpayer fails to appropriately provide for the recapture of items when a negative capital account exists;
- employment tax and worker classifications[39] — independent contractor versus employee status — together with issues regarding executive compensation and fringe benefits;
- S corporation examinations with an emphasis on determining the built-in gains tax, asset valuations for C corporation assets on conversion to S corporation status, and compensation for S corporation officers; and
- examinations involving sales of partnership interests will attempt to ensure that reported interests match the actual ownership interests reflected in the partnership agreements, that income is properly recognized on distributions of installment notes, and that debt cancellation, general income and expense items, and information from Schedules K-1 are correctly reported on partners' returns.

Additional examination issues include net operating loss carryforwards. (Taxpayers should be prepared to fully document losses incurred in the recessionary economy of 2008-2009.) Examinations of estate and gift tax returns will continue to focus on valuations and discounts associated with closely held entities and properties, fractional interests, sales that occur close to death, underfunded marital trusts, and overfunded bypass trusts on the death of the surviving spouse. For matters involving tax-exempt organizations, the changes between the historical and recently revised Form 990 provide a road map of issues deemed important to the government, including executive compensation for senior management and key employees, conflicts of interest, and — an old favorite — abuse of donor-advised funds. Nonfilers, Schedule C taxpayers, and "cash intensive" businesses provide a target-rich environment for the IRS. Finally and importantly, return preparers and advisers provide a unique opportunity to leverage ongoing IRS compliance efforts that simply won't be ignored.

**J. Summary**

The IRS is to be commended for its strong tax enforcement efforts. Practitioners must respect the basis for those efforts and provide meaningful assistance to help taxpayers appropriately respond to their tax-related obligations. It is impossible to be all things to all people, regardless of the work and personal sacrifice. However, effective representation requires the ability to "issue spot" matters within the appropriate field of expertise and, to a lesser extent, matters outside the practitioner's field of expertise. Tax people must be sensitive to nontax issues.

During any interaction with the IRS, the practitioner's reputation for integrity and personal credibility is exposed. Wear the armor proudly, but do not allow zealous representation to put a dent in that armor by crossing the proverbial line in the ethical sand. Clients may not care much about the government until it begins to care about them. Representation requires the exercise of professional judgment based on knowledge and experience in the tax trenches. It does not require a concession on the merits of positions that have meaningful support. Effective client representation requires an understanding of the relevant facts, a detailed knowledge of the applicable tax authorities, and respect for current IRS enforcement priorities and initiatives, together with an understanding of all applicable professional and ethical responsibilities. Finally, "people who complain about taxes can be divided into two classes: men and women."[40]

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[35]For the information disclosure letter, see *Doc 2009-17261* or *2009 TNT 145-22*.

[36]*See* IRS Penalty Memoranda dated March 23, 2009, released on March 26, 2009 (procedures for the processing of undisclosed interests in foreign accounts. The penalty initiative expired on Oct. 15, 2009).

[37]Section 163(h)(3).

[38]See reg. section 1.1031(K)-1.

[39]The IRS is conducting 6,000 employment tax examinations focused on worker classification issues.

[40]The author of the quotation is unknown.