Surgent cpe
EDUCATION FOR PROS

IRS Tax Examinations and Hot Issues

EXI4/24/V2

201 N. King of Prussia Road
Suite 370
Radnor, PA 19087
P : (610) 688 4477
F : (610) 688 3977
info@surgent.com
surgentcpe.com

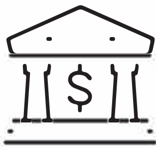
SURGENT
ContinuingEducation

Calling All **Exceptional**

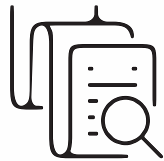
INSTRUCTORS

Surgent is currently accepting nominations

for prospective new discussion leaders in the following areas:

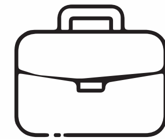


Tax



Accounting & Audit

Gov't and Not-for-Profit A&A



Business and Industry (all topics)

If you are an experienced CPA with strong public speaking and teaching skills and an interest in sharing your knowledge with your peers by teaching live seminars, we would love to hear from you!

Interested in becoming a Surgent discussion leader?

Reach out to us at recruitment@surgent.com

SURGENT
ContinuingEducation

SURGENT
ACCOUNTING & FINANCIAL EDUCATION

SURGENT FOR ENTERPRISE

Educational Solutions That Advance the Strategic Value of Everyone in Your Firm

At Surgent, we tailor our offerings — **exam review**, **continuing education**, and **staff training programs** — to meet your organization's specific needs in the most convenient and effective ways possible.

Personalized Exam Review

Help associates pass faster with the industry's most advanced exam review courses

- Adaptive study model offered for CPA, CMA, EA, CISA, CIA, and SIE exams
- Monitor employees' exam review progress with Firm360

Continuing Professional Education (CPE)

Make CPE easy for you and your staff with several ways to buy, earn, and track CPE

- Flex Access Program – Secure a pool of CPE hours your staff can pull from in live webinar and/or self-study format
- On-Site Training – Reserve an in-firm training with a Surgent instructor
- Course Licensing – License content from Surgent to lead your own CPE training

Staff Level Training

Leverage highly practical sessions, organized into suggested curricula according to staff experience levels

- Audit Skills Training Program
- Internal Audit Training Program
- Taxation Training Program

FIRM CPE PORTAL

Track and manage CPE for all users in your organization quickly and easily with Surgent's Firm CPE Portal.

Request a demo today!

Every firm is unique — and that is why we built our customizable, innovative Surgent for Enterprise program.

Contact our Firm Solutions team today to learn how Surgent can partner with you to create a solution to support staff development for your organization.

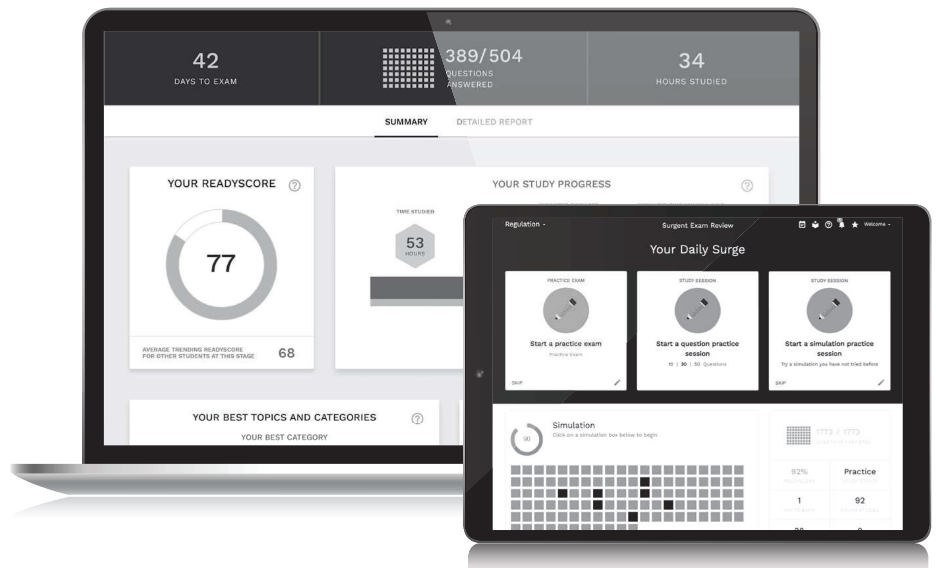
(484) 588.4197
salesinfo@surgent.com

SURGENT
ACCOUNTING & FINANCIAL EDUCATION

STUDY LESS AND PASS FASTER

with the industry's most advanced exam prep courses

Surgent's AI-powered software personalizes study plans for each student, targeting knowledge gaps and optimizing those plans in real time. This award-winning approach has been shown to save candidates hundreds of hours in study time.



KEY FEATURES

READYSCORE

Know what you're going to score before taking the exam.

PERFORMANCE REPORTS

Leverage your dashboard to know how you're doing every step of the way.

PASS GUARANTEE

If you fail your exam after using our course, we'll refund your money.

A.S.A.P. Technology

helps you pass the

- **CPA** Exam
- **CMA** Exam
- **EA** Exam
- **CIA** Exam
- **CISA** Exam
- **SIE** Exam

Leading education for your firm? Surgent offers preferred partner pricing, coaching, and more support methods to our firm clients and their staff. **Contact our Firms Solutions team today at salesinfo@surgent.com.**

Ready to explore exam prep course packages from Surgent? **Visit surgent.com to learn more!**

Table of Contents

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

Individual Audits.. 2

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

Worker Classification Audits......................... 4

S Corporation Compensation Issues 5

This product is intended to serve solely as an aid in continuing professional education. Due to the constantly changing nature of the subject of the materials, this product is not appropriate to serve as the sole resource for any tax and accounting opinion or return position and must be supplemented for such purposes with other current authoritative materials. The information in this manual has been carefully compiled from sources believed to be reliable, but its accuracy is not guaranteed. In addition, Surgent McCoy CPE, LLC, its authors, and instructors are not engaged in rendering legal, accounting, or other professional services and will not be held liable for any actions or suits based on this manual or comments made during any presentation. If legal advice or other expert assistance is required, seek the services of a competent professional.

Revised June 2024

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

NOTES

Examinations and Audits

Learning objectives	***1***
I. Overview	***2***
A. Chances of being audited: Latest information	**2**
B. Audits and COVID-19 credits	**3**
1. Who can withdraw?	*4*
2. How does a taxpayer request withdrawal?	*4*
3. Warning	*5*
C. Audits of high-wealth individuals	**5**
II. Introduction	***6***
A. Selection of returns for examination	**6**
1. In general	*6*
2. Screening of returns	*6*
3. The IRS Examination plan	*8*
4. Campus examination procedures	*8*
5. Office audit examination procedures	*9*
6. Field examination procedures	*9*
7. Documentation	*11*
8. Examination outcomes	*12*
9. Examination reports	*14*
10. Thirty-Day Letter	*14*
11. Appeals	*15*
B. Miscellaneous points	**16**
1. Chances of being audited	*16*
2. Audit results	*17*
3. Correspondence audits	*17*
4. International issues	*19*
5. Preventing an examination	*19*
6. Current trends	*20*
C. Burden of proof	**22**
1. General burden of proof	*22*
2. Section 7491	*22*
3. Impact on audits	*23*
D. Psychological checklist for an audit	**25**

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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, office exam and filed 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.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

I. Overview

A. Chances of being audited: Latest information

The chances of facing an IRS audit remained somewhat consistent over the last few years according to the IRS 2023 Data Book. Although the audit rate is at the lowest level in over a decade, according to updated data from the nation's tax-collection agency, the decreasing trend continued in FY 2023. This is due to an increase in the number of returns filed and a decrease in resources available to examine the returns filed. The 2023 Data Book covers IRS activities conducted from the period of October 1, 2022, through September 30, 2023.

The audit rate and the percentage of all returns examined, according to the IRS 2023 Data Book, was .44 percent for all individual returns filed and .74 percent for all corporations. This represents a decline from the 2022 examinations of .49 percent for all individual returns filed and of .84 percent for all corporations filed as of the end of FY 2022. For individual tax returns this represents approximately 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 loss of revenue agents and other personnel necessary for the examination process. The IRS is currently increasing its audit staff due to the influx of funds from the Inflation Reduction Act of 2022.

From FY 2010 through FY 2021, the IRS lost approximately 21.44 percent of its entire workforce. There were 107,621 full-time equivalent positions in 2010 compared to 89,767 in FY 2023 (84,553 in FY 2021). According to the Data Book, in FY 2022 the IRS was able to increase its full-time equivalent positions to 82,990 (79,070 in FY 2021) due to the increase in funds as a result of the Inflation Reduction Act. Of course, most of these positions are for people who do not examine returns. According to the IRS, over 5,000 workers were hired to answer the phones and provide increased taxpayer assistance. The actual workforce that examines returns consisted of 16,884 workers in FY 2023 and 16,984 in FY 2022. The decrease was to both workers who perform office examinations and those who perform field examinations. It should be noted that the decrease is not as detrimental as in previous time periods because the IRS has also been hiring new examiners due to the increased funding from the Inflation Reduction Act. The number of workers (Revenue Agents) who actually perform the examination of high-income earners and businesses still has declined despite the budget increase (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, it is noteworthy that the IRS still managed to assess an additional $31.9 billion from to the 582,944 tax examinations closed in FY 2023 compared to $30.2 billion from the 708,309 tax examinations closed in FY 2022.

Comparing FY 2020 to FY 2023, there was a significant increase of approximately $19 billion in additional tax assesses due to examinations. However, when comparing the 2023 data to 2010, the data represent a significant decline from the $44.8 billion in additional examination assessments in FY 2010 to the $31.9 billion in additional tax assessed in FY 2023. Even though it appears that the Tax Cuts and Jobs Act (TCJA), pandemic legislation, reduced funding, and reduced staffing have decimated the American taxing agency, the additional funding from the Inflation Reduction Act continues to assist the Agency in getting back on track.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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. With the additional funding, IRS personnel have finally caught up with all the processing necessary for the 2020 and 2021 filing season as well as providing an increased ability for taxpayers and practitioners to reach them on the telephone help lines. While originally in early 2023 the IRS had suspended issuing Notices because IRS personnel could not keep up with their automated systems sending out Notices, they have resumed sending out Notices as of late May 2023. Due to the funding infusion, they hired and trained workers who can assist taxpayers on the Notices.

The Inflation Reduction Act, signed into law August 16, 2022, approved the $60 billion in additional funding over a 10-year period to the IRS to step up compliance enforcement. These monies are earmarked to increase the IRS audit force and improve their technology. The $10 billion infused in FY 2022 and 2023 was mainly used to increase taxpayer services. These uses include providing phone assistance, opening the taxpayer assistance centers for longer hours, and hiring some new civil examiners as well as some criminal investigation workers (special agents) and workers who process tax returns. Unfortunately, for the civil examiners, 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. In 2023 and 2024, the IRS continues to focus on hiring examiners to audit returns filed and those returns not filed.

In the past, the Service would break down its workforce by specialty issues. For example, where there were international issues involved in a return, 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 diverted extensive resources from traditional examinations to high-wealth taxpayers. The IRS is examining the Forms 1040 of high-wealth taxpayers. These audits are being conducted by having taxpayers provide K-1 reconciliations and high Schedule A charitable contribution verification, and questioning passive versus nonpassive income and losses. In addition to the 1040 examinations, the IRS is concurrently examining several of these taxpayers' flow-through entities that are generating substantial flow-through items to the 1040s. As a result, these audits call for volumes of information and are taking a great deal of time and resource allocation.

B. Audits and COVID-19 credits

One of the hottest audit issues is the examination of the COVID-19 credits, which include the Employee Retention Credit (ERC), the Sick and Family Leave Credit, and the COBRA Credit. Statistics released showed that refunds for these credits totaled over $166 billion. The breakdown of the credits claimed is as follows:

- Total COVID-19 credits – $166,263,308,000.
    - Employee Retention Credit – $152,640,036,000.
    - Sick and Family Leave Credit – $12,439,039,000.
    - COBRA Credit – $1,184,173,000.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

These credits are claimed on Form 941. If a credit was not claimed on the original Form 941, taxpayers must file Form 941-X to get their monies refunded (IRS has placed a moratorium on filing Forms 941-X, so they are not accepting them currently). The IRS announced that personnel are continuing to process the 941-X returns, but due to the numerous fraud concerns surrounding the employee retention credit, they are examining the amended returns before releasing the funds. Not only are they performing the examinations to determine if the taxpayer is entitled to the ERC, but they are also checking the employer tax returns to verify that the employer reduced their wage expenses to avoid the duplicate tax benefit. In addition to examining unpaid ERC claims, the personnel are examining the ERC claims already paid to determine if recipient taxpayers were entitled to the credit. If it is determined that a taxpayer was not entitled, IRS will disallow the credit and expect the taxpayer to repay the monies, with interest and penalties. IRS is offering an ERC withdrawal process for taxpayers that want to withdraw their ERC claim. Those eligible are taxpayers whose ERC hasn't been paid yet, or those who received a check but haven't cashed or deposited it. Taxpayers who request to withdraw a claim will be asking the IRS not to process their entire adjusted employment tax return (Forms 941-X, 943-X, 944-X, or CT-1X) for the tax period that included the ERC claim. Claims that are withdrawn will be treated as if they were never filed. The IRS will not impose penalties or interest.

1. Who can withdraw?

A taxpayer can request the ERC withdrawal process if:

a. The ERC claim was made on an adjusted employment tax return (Forms 941-X, 943-X, 944-X, CT-1X).
b. The taxpayer filed an adjusted return only to claim the ERC and made no other adjustments.
c. The taxpayer wants to withdraw the entire amount of their ERC claim.
d. The IRS has not paid the claim; or the IRS has paid the claim, but the taxpayer has not cashed or deposited the refund check.

The IRS has stated that if a taxpayer willfully filed a fraudulent ERC claim, or assisted or conspired in such conduct, withdrawing a fraudulent claim will not exempt the taxpayer from potential criminal investigation and prosecution.

2. How does a taxpayer request withdrawal?

a. If the taxpayer has not received the refund or been notified that the claim is under audit, the instructions on the IRS website state:
   (i) Make a copy of the adjusted return with the claim to be withdrawn.
   (ii) In the left margin of the first page, write "Withdrawn."
   (iii) In the right margin of the first page:
      - Have an authorized person sign and date it.
      - Write the authorized person's name and title next to their signature.
   (iv) Fax the signed copy of the return to the IRS's ERC claim withdrawal fax line at 855-738-7609.

Note:

> This fax line is only for ERC claim withdrawals. The IRS will not process other documents sent to this fax line.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

If a taxpayer can't fax the withdrawal request, it can be mailed to the address in the instructions for the adjusted return that applies to the business or organization. Taxpayers should make sure they make a copy of the signed and dated first page to keep for their records. It will take longer for the IRS to receive the request if mailed. Taxpayers should track their package to confirm delivery.

b. If the taxpayer has not received the refund but has been notified that the claim is under audit, the taxpayer should follow the same steps as above but not fax or mail the request. Rather, if an examiner has been assigned, the taxpayer should ask the examiner how to submit the withdrawal request directly to the examiner. If an examiner has not been assigned, the taxpayer should respond to the audit notice with their withdrawal request, using the instructions in the notice for responding.

c. If the taxpayer has received a refund check but hasn't cashed or deposited it, the taxpayer should follow the same instructions above but not fax the request. Rather, the taxpayer should write "Void" in the endorsement section on the back of the refund check. The taxpayer should include a note that says, "ERC Withdrawal," and briefly explains the reason for returning the refund check. Taxpayers should make copies for their records of the front and back of the voided check, the explanation notes, and the signed and dated withdrawal request page. IRS instructs taxpayers not to staple, bend, or paper clip the voided check. Taxpayers should include this with their claim withdrawal request and mail it to the IRS at:

Cincinnati Refund Inquiry Unit
PO Box 145500
Mail Stop 536G
Cincinnati, OH 45250

Taxpayers should track their package to confirm delivery.

3. Warning

In Notice 2022-183, the IRS warned taxpayers to be leery of third parties pursuing them to claim the credit when they are not entitled to it. Since the fees received are upfront and contingent on the amount of the credit, many disreputable firms are encouraging taxpayers to claim the credit even though they are not entitled to it. The IRS also warned that if taxpayers claim a COVID-19 credit to which they are not entitled, they will be required to repay the credit plus interest and penalties. In some instances, criminal prosecution may be warranted depending on the circumstances for claiming the credit.

C. Audits of high-wealth individuals

The actual statistics from the 2023 Data Book of audits for high-wealth individuals showed that FY 2021 examinations for individuals with returns showing more than $10 million of positive income were audited at a rate of 2.9 percent; for 2020, those same individuals were audited at a rate of 2.4 percent; for 2019, the rate was 2 percent; and the rate was 5.2 percent for tax year 2018. For taxpayers with total positive income of $5 million to $10 million, the audit rate for tax year 2021 was 1.4 percent, compared to .7 percent for 2020, 2.7 percent for tax year 2019, and 2.2 percent for tax year 2018. For taxpayers with total positive income between $1 million and $5 million, the audit rate was .5 percent for 2021, .4 percent for tax year 2020, 1.5 percent for tax year 2019, and 1.2 percent for tax year 2018.

The funny thing is that the additional tax assessed for taxpayers with total positive income over $1 million for tax year 2021 was over 2.1 billion, versus the tax assessed for those taxpayers with total positive

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

income of $0–$50,000, which was $7 billion. So even though more audits are conducted for those with total positive income greater than $1 million, more additional assessments come from the $0–$50,000 audits. Regardless, the statistics in the 2023 Data Book do confirm that IRS resources continue to be diverted to high-income individuals.

II. 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.

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

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 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.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.
   (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]

---

[1] 2022 Taxpayer Advocate Report to Congress.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(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 2023 IRS Data Book, more than 75 percent of the taxpayers subject to campus correspondence audits had a total positive income of $50,000 or less. 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 on 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 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,

[2] Internal Revenue Manual (IRM) 4.10.2.9.2.3.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.
    (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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 2023, only 22.7 percent of the individual audits were conducted as site audits and 77.3 percent were correspondence audits. Correspondence audits decreased slightly from the 78.7-percent rate in FY 2022. 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. Receiving disallowances without the IRS ever reviewing information they provided prompts an increase in issuances of the "90-Day Letter," which overburdens 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]

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

---

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).

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.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.

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

---

8 Rev. Proc. 97-22, 1997-1 C.B. 652.
9 Rev. Proc. 98-25, 1998-1 C.B. 689.
10 ILM 201146017.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.

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*

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 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.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(i) In all events, a 90-Day Letter will be issued within the time frame fixed by law if the period of limitations expires 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*, to 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;

   (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.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

B. Miscellaneous points

1. Chances of being audited

The IRS's 2023 Data Book provides statistical data on tax returns audited for all returns filed in calendar year 2022, including the number of tax returns the IRS examines, the number of cases closed, and the number of cases that remain in process. FY 2023 reveals examinations on individual returns based on total positive income categories reported on the filed tax returns. For corporations, FY 2023 examinations are categorized by the balance sheet (BS). Finally, flow-through categories for partnerships and S Corporations are categorized by Form 1065 or Form 1120-S. The IRS's 2023 Data Book covers the Service's activities conducted from the period of October 1, 2022, through September 30, 2023. The total of all returns closed and in process in 2023 was 582,944 returns; in 2022, the total was 708,309, and in 2021, the total was 738,959. The data for individual corporate and pass-through entities compared to the total of all returns closed and in process is as follows:

Positive Income	2023 Examined	Percentage	2022 Examined	Percentage	2021 Examined	Percentage
Total Positive Income (TPI) < $100,000	429,235	74%	509,427	72%	539,221	73%
TPI $100,000 but < $200,000	44,892	7.7%	62,300	8.8%	72,440	9.8%
TPI > $200,000 but < $1,000,000	30,201	5.2%	38,198	5%	33,112	4%
TPI > $1,000,000	12,866	2.2%	15,242	2%	13,969	2%
Small Corp BS < $1M	2,601	.45%	4,574	.6%	4,880	.6%
Small Corp BS > $1M < $5M	1,228	.21%	963	.1%	1,512	.2%
Small Corp BS > $5M < $10M	272	.05%	237	.03%	255	.03%
Large Corp BS > $10M < $250M	907	.02%	1,501	.21%	1,898	.25%
Large Corp BS > $250M < $500M	133	.023%	148	.02%	269	.04%
Large Corp BS > $500M < $20B	779	.14%	1,024	.14%	1,156	.16%
Large Corp BS > $20B	180	.03%	299	.04%	312	.04%
Partnerships	3,111	.05%	3,645	.51%	4,141	.56%
S Corporations	5,130	.88%	6,226	.88%	7,091	1%

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

2. Audit results

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

Taxpayer	FY2023	FY2022	FY2021	FY2020	FY2019
Individuals with total positive income under $100,000	$7.9 billion	$6.8 billion	$5.1 billion	$1.2 billion	$702 million
TPI > $100,000 < $200,000	$390 million	$518 million	$586 million	$520 million	$1.1 billion
TPI > $200,000 <$1M	$507 million	$884 million	$707 million	$674 million	$1.25 billion
TPI >$1M	$2.1 billion	$4.3 billion	$1.6 billion	$969 million	$1.32 billion
Small Corporation balance sheet under $1 million	$259 million	$156 million	$4.3 billion	$151 million	$125 million
Small Corporation balance sheet > $1 million < $5 million	$69 million	$83 million	$184 million	$55 million	$71.4 million
Small Corporation balance sheet > $5 million < $10 million	$398 million	$119 million	$19 million	$29 million	$33.6 million
Large Corporation balance sheet $10 million <$250 million	$246 million	$204 million	$717 million	$293 million	$230 million
Large Corporation balance sheet >$250 million < $20 billion	$1.6 billion	$4.8 billion	$2.4 billion	$1.3 billion	$291 million
Large Corporation balance sheet >$20 billion	$16 billion	$8.1 billion	$11.4 billion	$4.1 billion	$17.1 billion

3. Correspondence audits

Because it costs less and requires less labor 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's 2023 report stated that the IRS continued in 2023 to struggle with processing delays. In 2023, the report identified that millions of taxpayers once again experienced significant burdens and frustration while awaiting refunds or other IRS actions necessary to comply with their tax obligations and resolve tax account issues. The Advocate found that throughout 2023, the IRS's backlog associated with paper-filed original and amended returns continued to delay the processing of much-needed taxpayer refunds and assistance with tax account issues. However, the report did note some good news during the 2023 filing season: Taxpayers who called the 1040 toll-free telephone line experienced shorter wait times and were more likely to get through to speak with a customer service representative (CSR). But answering the phones is only half the battle. The report concluded that because the IRS prioritized telephone service over other IRS operations such as processing amended returns, working on identity theft returns, and responding to taxpayer correspondence, Accounts Management (AM) CSRs responsible for answering calls were not able to process amended returns and answer taxpayer correspondence. This created a new backlog by

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

the end of the 2023 filing season. As a result, individual and business taxpayers experienced delays. These delays not only have negative financial implications for taxpayers awaiting refunds but also for the government, as the IRS must pay interest on overpayments it does not timely refund.

Over the years, the Taxpayer Advocate has identified those with income level below $50,000 as the most examined taxpayers by IRS Campuses. Major issues in IRS correspondence audits conducted by those Campuses include 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.

The law does not require the IRS to process amended returns. This leaves many taxpayers hanging, not knowing if or when they will get their refund. The Taxpayer Advocate states in the 2023 report: "Millions of taxpayers file claims for credit or refund with the IRS each year. Under current law, there is no requirement that the IRS pay or deny them. It may simply ignore them. The taxpayers' remedy is to file a refund suit in a U.S. district court or the U.S. Court of Federal Claims. For many taxpayers, this is not a realistic or affordable option, as full payment of the disputed amount is generally required, and there can be a sizeable filing fee. The absence of a processing requirement is a poster child for non-responsive government. While the IRS generally does process claims for credit or refund, the claims can, and sometimes do, spend months and even years in administrative limbo within the IRS. Providing symmetry between the assessment statute, which has a clear ending date, and a statute requiring the IRS to timely process claims for credit or refund would be good tax administration and would protect taxpayers' rights to be informed, to pay no more than the correct amount of tax, and to finality. We recommend Congress require the IRS to act on claims for credit or refund in a timely manner and impose certain consequences for failing to do so." Changing the law or otherwise mandating that the IRS process amended returns and issue refunds timely would be a welcome change for taxpayers and practitioners.[11]

In the 2023 IRS Data Book, correspondence audits accounted for 77.3 percent of all audits conducted by the IRS. This leaves only 22.7 percent for in-person examinations, which have been proven to be the most productive. The 2023 Data Book shows that approximately 75 percent of those audited by correspondence audits are taxpayers whose total positive income is $50,000 or less, and over 21 percent of those claimed the Earned Income Tax Credit.

---

[11] Taxpayer Advocate Service, *National Taxpayer Advocate Annual Report to Congress 2023* (Publication 2104).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.[12]

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 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-

---

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

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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

Currently with the influx of funding from the Inflation Reduction Act, the IRS is not facing funding challenges, but it is now facing hiring challenges. Finding as many people to hire as the IRS needs and the resources to train them will be a lengthy and complex task. IRS has changed some of the audit procedures by increasing 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.

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 labor 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 is 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 John 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

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

a tax practitioner and or an attorney due to the potential criminal implications. In April 2023, IRS published Notice 2023-34 stating that because certain foreign jurisdictions have enacted laws that characterize Bitcoin as legal tender, it is no longer accurate to state that virtual currency has no legal tender status in any jurisdiction, as it relates to Bitcoin. Also, in Notice 2023-27, IRS announced that a nonfungible token (NFT) is a unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset. As a result, when an individual has ownership of an NFT, the individual holds the right to a digital asset that represents a physical asset such as artwork, a musical composition, memorabilia, or a film/video. Notice 2023-27 states that the IRS and Department of the Treasury intend to issue guidance related to the treatment of certain NFTs as collectibles under IRC §408(m). The sale or exchange of a §408(m) collectible that is a capital asset held for more than one year is subject to a maximum 28-percent capital gains tax rate.

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.

e. 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.

f. 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 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.

g. 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.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.[13] 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.

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

---

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

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(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 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

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 refusing 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 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.[14]

---

[14] *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.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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:

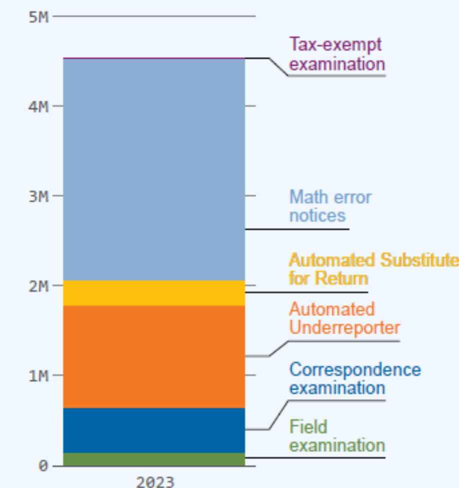
Only in the extremely rare case of evenly weighted evidence would the result vary. Under the default rules, the Service prevails in the event of a tie because the taxpayer would have failed to satisfy the burden of persuasion. The taxpayer, however, would prevail if a tie occurred after shifting the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

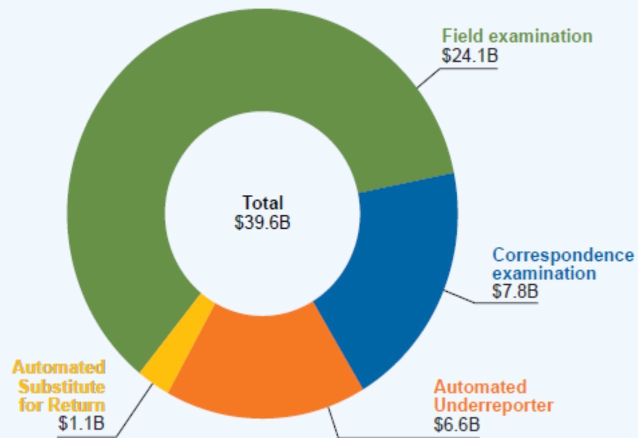
D. Psychological checklist for an audit

- 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.
- 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.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Compliance Activities, Fiscal Year 2023





SOURCE: 2023 *IRS Data Book* Tables 18, 21, 24, and 25

Compliance Presence

This section of the *IRS Data Book* highlights the IRS's compliance efforts. Examinations (audits) of most types of tax returns, information reporting and verification, math error notices, and criminal investigations are critical tools to determine if income, expenses, and credits are being accurately reported and to identify and resolve taxpayer errors and to identify fraud. These tools ensure the IRS has a presence across all types of taxpayers, for all income and asset levels.

For the past decade, the IRS has seen an increase in the number and complexity of returns filed paired with a decrease in resources available for examinations. The Service is constantly adapting and improving its processes to identify errors, detect fraudulent activity, and ensure resources are allocated as efficiently and effectively as possible. While the IRS accepts most returns as filed, some are selected for examination using various methods, including random sampling and computerized screening. IRS examinations are conducted through the mail (correspondence) or face-to-face (field).

The IRS also offers programs that encourage a more proactive approach to ensuring tax compliance for large and international businesses. Tax certainty programs, including the Advance Pricing Agreement (APA) Program and the Compliance Assurance Process (CAP) Program, help taxpayers improve their federal tax compliance via cooperation with the IRS prior to the filing of tax returns.

The IRS gathers independent information about income received and taxes withheld from information returns, such as Forms W–2 and 1099 filed by employers and other third parties. The IRS uses this information to verify self-reported income and tax on returns filed by taxpayers. With its Automated Underreporter Program, the IRS matches these information returns to tax returns and contacts taxpayers to resolve discrepancies. In the Automated Substitute for Return Program, the IRS uses information returns from third parties to identify nonfilers; construct tax returns for certain nonfilers based on that third-party information; and assess tax, interest, and penalties based on the substitute returns. To further verify the accuracy of reported information, the IRS also checks for mathematical and clerical errors before refunds are paid.

IRS's Criminal Investigation function conducts investigations of alleged criminal violations of the tax code and related financial statutes, which may in turn lead to prosecution, fines, and imprisonment.

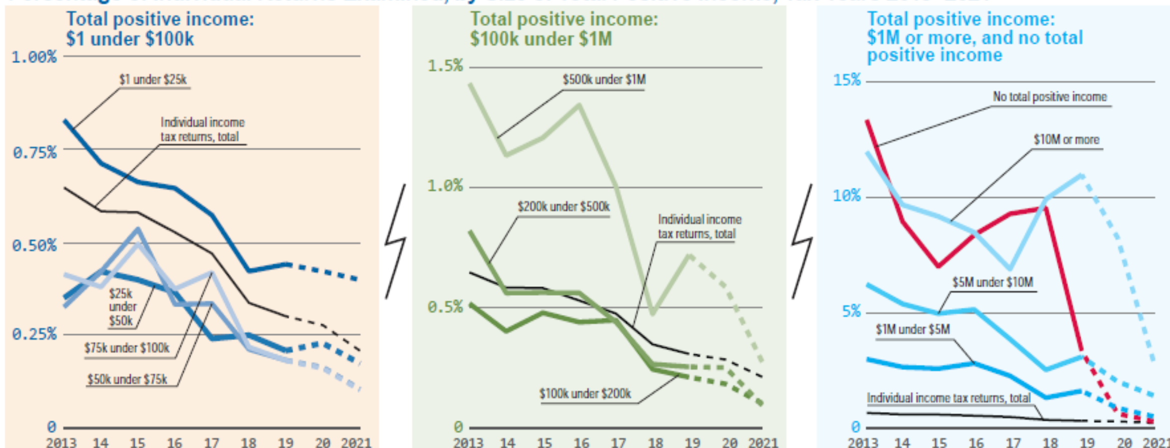
Highlights of the Data

- For all returns filed for Tax Years (TY) 2013 through 2021, the IRS has examined 0.44 percent of individual returns filed and 0.74 percent of corporation returns filed, as of the end of Fiscal Year (FY) 2023 (Table 17).
- The IRS has examined the returns of 8.7 percent of taxpayers filing individual returns reporting total positive income of $10 million or more for TYs 2013 through 2021, as of the end of FY 2023 (Table 17).
- The exam coverage rate for TY 2019 (the most recent year outside the statute of limitations period) of individual taxpayers reporting total positive income (TPI) of $10 million or more was 11.0 percent. The rate

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Internal Revenue Service Data Book, 2023

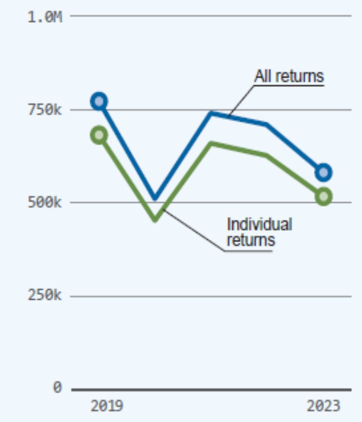
Percentage of Individual Returns Examined, by Size of Total Positive Income, Tax Years 2013–2021



NOTE: Represents total returns (closed and in-process) examined for each classification, as a percentage of the total number of returns filed for the tax year for that classification. Percentages for recent tax years (dashed segments) may increase as additional examinations are opened, as these returns are still within the statute of limitations.

SOURCE: 2023 *IRS Data Book* Table 17

Number of Returns Examined, Fiscal Years 2019–2023



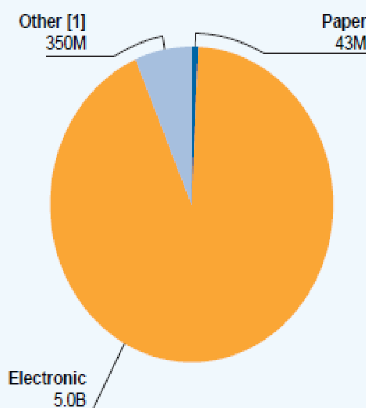
SOURCE: Selected *IRS Data Books*, Table 18

for taxpayers with TPI of $5 million–$10 million was 3.1 percent, and 1.6 percent for those with TPI of $1 million–$5 million (Table 17).

- In FY 2023, the IRS closed 582,944 tax return audits, resulting in $31.9 billion in recommended additional tax (Table 18).
- Of these closed examinations, 13,482 taxpayers, or 2.3 percent, did not agree with the IRS examiner's determination, resulting in an unagreed recommended additional tax of $19.5 billion (Table 18).
- In FY 2023, 22.7 percent of exams were conducted in the field, yielding over $24.1 billion in additional recommended tax (Table 18).
- The remaining 77.3 percent of audits were conducted via correspondence, resulting in almost $7.8 billion of additional recommended tax (Table 18).
- In FY 2023, 14,527 examinations protected a total of nearly $4.5 billion in refund payments, of which more than $4.4 billion came from field examinations and $38.6 million from correspondence examinations (Table 19).
- In FY 2023, there were 16,302 examinations resulting in refunds to the taxpayer, totaling more than $4.8 billion. Of this, $2.7 billion went to corporations (Table 20).
- The IRS examined 7,666 tax-exempt organization, employee retirement plan, government entity, tax-exempt bond, and related taxable returns in FY 2023 (Table 21).
- In FY 2023, 139 Advance Pricing Agreements (APA) were executed, 81.3 percent of which were bilateral in nature (Table 22).
- A total of 123 corporate taxpayers participated in the Compliance Assurance Process (CAP) Program during FY 2023 (Table 23).
- The IRS closed 1.0 million cases under the Automated Underreporter Program in FY 2023, resulting in $6.6 billion in additional assessments. The IRS closed 252,098 cases under its Automated Substitute for Return Program, resulting in nearly $1.1 billion in additional assessments (Table 24).
- The IRS received over 5.4 billion third-party information returns in

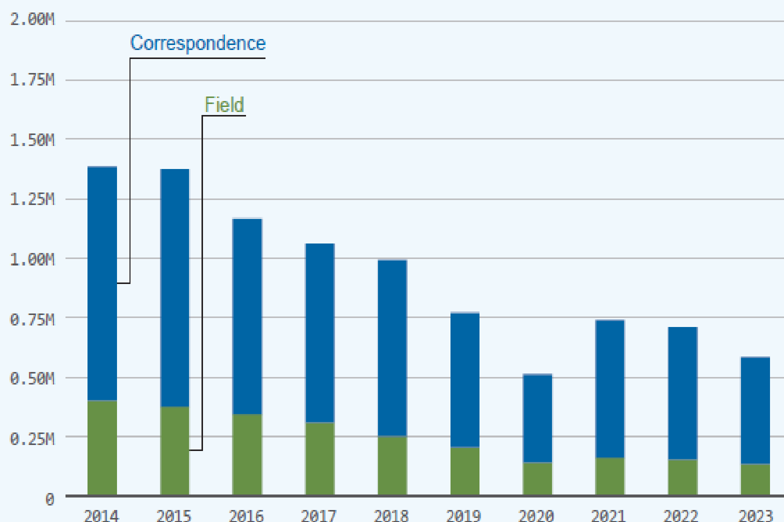
Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Number of Information Returns Received, by Type, Fiscal Year 2023



[1] Includes forms processed by the Social Security Administration.
SOURCE: 2023 *IRS Data Book* Table 24

Number of Returns Examined, by Examination Type, Fiscal Years 2014–2023

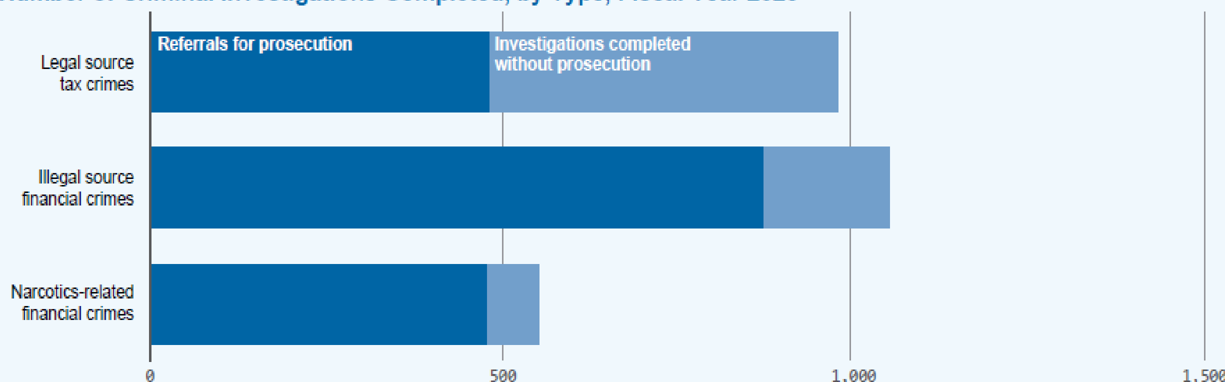


SOURCE: Selected *IRS Data Books*, Table 18

FY 2023; of these, 92.8 percent were filed electronically (Table 24).

- For TY 2022 individual income tax returns processed during FY 2023, the two most common math error types were related to the Child Tax Credit, which made up 24 percent of total math errors, and the Recovery Rebate Credit, which accounted for 20.1 percent. The most common type of error for TY 2021 and prior-year returns processed in FY 2023 was for errors related to the Recovery Rebate Credit, making up 47.1 percent of the total (Table 25).
- For these TY 2022 returns, the IRS sent 2.2 million notices to taxpayers for nearly 2.7 million math errors identified. For TY 2021 and prior-year returns, 1.5 million notices were sent for just under 1.8 million math errors identified (Table 25).
- In FY 2023, the IRS completed 2,584 criminal investigations in three areas—979 legal-source tax crime cases, which involve activities, industries, and occupations that generate legitimate income or threats to the tax system; 1,052 illegal-source financial crime cases, which relate to proceeds derived from unlawful sources such as money laundering; and 553 narcotics-related financial crime cases, which involve investigating narcotics-related tax and money-laundering crimes. These cases are often investigated in cooperation with the Justice Department and other law enforcement agencies (Table 26).

Number of Criminal Investigations Completed, by Type, Fiscal Year 2023



SOURCE: 2023 *IRS Data Book* Table 26

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Table 17. Examination Coverage and Recommended Additional Tax After Examination, by Type and Size of Return, Tax Years 2013–2021

[Money amounts are in thousands of dollars]

Type and size of return	Tax Year 2021†					
	All returns filed for Tax Year 2021 [1]	Returns examined			Number of returns examined with no change [5]	Recom-mended additional tax
		Closed [2]	In process [3]	Percentage covered [4]		
	(1)	(2)	(3)	(4)	(5)	(6)
All returns, total	**212,086,992**	**279,643**	**86,879**	**[6]**	**53,402**	**1,918,100**
Individual income tax returns, total	**161,206,833**	**268,560**	**72,716**	**0.2**	**50,664**	**1,621,557**
Size of total positive income [7]:						
No total positive income	2,931,717	5,342	3,053	0.3	722	81,916
$1 under $25,000	44,983,091	165,806	14,580	0.4	32,739	969,485
$25,000 under $50,000	37,679,393	53,763	12,919	0.2	8,988	274,574
$50,000 under $75,000	23,132,910	16,379	8,227	0.1	2,662	89,270
$75,000 under $100,000	14,828,621	8,354	6,410	0.1	1,531	46,034
$100,000 under $200,000	24,900,466	12,314	12,985	0.1	2,371	66,439
$200,000 under $500,000	9,597,600	3,624	5,478	0.1	892	30,902
$500,000 under $1,000,000	1,779,838	1,598	3,298	0.3	353	16,144
$1,000,000 under $5,000,000	867,592	1,003	3,315	0.5	254	23,856
$5,000,000 under $10,000,000	71,862	140	875	1.4	d	6,463
$10,000,000 or more	51,250	211	1,279	2.9	94	16,384
International returns [8]	382,493	26	297	0.1	d	90
Returns with earned income tax credit [9]	32,216,183	199,880	18,853	0.7	40,341	1,115,614
Corporation income tax returns, except Form 1120–S, total [10]	**1,556,982**	**1,481**	**2,687**	**0.3**	**599**	**42,358**
Returns other than Forms 1120–C and 1120–F, by size of balance sheet assets:						
No balance sheet	331,115	120	409	0.2	23	1,857
$1 under $250,000	632,014	513	698	0.2	167	6,324
$250,000 under $1,000,000	278,878	511	712	0.4	228	5,733
$1,000,000 under $5,000,000	176,971	243	433	0.4	129	4,431
$5,000,000 under $10,000,000	37,760	15	123	0.4	d	368
$10,000,000 under $50,000,000	42,316	14	79	0.2	d	6,635
$50,000,000 under $100,000,000	8,835	d	d	0.2	0	744
$100,000,000 under $250,000,000	7,394	5	23	0.4	d	103
$250,000,000 under $500,000,000	3,729	d	d	0.4	0	83
$500,000,000 under $1,000,000,000	2,448	d	d	0.9	d	471
$1,000,000,000 under $5,000,000,000	2,973	14	43	1.9	13	898
$5,000,000,000 under $20,000,000,000	932	13	48	6.5	10	2,601
$20,000,000,000 or more	512	20	61	15.8	18	11,008
Form 1120–C returns [11]	8,413	d	d	[12]	0	0
Form 1120–F returns [13]	22,692	d	d	0.1	0	1,103
Partnership returns [14]	**4,467,584**	**405**	**4,029**	**0.1**	**361**	**N/A**
S corporation returns [15]	**5,120,552**	**896**	**3,923**	**0.1**	**505**	**N/A**
Estate and trust income tax returns [16]	**3,033,133**	**d**	**d**	**[12]**	**d**	**151**
Estate tax returns [17]	**32,374**	**23**	**135**	**0.5**	**10**	**3,858**
Gift tax returns	**448,155**	**18**	**40**	**[12]**	**d**	**34**
Employment tax returns	**34,798,162**	**6,494**	**2,679**	**[12]**	**673**	**209,386**
Excise tax returns [18]	**1,423,217**	**1,761**	**549**	**0.2**	**585**	**40,756**
Other taxable returns [19]	**[6]**	**d**	**d**	**[6]**	**d**	**0**
Other nontaxable returns [20]	**[6]**	**0**	**45**	**[6]**	**0**	**N/A**

Footnotes at end of table.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Table 17. Examination Coverage and Recommended Additional Tax After Examination, by Type and Size of Return, Tax Years 2013–2021—Continued

[Money amounts are in thousands of dollars]

Type and size of return	Tax Year 2020†					
	All returns filed for Tax Year 2020 [1]	Returns examined			Number of returns examined with no change [5]	Recom-mended additional tax
		Closed [2]	In process [3]	Percentage covered [4]		
	(7)	(8)	(9)	(10)	(11)	(12)
All returns, total	**208,058,240**	**457,814**	**49,356**	**[6]**	**72,387**	**4,114,147**
Individual income tax returns, total	**164,511,483**	**432,602**	**34,687**	**0.3**	**66,376**	**3,262,682**
Size of total positive income [7]:						
No total positive income	3,631,912	16,944	5,560	0.6	488	1,020,406
$1 under $25,000	49,787,775	206,055	4,119	0.4	36,714	1,015,092
$25,000 under $50,000	39,516,857	87,982	3,644	0.2	12,347	412,478
$50,000 under $75,000	23,041,847	34,450	3,577	0.2	3,425	155,442
$75,000 under $100,000	14,726,736	21,035	3,097	0.2	1,695	104,751
$100,000 under $200,000	23,403,399	37,665	5,230	0.2	3,657	212,502
$200,000 under $500,000	8,165,629	17,459	3,008	0.3	4,776	122,195
$500,000 under $1,000,000	1,385,407	6,412	1,712	0.6	1,787	69,773
$1,000,000 under $5,000,000	622,329	3,112	2,226	0.9	835	76,930
$5,000,000 under $10,000,000	46,254	425	504	2.0	175	23,183
$10,000,000 or more	30,646	896	1,632	8.2	467	49,605
International returns [8]	152,692	167	378	0.4	10	325
Returns with earned income tax credit [9]	26,025,709	245,110	1,704	0.9	48,027	1,191,962
Corporation income tax returns, except Form 1120–S, total [10]	**1,499,042**	**5,158**	**4,461**	**0.6**	**2,383**	**352,032**
Returns other than Forms 1120–C and 1120–F, by size of balance sheet assets:						
No balance sheet	297,812	532	727	0.4	130	25,467
$1 under $250,000	630,817	1,945	1,425	0.5	899	24,093
$250,000 under $1,000,000	269,608	1,783	1,079	1.1	885	21,561
$1,000,000 under $5,000,000	171,930	482	422	0.5	249	14,766
$5,000,000 under $10,000,000	35,656	41	135	0.5	13	15,430
$10,000,000 under $50,000,000	38,451	105	122	0.6	47	6,379
$50,000,000 under $100,000,000	7,931	71	40	1.4	34	2,987
$100,000,000 under $250,000,000	6,506	50	53	1.6	33	1,765
$250,000,000 under $500,000,000	3,276	12	38	1.5	7	42
$500,000,000 under $1,000,000,000	2,243	12	46	2.6	7	899
$1,000,000,000 under $5,000,000,000	2,498	44	132	7.0	24	2,766
$5,000,000,000 under $20,000,000,000	824	42	99	17.1	30	227,270
$20,000,000,000 or more	451	29	116	32.2	*21	6,880
Form 1120–C returns [11]	9,071	d	d	[12]	0	0
Form 1120–F returns [13]	21,540	d	d	0.2	d	1,728
Partnership returns [14]	**4,645,903**	**420**	**2,594**	**0.1**	**343**	**N/A**
S corporation returns [15]	**4,892,722**	**1,212**	**2,063**	**0.1**	**395**	**N/A**
Estate and trust income tax returns [16]	**3,009,193**	**18**	**118**	**[12]**	**5**	**353**
Estate tax returns [17]	**31,747**	**462**	**531**	**3.1**	**180**	**68,395**
Gift tax returns	**253,425**	**371**	**283**	**0.3**	**244**	**18,770**
Employment tax returns	**27,891,847**	**14,830**	**4,080**	**0.1**	**1,851**	**316,419**
Excise tax returns [18]	**1,322,878**	**2,717**	**439**	**0.2**	**606**	**95,238**
Other taxable returns [19]	**[6]**	***6**	***10**	**[6]**	**d**	**257**
Other nontaxable returns [20]	**[6]**	***3**	***17**	**[6]**	**d**	**N/A**

Footnotes at end of table.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Table 18. Examination Coverage: Recommended Additional Tax, and Returns with Unagreed Additional Tax, After Examination, by Type and Size of Return, Fiscal Year 2023

[Money amounts are in thousands of dollars]

Type and size of return	Examinations closed in Fiscal Year 2023 [1]			Recommended additional tax		
	Total	Field [2]	Correspondence	Total	Field [2]	Correspondence
	(1)	(2)	(3)	(4)	(5)	(6)
United States, total	**582,944**	**132,587**	**450,357**	**31,905,844**	**24,144,779**	**7,761,064**
Taxable returns:						
Individual income tax returns, total	518,607	81,041	437,566	10,970,070	3,570,283	7,399,787
Size of total positive income [3]:						
No total positive income	74,151	10,733	63,418	5,624,362	1,304,709	4,319,654
$1 under $25,000	204,130	8,373	195,757	1,307,639	201,078	1,106,561
$25,000 under $50,000	85,856	10,006	75,850	542,862	174,929	367,933
$50,000 under $75,000	39,427	10,091	29,336	263,813	127,816	135,998
$75,000 under $100,000	25,671	7,300	18,371	175,992	92,223	83,769
$100,000 under $200,000	44,892	14,232	30,660	390,236	243,849	146,387
$200,000 under $500,000	21,612	6,998	14,614	308,927	192,074	116,853
$500,000 under $1,000,000	8,589	3,244	5,345	198,524	153,796	44,728
$1,000,000 under $5,000,000	7,867	4,651	3,216	410,461	336,376	74,086
$5,000,000 under $10,000,000	1,646	1,278	368	212,562	184,612	27,949
$10,000,000 or more	3,353	2,743	610	1,529,752	553,915	975,837
International returns [4]	1,413	1,392	21	4,941	4,909	32
Returns with earned income tax credit [5]	229,645	1,073	228,572	1,256,342	6,792	1,249,550
Corporation income tax returns, except Form 1120–S, total [6]	10,425	10,265	160	18,469,720	18,406,606	63,114
Returns other than Forms 1120–C and 1120–F [7]:	10,279	10,134	145	18,417,356	18,354,242	63,114
No balance sheet returns	1,193	1,180	13	133,078	132,636	442
Balance sheet returns by size of total assets:						
Under $250,000	2,986	2,964	22	119,247	76,303	42,944
$250,000 under $1,000,000	2,601	2,575	26	68,482	67,751	731
$1,000,000 under $5,000,000	1,228	1,216	12	68,809	68,501	308
$5,000,000 under $10,000,000	272	d	d	39,792	d	d
$10,000,000 under $50,000,000	447	414	33	125,051	108,351	16,701
$50,000,000 under $100,000,000	208	203	5	66,536	65,122	1,414
$100,000,000 under $250,000,000	252	244	8	54,506	54,506	0
$250,000,000 under $500,000,000	133	d	d	13,940	d	d
$500,000,000 under $1,000,000,000	176	d	d	75,982	d	d
$1,000,000,000 under $5,000,000,000	386	378	8	574,902	574,902	0
$5,000,000,000 under $20,000,000,000	217	212	5	946,909	946,909	0
$20,000,000,000 or more	180	d	d	16,130,120	d	d
Form 1120–C returns [7]	0	0	0	0	0	0
Form 1120–F returns [7]	146	131	15	52,364	52,364	0
Estate and trust income tax returns [8]	640	179	461	254,592	23,374	231,218
Estate tax returns [9]	1,214	1,214	0	372,388	372,388	0
Gift tax returns	741	741	0	583,586	583,586	0
Employment tax returns	37,361	26,387	10,974	1,063,783	997,773	66,010
Excise tax returns	5,304	4,958	346	176,058	175,408	651
Other taxable returns [10]	81	29	52	15,647	15,362	284
Nontaxable returns [11]:						
Partnership returns	3,111	2,739	372	N/A	N/A	N/A
S corporation returns [12]	5,130	5,002	128	N/A	N/A	N/A
Other nontaxable returns [13]	330	32	298	N/A	N/A	N/A

Footnotes at end of table.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Individual Audits

Learning objectives ***1***
I. Individual audits ***1***
A. Substantiation in general **1**
1. In general *1*
2. Proof of payment *2*
B. Charitable contributions **3**
1. Cash contributions *3*
2. Noncash contributions *4*
C. Electronic records **8**
D. Travel **8**
1. Travel *8*
2. Away from home *8*
3. Mixed purpose of travel *14*
4. Substantiation in general *15*
5. Substantiation by adequate records *15*
6. Meals and lodging *17*
7. Substantiation of travel *21*
8. Substantiation of gifts *21*
9. Cohan rule *22*
10. Strict substantiation *22*
11. Listed property *23*
12. Trade or business *24*
13. Oral testimony *25*
14. Lateesa Ward v. Commissioner *25*
15. IRS substantiation table *27*
E. Virtual currency **27**
1. In general *27*
2. What is virtual currency? *27*
3. Tax consequences *28*
4. Current audit concerns *28*
F. Identity theft **29**
1. In general *29*
2. What is tax-related identity theft? *29*
3. Warning signs of tax-related identity theft *29*
4. What to do if you suspect a client is a victim of tax related identity theft? *30*
5. Identity Theft Central *30*
6. Tax preparers *30*
7. Progress *31*
8. Highlights of the identity theft progress since 2015 *31*
9. Identity theft programs *32*
10. IRS Criminal Investigations *32*
11. Form 14039 *33*

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Individual Audits

Learning objectives

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

- Identify basic substantiation requirements for income and expense items;
- Explain the different levels of substantiation necessary to support an audited charitable contribution, both in cash and in kind;
- Discuss the issues involved in linking an expenditure with the taxpayer's being away from home;
- Identify the criteria that must be met in order for a travel expenditure to qualify as a deductible business expense;
- Explain various forms of record-keeping that may be used or must be used with respect to certain expenses;
- Identify which issues are most vulnerable to demand of proof in the course of an examination;
- Describe the specific documentary evidence a taxpayer must have with respect to meals and lodging expense;
- Discuss the elements of amount, date, place, and business purpose in connection with travel expense and the source of adequate records on audit;
- Distinguish the *Cohan* rule from the strict substantiation requirements and explain various circumstances that trigger the application of each doctrine;
- Explain the rules that apply to listed property;
- Explain virtual currency issues and;
- Explain tax related identity theft.

I. Individual audits

A. Substantiation in general

1. In general

The Service expects every taxpayer to keep a record of income and expenses; taxpayer's checkbook can and should record amounts, sources of deposits, and types of expenses. In addition, taxpayer must keep documents, such as receipts and sales slips, which can help prove a deduction. The Service is suspicious of records that do not appear to have been kept in an orderly fashion and in a safe place. They should be kept by year and type of income or expense, such as keeping all records related to a particular item in a designated envelope.

a. Basic records are documents that everybody should keep to prove income and expenses.

Proof of Income and Expense	
FOR items concerning taxpayer's...	KEEP as basic records
Income	Form(s) W-2 Form(s) 1099 Bank statements Brokerage statements Form(s) K-1
Expenses	Sales slips Invoices Receipts Canceled checks or other proof of payment Written communications from qualified charities

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

b. All requirements that apply to hard copy books and records also apply to **electronic storage systems** that maintain tax books and records. When hard copy books and records are replaced, the electronic storage systems must be maintained for as long as they are material to the administration of tax law.[1]

(i) An electronic storage system is any system for preparing or keeping your records either by electronic imaging or by transfer to an electronic storage media. The electronic storage system must index, store, preserve, retrieve, and reproduce the electronically stored books and records in a legible, readable format. All electronic storage systems must provide a complete and accurate record of your data that is accessible to the IRS. Electronic storage systems are also subject to the same controls and retention guidelines as those imposed on your original hard copy books and records.

(ii) The original hard copy books and records may be destroyed provided that the electronic storage system has been tested to establish that the hard copy books and records are being reproduced in compliance with IRS requirements for an electronic storage system and procedures are established to ensure continued compliance with all applicable rules and regulations. Taxpayer still has the responsibility of retaining any other books and records that are required to be retained.

(iii) The IRS may test an electronic storage system, including the equipment used, indexing methodology, software, and retrieval capabilities. This test is not considered an examination and the results must be shared with taxpayer. If the electronic storage system meets the requirements mentioned, the taxpayer will be in compliance. If not, taxpayer may be subject to penalties for non-compliance, unless taxpayer continues to maintain the original hard copy books and records in a manner that allows taxpayer and the IRS to determine the correct tax.

2. Proof of payment

One of the basic records is proof of payment; taxpayers should keep these records to support certain amounts shown on the tax return. Proof of payment alone is not sufficient proof that the item claimed on the return is allowable but is a necessary condition. Taxpayers should also keep other documents that will help prove that the item is allowable.

a. Generally, payment is proved with a cash receipt, financial account statement, credit card statement, canceled check, or substitute check. Taxpayers who make payments in cash must, whenever possible, get a dated and signed receipt showing the amount and the reason for the payment.

b. If payments are made by electronic funds transfer, taxpayers may be able to prove payment with an account statement.

---

[1] Rev. Proc. 97-22, 1997-1 C.B. 652 and Rev. Proc. 98-25, 1998-11C.B. 689.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Proof of Payment	
IF payment is by...	THEN the statement must show the...
Cash	Amount Payee's name Transaction date
Check	Check number Amount Payee's name Date the check amount was posted to the account by the financial institution
Debit or credit card	Amount charged Payee's name Transaction date
Electronic funds transfer	Amount transferred Payee's name Date the transfer was posted to the account by the financial institution
Payroll deduction	Amount Payee code Transaction date
Account statements.	Legible financial account statement prepared by bank or other financial institution if they show the items reflected above.
Pay statements.	Year-end or final pay statements

B. Charitable contributions

1. Cash contributions

Cash contributions include those paid by cash, check, electronic funds transfer, debit card, credit card, or payroll deduction. No cash contribution is deductible regardless of the amount unless taxpayer produces one of the following.

Note:

The examiner will ask for one of the following.

- A bank record that shows the name of the qualified organization, the date of the contribution, and the amount of the contribution. Bank records may include:
  - A canceled check;
  - A bank or credit union statement; or
  - A credit card statement.
- A receipt (or a letter or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution.
- The payroll deduction records:
  - A pay stub, Form W-2, or other document furnished by your employer that shows the date and amount of the contribution; and
  - A pledge card or other document prepared by or for the qualified organization that shows the name of the organization.

a. In addition, a deduction for a contribution of $250 or more is considered verified only if taxpayer has an **acknowledgment** of the contribution from the qualified organization or certain payroll deduction records.

(i) If taxpayer made more than one contribution of $250 or more, there must be either a separate acknowledgment for each or one acknowledgment that lists each contribution and the date of each contribution and shows the total contributions.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(ii) The taxpayer need not provide an acknowledgment for a series of separate contributions to the same organization, none of which individually met the $250 threshold but which, in the aggregate, do.

(iii) If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

Planning point:

Once the examiner determines that there are contributions of $250 or more, he will request the acknowledgment. The acknowledgment must meet these tests.

- It must be written.
- It must include:
  - The amount of cash taxpayer contributed;
  - Whether the qualified organization gave taxpayer any goods or services as a result of the contribution (other than certain token items or membership benefits);
  - A description and good faith estimate of the value of any goods or services; and
  - A statement that the only benefit received was an intangible religious benefit if that was the case. The acknowledgment does not need to describe or estimate the value of an intangible religious benefit. An intangible religious benefit is a benefit that generally is not sold in commercial transactions outside a donative (gift) context. An example is admission to a religious ceremony.
- Taxpayer must get the acknowledgment on or before the earlier of:
  - The date taxpayer filed the return for the year taxpayer makes the contribution; or
  - The due date, including extensions, for filing the return.

b. If the acknowledgment does not show the date of the contribution, the taxpayer will be requested to produce a bank record or receipt that does show the date of the contribution. If the acknowledgment does show the date of the contribution and meets the other tests just described, no other records are needed.

Note:

If taxpayer made a contribution by payroll deduction and the employer withheld $250 or more from a single paycheck, taxpayer must keep and produce for the examiner:

- A pay stub, Form W-2, or other document furnished by taxpayer's employer that shows the amount withheld as a contribution; and
- A pledge card or other document prepared by or for the qualified organization that shows the name of the organization and states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

A single pledge card may be kept for all contributions made by payroll deduction regardless of amount as long as it contains all the required information. If the pay stub, Form W-2, pledge card, or other document does not show the date of the contribution, taxpayer must produce another document that does show the date of the contribution. If the pay stub, Form W-2, pledge card, or other document does show the date of the contribution, taxpayer does not need any other records except those just described in the above bullets.

2. Noncash contributions

a. With respect to any noncash contribution, the examiner will request the taxpayer to provide a receipt from the charitable organization -- which taxpayer is required to obtain -- showing:

(i) The name of the charitable organization,

(ii) The date and location of the charitable contribution, and

(iii) A reasonably detailed description of the property.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Note:

In lieu of a receipt, taxpayer may provide the examiner a letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the above information.

If the taxpayer can provide no receipt or letter, the taxpayer is not required to have one if it was impractical to get one (for example, if taxpayer leaves property at a charity's unattended drop site).

The Service has required a taxpayer to keep reliable **written records** for each item of donated property, which includes the following.

(i) The name and address of the organization to which taxpayer contributed.

(ii) The date and location of the contribution.

(iii) A description of the property in detail reasonable under the circumstances. For a security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.

(iv) The fair market value of the property at the time of the contribution and how taxpayer figured the fair market value. If it was determined by appraisal, taxpayer should also keep a copy of the signed appraisal.

(v) The cost or other basis of the property if its fair market value must be reduced by appreciation. The examiner will request from taxpayer a record that includes both the amount of the reduction and how it was calculated.

Note:

Long-held property, such as clothing, that is not held for investment is not the kind of property with respect to which an investment purpose would prompt a taxpayer to retain records of the cost of original property. Contributions of such property are now, at least anecdotally, under attack in audit. For example, if a taxpayer contributes all the unused shirts and pants to a charity totaling $800 of current fair market value, which is probably in excess of the amount paid for the items, examiners have been known to request records of the costs, as the taxpayer is only entitled to the lesser of fair market value or basis. The examiner may determine, in the absence of an offer of proof, report the cost at zero and disallow the deduction. Now not many taxpayers would go forward to prove the contrary, even though they quite often prevail because the courts apply the *Cohan* rule, but a cash-strapped government may play hardball now where it formerly did not.

Perhaps such matter could be resolved in Appeals, where the report can be tested legally. If the taxpayer has evidence of the fair market value of the contributed property, the factual determination of the examiner is that the appreciation from a zero cost must be subtracted from fair market value to determine the amount of the contribution. However, such reduction is necessary only where the use of tangible personal property by the charity is unrelated to the purpose or function constituting the basis for its tax exemption.[2] If the use of the contribution by the charity is to provide clothing to impoverished individuals, and this is its tax-exempt function, no reduction is required. Of course, if the contribution were made to a charity that would sell the clothing to raise funds to further its separate tax-exempt use, the reduction made by the examiner would be appropriate. The planning point, given the audit risk, is to make contributions to charities with a tax-exempt use related to the contributed property.

(vi) The amount claimed as a deduction for the tax year as a result of the contribution, if less than the entire interest in the property was contributed during the tax year. The records must include the amount claimed as a deduction in any

[2] I.R.C. §170(e)(1)(B)(i)(I).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

earlier years for contributions of other interests in this property. They must also include the name and address of each organization to which the other interests were contributed, the place where any such tangible property is located or kept, and the name of any person in possession of the property, other than the organization to which you contributed.

(vii) The terms of any conditions attached to the gift of property.

b. If taxpayer claims a deduction of at least $250 but not more than $500 for a noncash charitable contribution, taxpayer must obtain and keep an acknowledgment of the contribution from the qualified organization. If taxpayer made more than one contribution of $250 or more, taxpayer must have either a separate acknowledgment for each or one acknowledgment that shows the total contributions. The acknowledgment must contain the name, date, and description, and written records must include the information listed above for other contributions. The acknowledgment must also meet these tests.

(i) It must be written.

(ii) It must include:

- A description (but not necessarily the value) of any property taxpayer contributed;
- Whether the qualified organization gave taxpayer any goods or services as a result of taxpayer's contribution (other than certain token items and membership benefits); and
- A description and good faith estimate of the value of any goods or services described in (b). If the only benefit taxpayer received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.

(iii) Taxpayer must get the acknowledgment on or before the earlier of:

- The date the return is filed for the year taxpayer makes the contribution; or
- The due date, including extensions, for filing the return.

c. Additional rules apply in the case where the deduction is $500 or more but not in excess of $5,000, determined by combining the claimed deductions for all **similar items of property** donated to **any** charitable organization during the year. In addition to the acknowledgment and written records the records must also include:

(i) How you got the property, for example, by purchase, gift, bequest, inheritance, or exchange;

(ii) The approximate date you got the property or, if created, produced, or manufactured by or for you, the approximate date the property was substantially completed; and

(iii) The cost or other basis, and any adjustments to the basis, of property held less than 12 months and, if available, the cost or other basis of property held 12 months or more. This requirement, however, does not apply to publicly traded securities.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Note:

> If taxpayer is not able to provide information on either the date taxpayer got the property or the cost basis of the property, the examiner will request a written statement of explanation if the taxpayer claims a reasonable cause for not being able to provide this information. The examiner will not request one if one was not attached to the return.

d. If taxpayer claimed a deduction of over $5,000 for a charitable contribution of one property item or a group of similar property items, taxpayer must have both the acknowledgment and the written records for contributions over $500. In figuring, combine the claimed deductions for all similar items donated to any charitable organization during the year are combined for purposes of determining whether the deduction is over $5,000. Generally, taxpayer must also obtain a qualified written appraisal of the donated property from a qualified appraiser.

e. With respect to the gift of a "qualified conservation contribution," the examiner will request the taxpayer to produce a record that includes the fair market value of the underlying property before and after the gift and a statement of the conservation purpose furthered by the gift.

f. If taxpayer renders services to a qualified organization and have unreimbursed out-of-pocket expenses related to those services, the following three rules apply.
   - (i) Taxpayer must have **adequate records** to prove the amount of the expenses.
   - (ii) Taxpayer must get an **acknowledgment** from the qualified organization that contains:
     - A description of the services taxpayer provided;
     - A statement of whether or not the organization provided taxpayer any goods or services to reimburse taxpayer for the expenses you incurred;
     - A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse; and
     - A statement that the only benefit received was an intangible religious benefit if that was the case. The acknowledgment does not need to describe or estimate the value of an intangible religious benefit.
   - (iii) Taxpayer must get the acknowledgment on or before the earlier of:
     - The date taxpayer filed the return for the year taxpayer made the contribution; or
     - The due date, including extensions, for filing the return.

g. If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.
   - (i) The records must show the name of the organization taxpayer was serving and the date each time taxpayer used your car for a charitable purpose.
   - (ii) If taxpayer used the standard mileage rate of 14 cents a mile, the records must show the miles taxpayer drove the car for the charitable purpose.
   - (iii) If taxpayer deducted actual expenses, the records must show the costs of operating the car that are directly related to a charitable purpose.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

C. Electronic records

Using electronic records to conduct examinations should make the audit more efficient for everyone. Examiners will be requesting these files in the majority of cases where the taxpayers already use electronic accounting software to maintain their books and records. If the taxpayers maintain their records in electronic format, the IRS has the legal authority to request the records in electronic format and the taxpayer must provide it in electronic format when requested.[3]

If a taxpayer or the taxpayer's representative declines to submit the requested materials voluntarily, the IRS has the right to summons the information requested, use indirect methods to reconstruct income, and/or disallow the items reported for lack of substantiation. The representative could be in violation of Treasury Department Circular No. 230 because §10.20(a)(1) of Circular 230 states that "a practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged."

D. Travel

1. Travel

The Code permits a taxpayer to deduct all the ordinary and necessary expenses paid or incurred during the taxable year in **carrying on any trade or business**, including **traveling expenses** (including amounts expended for **meals or lodging** to the extent they are **not lavish or extravagant** under the circumstances) while **away from home** in the pursuit of a trade or business.

a. Traveling expenses include travel **fares**, **meals and lodging**, and expenses incident to travel such as expenses for sample rooms, **telephone and telegraph**, public stenographers, etc. Only such traveling expenses as are **reasonable and necessary in the conduct of the taxpayer's business** and directly attributable to it may be deducted.
   - (i) **If the trip is undertaken for other than business purposes**, the travel fares and expenses incident to travel are **personal expenses** and the meals and lodging are living expenses.
   - (ii) If the trip is solely on business, the reasonable and necessary traveling expenses, including travel fares, meals and lodging, and expenses incident to travel, are business expenses.

b. To qualify for deduction, the traveling expense must be: (i) reasonable and necessary; (ii) incurred while the taxpayer was traveling "**away from home**"; and (iii) directly related to the conduct of the taxpayer's trade or business.[4]

2. Away from home

A taxpayer is allowed a deduction for travel expenses, including meal and lodging expenses, if the expenses are ordinary and necessary, incurred while **away from home**, and incurred in the pursuit of a trade or business.[5]

---

[3] I.R.C. §7602(a), I.R.C. §6001, Treasury Regs 1.6001-1(a) and -1(e), Rev. Rul. 71-20 and Rev. Proc. 98-25.

[4] *Mitchell v. Commissioner*, 74 T.C. 578 (1980); *Foote v. Commissioner*, 67 T.C. 1 (1976); *Kroll v. Commissioner*, 49 T.C. 557 (1968).

[5] *Commissioner v. Flowers*, 326 U.S. 465 (1946).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

a. For these purposes, generally a taxpayer's "home" (or tax home) means the vicinity of the taxpayer's principal place of business or employment.[6]

(i) When different from the vicinity of his principal place of employment, a taxpayer's residence may be treated as his tax home if his principal place of business is "temporary," rather than "indefinite."[7]

(ii) However, a taxpayer may be treated as an itinerant taxpayer, as never "away from home," and therefore as not entitled to travel expense deductions.[8]

b. In determining whether a taxpayer has a fixed tax home, courts consider three factors,[9] as follows:

(i) Whether there existed a business connection to the location of the alleged tax home;

(ii) Whether duplicate living expenses were incurred while traveling and while maintaining the alleged tax home; and

(iii) Whether personal connections existed to the alleged tax home.[10]

c. There is an exception to the general rule that a taxpayer's tax home is his or her principal place of employment.[11]

(i) The taxpayer's tax home may be the taxpayer's personal residence if the taxpayer's employment away from home is temporary.[12]

(ii) On the other hand, the exception does not apply, and the taxpayer's tax home remains the principal place of employment if the employment away from home is indefinite.

(iii) A court requires that a taxpayer must have some business justification beyond merely personal reasons for maintaining an alleged tax home remote from a place of employment. A person who has no principal place of business nor a place he or she resides permanently is an itinerant and has no tax home from which he or she can be away.[13] Where a taxpayer has no business connections with the primary residence, there is no compelling reason to maintain that residence and incur substantial, continuous, and duplicative expenses elsewhere.[14] In that situation, the expenses incurred while temporarily away from that residence are not deductible.[15]

d. If a taxpayer has several regular places of work, however, though commuting expenses from the taxpayer's home to his first work site and from his last work site to his home are not deductible, transportation expenses between the work sites are deductible.[16] Travel away from home generally requires that the taxpayer remain either overnight or for a period requiring sleep or rest.[17] For certain kinds of expenses otherwise deductible, such as expenses related to travel, meals and entertainment, and "listed property," a taxpayer

---

6 *Mitchell v. Commissioner*, 74 T.C. 578 (1980); see *Coombs v. Commissioner*, 608 F.2d 1269 (9th Cir. 1979), affg. in part and revg. in part 67 T.C. 426 (1976).
7 See *Peurifoy v. Commissioner*, 358 U.S. 59 (1958).
8 See *James v. United States*, 308 F.2d 204 (9th Cir. 1962); *Barone v. Commissioner*, 85 T.C. 462 (1985), affd. without published opinion 807 F.2d 177 (9th Cir. 1986).
9 Rev. Rul. 73-529, 1973-2 C.B. 37.
10 See *Henderson v. Commissioner*, 143 F.3d 497 (9th Cir. 1998), affg. T.C. Memo. 1995-559.
11 *Peurifoy v. Commissioner*, 358 U.S. 59 (1958).
12 *Mitchell v. Commissioner*, T.C. Memo. 1999-283.
13 *Deamer v. Commissioner*, 752 F.2d 337 (8th Cir. 1985), affg. T.C. Memo. 1984-63; *Edwards v. Commissioner*, T.C. Memo. 1987-396.
14 See *Henderson v. Commissioner*, 143 F.3d 497 (9th Cir. 1998), affg. T.C. Memo. 1995-559.
15 See *McNeill v. Commissioner*, T.C. Memo. 2003-65; *Aldea v. Commissioner*, T.C. Memo. 2000-136.
16 *Steinhort v. Commissioner*, 335 F.2d 496 (5th Cir. 1964), affg. T.C. Memo. 1962-233; *Feistman v. Commissioner*, 63 T.C. 129 (1974).
17 *United States v. Correll,* 389 U.S. 299 (1967).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

must satisfy substantiation requirements before such expenses will be allowed as deductions.[18]

e. **Case law**

(i) The Tax Court held that a truck driver did not have a tax home and could not deduct travel expenses; the court denied his deduction for a trucking equipment violation fine but allowed an unreimbursed employee expense deduction for truck stop electrification and a deduction for state and local taxes paid.[19] Taxpayer was a long-distance truck driver for a trucking company and logged business travel for 358 days out of the year. Because of the nature of his business, taxpayer was not required to return to his employer's principal location to receive his next assignment. Instead, he received his new driving assignment at the end point of the previous assignment. Taxpayer was required to have a commercial driver's license and had listed his mother's address, because a "brick and mortar" address was required to obtain the license. Taxpayer did not maintain any other residence. Taxpayer stayed at his mother's house only three days. Taxpayer was in the Kansas City area an additional five nights in 2009: February 14, February 27, March 4, April 7, and April 15. While in Kansas City, taxpayer did not stay at his mother's house and instead slept in his truck in a casino parking lot. Taxpayer did not keep his belongings at his mother's house; instead, he kept them in a rented storage locker. Taxpayer did not pay his mother for rent, utilities, or any other expenses. If taxpayer's mother needed money, he would loan it to her, but he did not make any loans to her. Taxpayer claimed deductions for unreimbursed employee business expenses which included per diem expenses while on the road, a hotel expense, and other minor costs incurred while on the road. Taxpayer's business expenses included service fees of $7,383 for truck stop electrification (TSE) such as "IdleAire" at truck stops and truck rest locations. None of the expenses taxpayer deducted on his Schedule A were reimbursed by his employer as the employer's policy stated that employees are responsible for payment of meals, hotels, parking charges, and other personal charges incurred by the employee.

---

[18] Emp. Regs. §1.274-5T. I.R.C. §280F(d)(4) includes passenger automobiles and other property used as a means of transportation unless excepted by I.R.C. §§280F(d)(4)(C) or (5)(B), and cellular phones. See I.R.C. §§280F(d)(4)(A)(i), (ii), (v). With respect to such "listed property," a taxpayer must prove: (1) The amount of each separate expenditure with respect to such property; (2) the amount of each business use based on the appropriate measure; and (3) the business purpose for an expenditure or use with respect to such property. Temp. Regs. §1.274-5T(b)(6).

[19] *Howard v. Commissioner*, T.C. Memo 2015-38.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Note:

> The U.S. Department of Transportation (DOT) mandates that truck drivers rest 10 hours for every 14 hours of driving. This requirement results in extended periods of time that drivers spend resting and sleeping in the cabs of their trucks. As a consequence, most long-haul truck drivers need to find a way to power their trucks for close to 10 hours per day, as power allows them to generate electricity and charge the vehicle's batteries and warm up the engines. Truck Stop Electrification (TSE) allows truck drivers to have heat, air conditioning, and electricity for in-cab appliances without idling their truck engines. The Service argued that TSE is analogous to a hotel and thus should be deemed an unreimbursed travel expense. The Court found TSE is analogous to a diesel fuel substitute and not a hotel and is a trade or business expense. This need generally leaves a truck driver with two options: power the vehicle with diesel fuel and let the truck idle or substitute diesel fuel consumption by using TSE at trucks stop and rest stops. TSE provides a range of added benefits including reducing the purchase of fuel, reducing emissions, and providing communication and entertainment to the drivers.

- The term "trade or business" includes the trade or business of being an employee.[20] The Service concedes that the per diem expenses, a hotel expense, and the IdleAire bill were ordinary and necessary and that the expenses were incurred in the pursuit of taxpayer's trade or business.
- No deduction is allowed with respect to any listed property unless the taxpayer meets the heightened substantiation requirements. Listed property includes any other property used as a means of transportation. However, listed property does not include property substantially all of the use of which is in a trade or business of providing to unrelated persons services consisting of the transportation of persons or property for compensation or hire.[21] Because the truck was such property, taxpayer's TSE IdleAire expenses were incurred with respect to the truck, which was not listed property. Accordingly, these expenses were not subject to the heightened substantiation requirements. Taxpayer provided adequate documentation to substantiate his unreimbursed employee business expenses. Taxpayer provided the Court with detailed IdleAire location expense receipts and his detailed daily driving log, which supported taxpayer's IdleAire locations in the course of duty.
- Taxpayer asserts that his other reported unreimbursed employee expenses (per diem expenses and a hotel expense) were deductible because they were incurred while taxpayer was traveling away from his home for business purposes. To claim a traveling expense deduction, a taxpayer must show: (1) that his or her expenses are ordinary and necessary; (2) that he or she was away from home when he or she incurred the expenses; and (3) that the expenses were incurred in pursuit of a trade or business. The only issue remaining is whether taxpayer was away from home when he incurred the expenses.
- During the year taxpayer did not have a principal place of business. Because of the nature of his employment, taxpayer did not have a principal place of business.
  - In instances when a taxpayer does not have a principal place of business, a permanent place of residence may be considered a

---

[20] *Primuth v. Commissioner*, 54 T.C. 374 (1970); *Christensen v. Commissioner*, TY.C. 1456 (1952).
[21] I.R.C §280F(d)(4)(A)(ii).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

tax home.[22] An employee without a principal place of business may treat as his tax home a permanent place of residence at which he incurs substantial continuing living expenses.[23] A taxpayer has a home for this purpose only when he or she has incurred substantial continuing living expenses at the permanent place of residence.[24]

- When the taxpayer has neither a principal place of business nor a permanent residence, he has no tax home from which he can be away. His home is wherever he happens to be. Additionally, if a taxpayer is constantly on the move due to his work, he is never away from home.[25] Thus, the taxpayer will not be entitled to a business deduction for traveling expenses as he does not have a tax home.
- Whether taxpayer had a tax home and whether his mother's house was indeed his permanent residence are factual questions resolved by the fact that taxpayer made only one visit to stay with his mother during the year in question and the visit lasted three days while he served jury duty. On the five other occasions on which taxpayer visited the Kansas City area, he slept in his truck parked in a casino parking lot. Additionally, taxpayer kept no belongings at his mother's house; instead, he kept them in a rented storage locker. Most significantly, taxpayer bore no expenses in maintaining a home. He paid no money for rent, utilities, or any other household expenses.
- Taxpayer does not meet the threshold requirements for his mother's house to be deemed his permanent residence. Taxpayer did not have any other qualifying residence. Thus, taxpayer could not be away from home because he had no home to be away from.[26] He did not satisfy all of the conditions to claim a deduction for traveling expenses paid or incurred while away from home.
- Taxpayer is entitled to deduct only the portion of his unreimbursed employee business expenses for TSE. As unreimbursed employee business expenses are itemized deductions, taxpayer was allowed to deduct them only to the extent they exceed 2 percent of his adjusted gross income.

(ii) The Tax Court held that a truck driver was not entitled to a depreciation expense deduction for a truck he sold in a prior year and that he was not entitled to travel expense deductions because he was an itinerant worker or "tax turtle" who carried his tax home with him on the road.[27] Taxpayer was a truck driver who took deductions for depreciation and travel expenses that would offset most of his income for that year. The Commissioner agreed that he was entitled to a depreciation deduction -- just not for that

[22] *Barone v. Commissioner*, 85 T.C. 462 aff'd without published opinion, 807 F.2d 177 (9th Cir. 1986).
[23] *Sapson v. Commissioner*, 49 T.C. 636 (1968).
[24] *James v. United States*, 308 F.2d 204 (9th Cir. 1962); *Barone v. Commissioner*, 85 T.C. at 466.
[25] *Deamer v. Commissioner*, 752 F.2d at 339 (quoting *Hantzis v. Commissioner*, 638 F.2d 248 (1st Cir. 1981), rev'g T.C. Memo 1979-299).
[26] See *Barone v. Commissioner*, 85 T.C. at 465; *Wirth v. Commissioner*, 61 T.C. 855 (1974).
[27] *Jacobs v. Commissioner*, T.C. Summ. Op. 2015-3.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

year -- but refused to allow him any deductions for travel expenses because he concluded that taxpayer was living on the road. His trips were mainly long haul "over the road" -- meaning he spent a significant number of weeks and months on the road and was paid by the mile. When he was not on the road, taxpayer considered his home to be in a place, where he stayed in the guest room of his longtime friend and fellow Israeli expat, he described as an American-style kibbutz, where his friend his wife and children lived, and taxpayer recreated the communal life of their homeland with everyone contributing everything they had and taking only what each needed. Taxpayer claimed he put in around $10,000 per year to the "kibbutz," though he had no evidence to substantiate his claim.

- The only the question of whether taxpayer could claim any per diem meal expenses as reasonable and necessary travel expenses incurred while away from his home in the pursuit of a trade or business or whether these were nondeductible personal, living, or family expenses. A taxpayer has to have "adequate records" for all his claimed deductions, and he has to have extra evidence for some deductions. But most importantly of all, he has to show that he was actually away from home when he incurred the expenses that he is trying to deduct.
- Tax law defines a home as the permanent residence at which a taxpayer incurs substantial continuing living expenses only if he or she does not have a principal place of employment.[28] But what if a taxpayer is constantly on the move? Cases decided over many decades give us the answer -- a taxpayer who is constantly in motion is a "tax turtle" -- that is, someone with no fixed residence who carries his or her "home" with him or her.[29] Such a taxpayer is not entitled to business deductions for traveling expenses under §162.[30]
- The ultimate allowance or disallowance of a deduction is a function of the Court's assessment of the reason for a taxpayer's maintenance of two homes.
    - If the reason is perceived to be personal, the taxpayer's home will generally be held to be his or her place of employment rather than his or her residence and the deduction will be denied.
    - If the reason is felt to be business exigencies, the person's home will usually be held to be his or her residence and the deduction will be allowed.[31]
    - The IRS has a revenue ruling that deals specifically with taxpayers who live on the road.[32] It lists three extra factors to help decide whether a taxpayer is an itinerant: (i) the business connection to the locale of the claimed home; (ii) the duplicative nature of the taxpayer's living expenses while traveling and at

---

28 *Barone v. Commissioner*, 85 T.C. 462 (1985), aff'd without published opinion, 807 F.2d 177 (9th Cir. 1986).

29 See, e.g., *Henderson v. Commissioner*, 143 F.3d 497 (9th Cir. 1998), aff'g T.C. Memo. 1995-559; *Deamer v. Commissioner*, 752 F.2d 337 (8th Cir. 1985), aff'g T.C. Memo. 1984-63; *Johnson v. Commissioner*, 115 T.C. 210 (2000).

30 *Kroll v. Commissioner*, 49 T.C. 557 (1968).

31 *Hantzis v. Commissioner*, 638 F.2d 248 (1st Cir. 1981) (disallowing deduction for Boston law student with a summer job in New York), rev'g T.C. Memo. 1979-299; *Minick v. Commissioner*, T.C. Memo. 2010-12 (applying *Hantzis* factors); *Farran v. Commissioner*, T.C. Memo. 2007-151 (applying *Hantzis* factors).

32 Rev. Rul. 73-529, 1973-2 C.B. 37.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

the claimed home; and (iii) personal attachments to the claimed home.

(1) The trucking business did not give taxpayer some reason to live in kibbutz if he in fact did so.

(2) Taxpayer did not establish a quantum of expense at the kibbutz that would be duplicated by his truck business.

(3) Taxpayer was there infrequently and occupied the guest bedroom when he did.

3. Mixed purpose of travel

If a taxpayer travels to a destination and while at such destination engages in **both business and personal activities**, traveling expenses **to and from** such destination are **deductible only if** the trip is **related primarily to the taxpayer's trade or business**. If the trip is **primarily personal in nature**, the traveling expenses **to and from the destination are not deductible** even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination that are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

a. Determining the **primary nature of a trip**: Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The **amount of time** during the period of the trip which is spent on **personal** activity **compared to** the **amount of time** spent on **activities directly relating to the taxpayer's trade or business** is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.

b. Where a taxpayer's spouse is a companion on a business trip, expenses attributable to the **spouse's travel are not deductible unless** it can be adequately shown that the **spouse's presence** on the trip has a **bona fide business purpose**. The **spouse's performance of some incidental service** does not cause her expenses to qualify as deductible business expenses. The same rules apply to any other members of the taxpayer's family who accompany the taxpayer on such a trip.

c. Usually, if the location of the taxpayer's regular place of business changes, so does the taxpayer's tax home -- from the old location to the new location -- unless the period of employment at the new location is, or is reasonably expected to be, temporary. By law, a taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds one year.

d. Expenses paid or incurred by a taxpayer in attending a convention or other meeting may constitute an ordinary and necessary business expense depending upon the facts and circumstances of each case. No distinction is made between self-employed persons and employees. The fact that an employee uses vacation or leave time or that his attendance at the convention is voluntary will not necessarily prohibit the allowance of the deduction. The allowance of deductions for such expenses will depend upon whether there is a sufficient relationship between the taxpayer's trade of business and his attendance at the convention or other meeting so that he is benefiting or advancing the interests of his

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

trade or business by such attendance. If the convention is for political, social, or other purposes unrelated to the taxpayer's trade or business, the expenses are not deductible.

Note:

> All deductions pursuant to §212 for the costs, including registration fees, travel, meals, and lodging, incurred to attend a convention, seminar, or similar meeting are disallowed even if the personal benefits of the trip are secondary to the investment benefits.

4. Substantiation in general

In general, a taxpayer must substantiate each element of an expenditure or use by adequate records or by sufficient evidence corroborating his own statement. A taxpayer is to maintain and produce such substantiation as will constitute proof of each expenditure or use referred to. **Written evidence** has considerably more probative value than oral evidence alone. In addition, the probative value of written evidence is greater the closer in time it relates to the expenditure or use. A **contemporaneous log is not required**, but a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not made at or near the time of the expenditure or use must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence.[33]

5. Substantiation by adequate records

To meet the "adequate records" requirements, a taxpayer must maintain an account book, diary, log, statement of expense, trip sheets, or similar record, and documentary evidence, which, when combined, are sufficient to establish each element of an expenditure or use specified above. It is not necessary to record information in an account book, diary, log, statement of expense, trip sheet, or similar record that duplicates information reflected on a receipt so long as the account book, etc. and receipt complement each other in an orderly manner.[34]

a. An account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure or use is made at or near the time of the expenditure or use.[35]

b. For these purposes, the phrase "made at or near the time of the expenditure or use" means the element of an expenditure or use is recorded at a time when, in relation to the use or making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure or use, such as the amount, time, place, and business purpose of the expenditure and business relationship. An expense account statement that is a transcription of an account book, diary, log, or similar record prepared or maintained in accordance with these provisions is considered a record prepared or maintained in such manner if such expense account statement is submitted by an employee to his employer or by an independent contractor to his client or customer in the regular course of good business practice. For example, a log maintained on a weekly basis, which accounts for use during the week, is considered a record made at or near the time of such use.[36]

---

33 Temp. Regs. §1.274-5T(c)(1).
34 Temp. Regs. §1.274-5T(c)(2)(i).
35 Temp. Regs. §1.274-5T(c)(2)(ii).
36 Temp. Regs. §1.274-5T(c)(2)(ii)(A).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Planning point:

The examiner will request the taxpayer's account book to determine the extent to which the taxpayer has maintained records and then review what is received to determine its adequacy. If the taxpayer produces one, the taxpayer will be interviewed concerning his recording habits of items in the book with a focus on the regularity of entry and proximity in time the taxpayer would make entries to the transactions recorded. Regardless of whether the taxpayer produces an account book, he will request receipts for the claimed expenses.

c. In order to constitute an adequate record of business purpose, a **written statement of business purpose** generally is required. However, the degree of substantiation necessary to establish business purpose will vary depending upon the facts and circumstances of each case.

(i) Where the business purpose is evident from the surrounding facts and circumstances, a written explanation of such business purpose will not be required. For example, in the case of a salesperson calling on customers on an established sales route, a written explanation of the business purpose of such travel ordinarily will not be required. Similarly, in the case of a business meal, if the business purpose of such meal is evident from the business relationship to the taxpayer of the persons entertained and other surrounding circumstances, a written explanation of such business purpose will not be required.[37]

(ii) In order to constitute an adequate record that substantiates business/investment use of **listed property**, the record must contain sufficient information as to each element of every business/investment use. However, the level of detail required in an adequate record to substantiate business/investment use may vary depending upon the facts and circumstances.

- For example, a taxpayer who uses a truck for both business and personal purposes and whose only business use of a truck is to make deliveries to customers on an established route may satisfy the adequate record requirement by recording the total number miles driven during the taxable year, the length of the delivery route once, and the date of each trip at or near the time of the trips.
- Alternatively, the taxpayer may establish the date of each trip with a receipt, record of delivery, or other documentary evidence.[38]

(iii) Generally, an adequate record must be written. However, a record of the business use of listed property, such as a computer or automobile, prepared in a computer memory device with the aid of a logging program will constitute an adequate record.[39]

Note:

Taxpayers and their advisors should pay heed to technological developments to aid in audit. Apps for smartphones or other devices are available to create an electronic record mirroring a book of account.

37 Temp. Regs. §1.274-5T(c)(2)(ii)(B).
38 Temp. Regs. §1.274-5T(c)(2)(ii)(C)(1).
39 Temp. Regs. §1.274-5T(c)(2)(ii)(C)(2).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

d. If a taxpayer has not fully substantiated a particular element of an expenditure or use, but the taxpayer establishes to the satisfaction of the district director that he has substantially complied with the "adequate records" requirements with respect to the expenditure or use, the taxpayer may be permitted to establish such element by evidence that the district director shall deem adequate.[40]

6. Meals and lodging

Traveling expenses include meals and lodging while away from home. If a taxpayer's principal place of employment is other than his residence and he chooses not to move his residence for personal reasons, the additional living or travel expenses are not considered to be ordinary and necessary business expenses.[41] If, however, a taxpayer is away from home on a temporary basis, his living or travel expenses may be considered deductible business expenses. Employment has been defined as "temporary" if it is foreseeably terminable or lasts for a relatively short, fixed duration.[42] Whether a taxpayer's job is temporary, or indefinite is determined by the facts and circumstances of each case.

a. In general, documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure, is required for any expenditure for lodging while traveling away from home,[43] and any other expenditure of $75 or more except, for transportation charges, documentary evidence will not be required if not readily available.[44]

Note:

Documentary evidence is not needed if any of the following conditions apply.

- Taxpayer has meals or lodging expenses while traveling away from home for which taxpayer accounted to the employer under an accountable plan, and taxpayer uses a per diem allowance method that includes meals and/or lodging.
- The expense, other than lodging, is less than $75.
- Taxpayer had a transportation expense for which a receipt is not readily available.

If taxpayers use the standard meal allowance, they must still keep records to prove the time, place, and business purpose of the travel even though they do not need to provide a receipt for the meals. If actual costs are used, receipts are necessary.

b. The Service in its discretion may prescribe rules waiving the documentary evidence requirements in circumstances where it is impracticable for such documentary evidence to be required. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expenditure.

Example: A hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as for lodging, meals, and telephone.

A restaurant receipt is sufficient to support an expenditure for a business meal if it contains the following: name and location of the restaurant, the date and amount of the expenditure, the number of people served, and, if a charge is

---

40 Temp. Regs. §1.274-5T(c)(2)(v).
41 *Tucker v. Commissioner*, 55 T.C. 783 (1971).
42 Chief Counsel Advice (CCA) 2000018052, Mar. 10, 2000; Rev. Ruling 99-7, 1999-5, IRB 4; Rev. Ruling 93-86, 1993-2 CB 71; *Boone v. United States*, 482 F.2d 417 (5th Cir. 1973).
43 Treas. Regs. §1.274-5(c)(2)(iii)(A)(1).
44 Treas. Regs. §1.274-5(c)(2)(iii)(A)(2).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

made for an item other than meals and beverages, an indication that such is the case.

c. A document may be indicative of only one (or part of one) element of an expenditure. Thus, a cancelled check, together with a bill from the payee, ordinarily would establish the element of cost. In contrast, a cancelled check drawn payable to a named payee would not by itself support a business expenditure without other evidence showing that the check was used for a certain business purpose.[45]

d. The examiner will request the taxpayer to produce an account book, diary, log, statement of expense, trip sheets, or similar record. The taxpayer should also keep documentary evidence that, together with the record, will support each **element** of an expense. Documentary evidence ordinarily will be considered adequate if it shows the **amount, date, place, and essential character** of the expense.

(i) In the case of a hotel, a receipt from the hotel is enough to support expenses for business travel if it has all of the following information.

- The name and location of the hotel.
- The dates taxpayer stayed there.
- Separate amounts for charges such as lodging, meals, and telephone calls.

(ii) In the case of a restaurant, a restaurant receipt is enough to prove an expense for a business meal if it has all of the following information.

- The name and location of the restaurant.
- The number of people served.
- The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

e. A canceled check, together with a bill from the payee, ordinarily establishes the cost, and the fact of payment. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a **business purpose**.

(i) Likewise, a credit card entry can establish the time, place, and amount of an expenditure but not its character or its relationship to the taxpayer's business.

(ii) If the taxpayer does not have such a journal, the examiner will immediately ask for receipts. Such receipts often will not establish business purpose.

Note:

A taxpayer does not have to record amounts the employer pays directly for any ticket or other travel item. However, if the taxpayer charges these items to the employer, through a credit card or otherwise, the taxpayer must keep a record of the amounts the taxpayer spends.

f. The examiner will ask questions designed to determine the recording of the elements of an expense or of a business use was made at or near the time of the expense or use and support it with sufficient documentary evidence.

(i) The examiner must determine how probative oral statements are in the absence of a timely-kept record that opens the recording to a suspicion of inaccurate recall. In most cases, the examiner will ask when the entries were made in the

[45] Treas. Regs. §1.274-5(c)(2)(iii)(B).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

record and count as near to the time of expenditure a recording within a couple of weeks.

(ii) The examiner will ask if an expense account statement was given to the taxpayer's employer, client, or customer and whether it was copied from the account book, diary, log, statement of expense, trip sheets, or similar record.

Planning point:

Proving business purpose: The most frequently debated element in establishing an expense is its business purpose. Taxpayers will often have receipts that are sufficient to establish the amount of an expenditure, the date of the expenditure, but not its connection to the taxpayer's business. The examiner will request a written statement of the business purpose of an expense. This can be waived in cases where the business purpose of an expense is clear from the surrounding circumstances.

g. The taxpayer need not put confidential information relating to an element of a deductible expense (such as the place, business purpose, or business relationship) in the account book, diary, or other record. However, taxpayer does have to record the information elsewhere at or near the time of the expense and have it available to fully prove that element of the expense.

h. If the examiner determines that the taxpayer lacks complete records to prove an element of an expense, then the taxpayer will be given the opportunity to prove the element with:

(i) Taxpayer's own written or oral statement containing specific information about the element, and

(ii) Other **supporting evidence** that is sufficient to establish the element.

Note:

If the taxpayer has no supporting evidence for the element and the taxpayer's own statements, the examiner will generally place little or no weight on testimony. Courts often do this by treating unsupported assertions as self-serving, although they have rarely accepted the oral testimony alone, generally when the Service has no contrary evidence of the element.

What constitutes supporting evidence?

In the case of the cost, time, place, or date of an expense, the supporting evidence must be either direct evidence or documentary evidence.

- Direct evidence can be written statements, or the oral testimony of taxpayer's guests or other witnesses setting forth detailed information about the element.
- Documentary evidence can be receipts, paid bills, or similar evidence.

If the unproved element is either the business relationship of taxpayer's guests or the business purpose of the amount spent, the supporting evidence can be **circumstantial**, rather than direct. For example, the nature of the work, such as making deliveries, provides circumstantial evidence of the use of a car for business purposes. Invoices of deliveries establish when taxpayer used the car for business.

i. If, because of the nature of the situation in which an expense is made, taxpayer could not get a receipt, the substantiation requirements with other evidence may be met if all the following are true.

(i) Taxpayer was unable to obtain evidence for an element of the expense or use that completely satisfies the requirements of a record made at or near the time of expenditure.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(ii) Taxpayer is unable to obtain evidence for an element that combines the taxpayer's own written or oral statement containing specific information about the element, coupled with other supporting evidence that is sufficient to establish the element.

(iii) Taxpayer has presented other evidence for the element that is the best proof possible under the circumstances.

The examiner must first determine the circumstances that made the taxpayer unable to obtain an adequate record of the use or expense. Then, the examiner must determine whether the taxpayer has any evidence that was possible under the circumstance. If that evidence was the best under the circumstances, was the taxpayer unable to obtain any other supporting evidence to taxpayer's oral assertions?

j. The examiner must review the records to determine the extent to which expenses are aggregated or separated. Each separate payment is generally considered a separate expense that must be separately audited. The cost of a customer or client dinner followed by attendance at the theater are two separate expenses. If these costs are aggregated in the taxpayer's records the taxpayer and they cannot be separated, the examiner will disallow the entire expense since entertainment is not deductible. If it can be separated:
   - The examiner will determine the cost an individual ticket that is part of season or series tickets for business use as a separate item by dividing the total cost (but not more than face value) by the number of games or performances in the series. The examiner will ask for records establishing whether each separate ticket is used as a gift or entertainment. The examiner will not allow any expense deduction for the cost of the entertainment.
   - The examiner will ask if the expense for the tickets or box seats includes food and beverages that are separately stated and determine if such food and beverage expense is reasonable. If the food is separately stated, the examiner will limit the deduction to 50 percent if the taxpayer provides the business purpose of the meal.[46]

   Taxpayer can make one daily entry in the record for reasonable categories of expenses. Examples are taxi fares, Uber/Lyft fares, or other incidental travel costs.
   - Meals should be in a separate category. One can include tips for meal-related services with the costs of the meals.
   - Expenses of a similar nature occurring during the course of a single event are considered a single expense. The total expense for the refreshments is treated as a single expense, for example, if during entertainment at a cocktail lounge, taxpayer pays separately for each serving of refreshments.

k. If more than one guest is involved, the examiner will ask the identity of each such person and determine which had a business relationship (and deductible) and those who did not (and not deductible). Total costs will be allocated among the taxpayer and business guests and non-business guests on a pro rata basis.

---

[46] Notice 2018-76.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

7. Substantiation of travel

No deduction or credit shall be allowed with respect to **traveling away from home** (including **meals and lodging**), any activity which is of a type generally considered to constitute **entertainment**, amusement, or recreation, or with respect to a facility used in connection with such an activity, **business gifts**, or any **listed property** unless the taxpayer **substantiates each element of the expenditure or use** in a specified manner. This limitation supersedes the judicial doctrine (*Cohan*) that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expenses, but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely.[47]

a. **No deduction** or credit shall be allowed for **travel, a gift, or with respect to listed property** unless the taxpayer substantiates the requisite elements of each expenditure or use as set forth.[48]

   (i) ***Travel***: The elements to be provided with respect to an expenditure for travel away from home are:

   - ***Amount***. Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;[49]
   - ***Time***. Dates of departure and return for each trip away from home, and number of days away from home spent on business;[50]
   - ***Place***. Destinations or locality of travel, described by name of city or town or other similar designation;[51] and
   - ***Business Purpose***. Business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel.[52]

8. Substantiation of gifts

However, no deduction is allowed as a business expense for any expense for gifts made directly or indirectly to any individual to the extent that such expense exceeds $25.[53] Additionally, to substantiate expenses relating to gifts, a taxpayer must provide adequate records or corroborating evidence showing, among other things, the business purposes of the gifts and the business relationships between the taxpayer and the gift recipients.[54] In the case of the description of a gift, the supporting evidence must be either direct evidence or documentary evidence.

a. Direct evidence can be written statements, or the oral testimony of taxpayer's guests or other witnesses setting forth detailed information about the element.

b. Documentary evidence can be receipts, paid bills, or similar evidence.

If the taxpayer claims a gift of $25, the examiner will attempt to determine the names of the donees to determine if they are related and the multiple gifts are being used to try to avoid the $25 annual limit on the amount that can be deduct for gifts to any one person.

---

47 *Cohan v. Commissioner*, 39 F. 2d 540 (2d Cir. 1930).
48 Temp. Regs. §1.274-5T(b)(1).
49 Temp. Regs. §1.274-5T(b)(2)(i).
50 Temp. Regs. §1.274-5T(b)(2)(ii).
51 Temp. Regs. §1.274-5T(b)(2)(iii).
52 Temp. Regs. §1.274-5T(b)(2)(iv).
53 I.R.C. §274(b).
54 I.R.C. §274(d); Temp. Regs. §§1.274-5T(b)(5), (c).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Example: Bob Jones sells products to Local Company. He and his wife, Jan, gave Local Company three gourmet gift baskets to thank them for their business. They paid $80 for each gift basket, or $240 total. Three of Local Company's executives took the gift baskets home for their families' use. Bob and Jan have no independent business relationship with any of the executives' other family members. They can deduct a total of $75 ($25 limit × 3) for the gift baskets.

9. Cohan rule

As a general rule, if there is sufficient evidence that the taxpayer has incurred a deductible expense, but the taxpayer is unable to substantiate adequately the precise amount of the deduction to which he or she is otherwise entitled, a court may estimate the amount of the deductible expense and allow the deduction to that extent.[55] In these instances, the Court is permitted to make as close an approximation of the allowable expense as it can, bearing heavily against the taxpayer whose inexactitude is of his or her own making. However, in order for the Court to estimate the amount of an expense, the court must have some basis upon which an estimate may be made.

Note:

> An examiner will make an offer of allowance of some claimed expenses only if there is evidence that certain payments were made and recorded. The precedent established in *Cohan* still supports the deduction of expenses not subject to §274 and §170 if the taxpayer can provide some documentation and the amount can be estimated. Nevertheless, such reliance cannot overlook the necessary foundational evidence. Approximations under the *Cohan* rule necessarily bear heavily upon taxpayers whose inexactitude in failing to keep records created the problem.

10. Strict substantiation

Section 274 overrides the *Cohan* rule for certain business expenses.[56] Section 274 requires stricter substantiation for travel, meals, entertainment, and listed property such as a passenger automobile. Taxpayers must provide adequate records or sufficient other evidence establishing the amount, time, place, and business purpose of the expense to corroborate the taxpayers' statements.[57] Even if such an expense would otherwise be deductible, §274 may still disallow a deduction if the taxpayer does not have sufficient substantiation.[58]

a. Certain business expenses that are subject to strict substantiation rules that supersede the *Cohan* doctrine include:
   - (i) any traveling expense, including meals and lodging away from home;
   - (ii) entertainment, amusement, and recreational expenses;
   - (iii) any expense for gifts; or
   - (iv) the use of "listed property,"[59] including passenger automobiles.

b. To deduct such expenses, the taxpayer must substantiate by adequate records or sufficient evidence to corroborate the taxpayer's own testimony:
   - (i) the amount of the expenditure or use, which includes mileage in the case of automobiles;
   - (ii) the time and place of the travel, entertainment, or use; and
   - (iii) its business purpose.

---

55 *Cohan v. Commissioner*, 39 F.2d 540, (2d Cir. 1930); *Vanicek v. Commissioner*, 85 T.C. 731 (1985); *Sanford v. Commissioner*, 50 T.C. 823 (1968), affd. per curiam 412 F.2d 201 (2d Cir. 1969); Temp. Regs. §1.274-5T(a).
56 Temp. Regs. §1.274-5T(a).
57 I.R.C. §274(d).
58 Temp. Regs. §1.274-5T(a).
59 I.R.C. §280F(d)(4).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Question to Ponder:

> There is an increased emphasis by the IRS and courts on deductions for travel expenses. The courts have not been allowing the use of *Cohan* as much as in prior years. What challenges do you face obtaining the required documentation from your clients?

11. Listed property

Specifically, §274(d) provides that no deduction is allowable with respect to listed property unless the deduction is substantiated in accordance with the strict substantiation requirements. Included in the definition of listed property is any passenger automobile.[60] No deduction is allowable for expenses incurred in respect of a passenger automobile on the basis of any approximation or the unsupported testimony of the taxpayer.[61]

a. Listed property is defined to include **passenger automobiles** and **any other property used as a means of transportation**. "**Passenger automobile**" means any four-wheeled vehicle (including a truck or van) that is manufactured primarily for use on public streets, roads, and highways and is rated at 6,000 pounds gross vehicle weight or less. It also includes **any part, component, or other item that is physically attached or traditionally included in the purchase price of an automobile**.[62]

b. While a vehicle whose gross vehicle weight exceeded 6,000 pounds may be excepted from the definition of **passenger automobile**, this only means that the amount of petitioners' deduction for Schedule C depreciation and §179 expenses was not limited by §280F(a).[63] Such vehicle may nonetheless be other property used as a means of transportation,[64] which was listed property whose expenses still have to be substantiated in accordance with §274(d) and the regulations thereunder.

c. The taxpayer must substantiate the automobile expenses by adequate records or other corroborating evidence of items such as the amount of the expense, the time and place of the automobile's use, and the business purpose of its use.[65]
   (i) Mileage logs detailing their business miles must also show the nonbusiness miles in order to deduct actual auto expenses since the percentage of employee business use for the vehicles must be determined.
   (ii) Mileage logs that had only estimates as to the total mileage driven for the vehicles for each year may still use the standard business mileage rate if those logs indicate the total amount of business miles.

d. Written evidence has considerably more probative value than oral evidence, and the probative value of written evidence is greater the closer in time it is to the expenditure or use. Although a contemporaneous log is not required, a record made at or near the time of the expenditure or use that is supported by sufficient documentary evidence has a higher degree of credibility than a subsequently prepared statement. The corroborative evidence required to support a statement not made at or near the time of the expenditure or use must have a high degree of probative value to elevate the statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence.

---

60 I.R.C. §280F(d)(4)(A)(i).
61 I.R.C. §274(d). *Golden v. Commissioner*, T.C. Memo. 1993-602.
62 I.R.C. §1.280F-6(c)(2).
63 I.R.C. §280F(d)(5).
64 I.R.C. §280F(d)(4)(A)(ii).
65 See *Maher v. Commissioner*, T.C. Memo. 2003-85.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Note:

Automobile expenses otherwise deductible as a business expense will be disallowed in full unless the taxpayer satisfies strict substantiation requirements.[66] The examiner will ask the taxpayer to substantiate the automobile expenses by adequate records or other corroborating evidence. The examiner will review what is produced to determine if it corroborates the amount of the expense, the time and place of the automobile's use, and the business purpose of its use.[67] To satisfy the adequate records requirement, a taxpayer must maintain records and documentary evidence that in combination are sufficient to establish each element of an expenditure or use.[68] Although a contemporaneous log is not required, corroborative evidence to support a taxpayer's reconstruction of the elements of the expenditure or use must have a high degree of probative value to elevate such statement to the level of credibility of a contemporaneous record.[69]

e. If the taxpayer extrapolates from adequate records for part of the year the amount of business use for the year, the examiner will request the taxpayer to demonstrate by other evidence that the periods for which an adequate record is kept are representative of the use throughout the tax year.

Example 1: Taxpayer uses his car to visit the offices of clients, meet with suppliers and other subcontractors, and pick up and deliver items to clients. There is no other business use of the car, but Taxpayer and family use the car for personal purposes. Taxpayer keeps adequate records during the first week of each month that show that 75% of the use of the car is for business. Invoices and bills show that the business use continues at the same rate during the later weeks of each month. The weekly records are representative of the use of the car each month and are sufficient evidence to support the percentage of business use for the year.

Example 2: Taxpayer is a sales representative who calls on customers on an established sales route, you do not have to give a written explanation of the business purpose for traveling that route. You can satisfy the requirements by recording the length of the delivery route once, the date of each trip at or near the time of the trips, and the total miles you drove the car during the tax year. You could also establish the date of each trip with a receipt, record of delivery, or other documentary evidence.

f. Taxpayer can account for several uses of a car that can be considered part of a single use, such as a round trip or uninterrupted business use, with a single record. Minimal personal use, such as a stop for lunch on the way between two business stops, is not an interruption of business use.

Example: Taxpayer made deliveries at several different locations on a route that begins and ends at the employer's business premises and that includes a stop at the business premises between two deliveries. Taxpayer can account for these using a single record of miles driven.

12. Trade or business

Expenses can only have a business purpose if the taxpayer is engaged in a trade or business. Section 162 generally allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Such expenses must be directly connected with or

---

[66] I.R.C. §274(d).

[67] See *Sanford v. Commissioner*, 50 T.C. 823 (1968), affd. per curiam 412 F.2d 201 (2d Cir. 1969); *Maher v. Commissioner*, T.C. Memo. 2003-85.

[68] Temp. Regs. §1.274-5T(c)(2).

[69] Temp. Regs. §1.274-5T(c)(1).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

pertain to the taxpayer's trade or business. Whether a taxpayer's activities constitute the carrying on of a trade or business requires an examination of the particular facts and circumstances of each case.[70] Carrying on a trade or business requires a showing of more than an initial investigation of business potential.[71]

a. In order to establish that he was engaged in a trade or business, the taxpayer must be continuously and regularly involved in the activity for the primary purpose of making a profit.[72] Whether the taxpayer engages in an activity with the primary purpose of making a profit is a question of fact to be resolved based on all the facts and circumstances in a particular case.[73] While the focus of the test for whether a taxpayer engaged in an activity with the intention of making a profit is on the subjective intention of the taxpayer, greater weight is given to the objective facts than is given to the taxpayer's mere statement of his intent.[74]

b. The regulations provide a nonexclusive list of relevant factors to be weighed when considering whether a taxpayer is engaged in an activity for profit. No one factor is determinative of whether an activity is engaged in for profit.[75] The relevant factors are: (i) the manner in which the taxpayer carried on the activity; (ii) the expertise of the taxpayer or his advisers; (iii) the time and effort expended by the taxpayer in carrying on the activity; (iv) the expectation that the assets used in the activity may appreciate in value; (v) the success of the taxpayer in carrying on other activities for profit; (vi) the taxpayer's history of income or losses with respect to the activity; (vii) the amount of occasional profits, if any, that are earned from the activity; (viii) the financial status of the taxpayer; and (ix) whether elements of personal pleasure or recreation are involved in the activity.[76]

13. Oral testimony

In the absence of adequate records to substantiate each element of an expense, a taxpayer may alternatively establish an element by "his own statement, whether written or oral, containing specific information in detail as to such element," and by "other corroborative evidence sufficient to establish such element."[77] The use of the standard mileage rate establishes only the amount deemed expended with respect to the business use of a passenger automobile. The taxpayer must still establish the amount (i.e., business mileage), the time, and the business purpose of each use.

14. Lateesa Ward v. Commissioner

In *Lateesa Ward v. Commissioner*,[78] Ms. Ward was an attorney conducting business as the sole shareholder of S corporation Ward & Ward Company. During the audit years, the company took deductions for travel, client meals, hotels, parking expenses, supplies, insurance, and contractor expenses. The IRS disallowed the expenses due to a lack of substantiation.

Ms. Ward testified before the Court on the expense deductions but provided very little evidence to substantiate them. The Court stated that when a taxpayer fails to substantiate deductions with precision, the Court may estimate certain expenses (under the *Cohan* rule), but only if some evidence exists to

---

[70] *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).
[71] *Dean v. Commissioner*, 56 T.C. 895 (1971); *Glotov v. Commissioner*, T.C. Memo. 2007-147.
[72] *Commissioner v. Groetzinger*, 480 U.S. 23 (1987); see also Treas. Regs. §1.183-2(a).
[73] *Golanty v. Commissioner*, 72 T.C. 411 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981).
[74] See *Stasewich v. Commissioner*, T.C. Memo. 2001-30.
[75] *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984), affg. 78 T.C. 471 (1982).
[76] Treas. Regs. §1.183-2(b).
[77] Temp. Regs. §1.274-5T(c)(3).
[78] *Lateesa Ward and Ward & Ward Company v. Commissioner*, T.C. Memo 2021-31.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

support estimates and the Court is convinced the expenses were incurred in connection with a trade or business.

The Court emphasized that the law has enhanced substantiation requirements under §274 for some expenses. These include travel, meals, and entertainment. To deduct these expenses, a taxpayer must "substantiated by adequate records or by sufficient evidence" the amount, time and place, and business purposes of the expenditures.

To substantiate the expenses of the travel, client meals, hotel and parking expenses, the company provided its 2011 bank statements, which did show that charges for these types of expenses were incurred. For the insurance expenses, bank statements showed payments to what appeared to be an insurance company, but it was not determinable if the payments were for business insurance. For the contractor and supply expenses, no documentation was provided.

The Court determined that for the travel, client meals, hotel and parking expenses, the bank statements provided did not show if there was a business purpose for the expenses, nor the dates of travel. The Court found that since the substantiation provided did not provide enough information to satisfy the stringent requirements of §274, those expenses were not deductible.

As far as the insurance and contractor expenses are concerned, the Court found that no documentation was provided to substantiate the expenses, so they were not deductible.

Lastly the Court, using the *Cohan* rule, allowed the supply expenses based on Ms. Ward's testimony even though no documentation was provided.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

15. IRS substantiation table

The IRS published the following table to express the type of substantiation that is required for travel, gifts, and listed property:

	Amount	Time	Place or Description	Business Purpose and Business Relationship
Travel	Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, fees, and tips, etc.	Dates of departure and return for each trip and number of days spent on business.	Destination or area of travel (name of city, town, or other designation).	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. Relationship: N/A
Gifts	Cost of the gift.	Date of the gift.	Description of the gift.	
Transportation	Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date that use began for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of the car.	The business destination.	Purpose: Business purpose for the expense. Relationship: N/A

E. Virtual currency

1. 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.

2. 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.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

3. 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.

4. 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 transactions 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 taxpayers that were identified. 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, amending the return to report the transactions if applicable, or explaining 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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.

F. Identity theft

1. In general

Identity theft is one of the nation's top crimes. Not only do criminals steal a person's identity to compromise credit cards but they also use it as a means to claim false refunds. Tax preparers play a critical role in assisting clients, both individuals and businesses, who are victims of tax-related identity theft. The IRS is working hard to prevent and detect identity theft as well as reduce the time it takes to resolve these cases. When a taxpayer is a victim of tax-related identity theft they may be contacted in several ways. The first is when they try to file their return and it is rejected. The second is when they are notified of an examination by an examiner regarding the examination of their return and they find that it is not their return. The third is when the taxpayer is notified by the IRS that information received shows wages from an unknown employer. Lastly, they are contacted by a special agent in the Criminal Investigation Division of the IRS.

2. What is tax-related identity theft?

Tax-related identity theft occurs when someone uses your client's stolen Social Security number to file a tax return claiming a fraudulent refund. Thieves may also use a stolen EIN from your business client to create false Forms W-2 to support refund fraud schemes.

3. Warning signs of tax-related identity theft

As a preparer you may be unaware your client is a victim of identity theft until you attempt to file the tax return and it is rejected. Your client also may receive an IRS notice because:

a. More than one tax return was filed using your client's SSN;

b. Your client has a balance due, refund offset, or a collection action taken for a year in which your client did not file a tax return;

c. IRS records indicate your client received wages from an unknown employer; or

d. A business client may receive an IRS letter about an amended tax return, fictitious employees or about a defunct, closed, or dormant business.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

4. *What to do if you suspect a client is a victim of tax related identity theft?*

If your client's SSN has been compromised, whether from a data breach, computer hack or stolen wallet, and they have reason to believe they are at risk for tax-related identity theft, you should take these steps:

a. If your client received an IRS notice, respond immediately to the IRS notice: call the telephone number provided or, if instructed, go to IDVerify.irs.gov.
b. Complete **Form 14039, *Identity Theft Affidavit***, if your e-filed return rejects because of a duplicate filing under your SSN or you are instructed to do so. Use a fillable form at IRS.gov, print, then attach the form to your return and mail according to instructions.
c. Continue to pay your taxes and file your tax return, even if you must do so by paper.
d. To inquire about a specific client's return information, you must have a power of attorney on file, and you must authenticate your identity with the IRS customer service representative.
e. IRS clarified when a taxpayer should not file a ***Form 14309, Identity Theft Affidavit***.[79] For example, when the IRS discovers what might be identity theft and contacts the taxpayer there is no need to file the Form 14039 affidavit. Generally, when the IRS sends the taxpayer a letter because a return that was filed was a suspicious tax return based on hundreds of processing filters and pulls the suspicious return for review. They will not process the tax return until hearing back from the taxpayer so there is no need to file Form 14309. If in doubt, call the IRS to determine if a Form 14309 is necessary.

If you previously contacted the IRS and **did not have a resolution**, contact the Identity Protection Specialized Unit at 1-800-908-4490. A case can take from 120 days to 180 days to resolve.

Question to Ponder:

What are some issues you and your clients have had regarding identity theft?

5. *Identity Theft Central*

On their website IRS launched Identity Theft Central. This is an online tool to access information and data security protections for taxpayers, tax professionals and businesses regarding identity theft. It contains resources on how to report identity theft, how taxpayers can protect themselves against phishing, online scams, and other programs.

6. *Tax preparers*

Identity thieves have been busy targeting tax professionals to either trick or hack their way into the tax professionals' computer systems to access client data. They use stolen data to file fraudulent tax returns that make it more difficult for the IRS and the states to detect because the fraudulent returns use real financial information. The Security Summit has provided recommendations to assist tax preparers in protecting their client data because the number of data thefts reported by tax professionals to the IRS continues to climb. Through June 30, 2021, there have been 222 data theft reports this year from tax professionals to the IRS, outpacing the rate of 211 in 2020 and 124 in 2019. The Security Summit's recommendations include:

a. Use multi-factor authentication to protect tax preparation software accounts. All tax software providers now offer multi-factor authentication options, which require more than just a username and password to access accounts.

[79] IRS Fact Sheet 2018-6.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

b. Assist clients in signing up for Identity Protection PINs. The IRS now offers IP PINs to all taxpayers who can verify their identities online, on the phone with an IRS employee after filing a Form 15227, or in person. Tax professionals cannot obtain an IP PIN for their clients. Clients must verify their identities to the IRS. The easiest way to do so is by beginning with the "Get an IP PIN" tool on IRS.gov.

c. Help clients fight unemployment compensation fraud. One of the larger scams of 2020 involved identity thieves using stolen identities to file for unemployment compensation benefits with the states during the pandemic-induced economic downturn. States issue Forms 1099-G to taxpayers and the IRS to report taxable unemployment income. If a client received a Form 1099-G when they did not claim unemployment compensation, notify the proper authorities to report the crime.

d. Avoid spear phishing scams. One of the most successful tactics used by identity thieves against tax professionals is the spear phishing scam. Thieves take time to craft personalized emails to entice tax professionals to open a link embedded in the email or open an attachment. The link or attachment may secretly download software onto the tax pros' computers that will give thieves remote access to the tax professionals' systems.

7. Progress

The IRS has joined with representatives of the software industry, tax preparation firms, payroll and tax financial product processors and state tax administrators to combat identity theft refund fraud to protect the nation's taxpayers.

Between 2015 and 2019, the number of taxpayers reporting they were identity theft victims fell by 80 percent. In 2019, the IRS received 137,000 reports from taxpayers compared to 677,000 in 2015. This was the fourth consecutive year this number declined. There were 199,000 reports in 2018, 242,000 in 2017 and 401,000 in 2016.

States continue to work with financial institutions to create programs that help identify suspect refunds.

8. Highlights of the identity theft progress since 2015

The IRS has confirmed that between 2015 and 2019, the number of confirmed identity theft returns declined by 68 percent. For 2019, there were 443,000 confirmed identity theft returns compared to 1.4 million in 2015. In 2019, the IRS began allowing taxpayers more time to respond to inquiries about the questionable return, which the IRS states has slowed the verification process. There were 649,000 confirmed identity theft returns in 2018; 597,000 in 2017; and 883,000 in 2016.

Between 2015 and 2019, the IRS protected a combined $26 billion in fraudulent refunds by stopping confirmed identity theft returns. In 2019, the 443,000 confirmed fraudulent returns tried to obtain $1.9 billion in refunds. The IRS protected $3.1 billion in 2018, $6 billion in 2017, $6.4 billion in 2016, and $8.7 billion in 2015.

Lastly, between 2015 and 2019, Summit financial industry partners recovered an additional $1.7 billion in fraudulent refunds. IRS stated that the financial industry is a key partner in fighting identity theft by helping them and the states recover fraudulent refunds that may have been issued. In 2019, financial institutions recovered 112,000 federal refunds totaling $294 million. In previous years, there were 84,000 federal refunds totaling $112 million for 2018; 144,000 refunds worth $204 million in 2017; 124,000 refunds worth $281 million in 2016; and 249,000 refunds totaling $852 million in 2015.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

9. Identity theft programs

If the IRS suspects the return may not be from the taxpayer, they will not process the return but instead send the taxpayer a letter requesting documentation to confirm that the taxpayer did indeed file the return. Also included in most software filing programs is a requirement that the taxpayer's driver's license number be included. This is because when the state return is filed, they will use their database to confirm the taxpayer's identity.

The Summit partners have put an increased emphasis on identity theft protections for business returns in the Form 1120 and 1041 series. Since businesses can also have their identity stolen to obtain fraudulent refunds, the IRS will be asking tax professionals to gather more information on their business clients. The data being collected assists the IRS in authenticating that the tax return being submitted is actually a legitimate return filing and not an identity theft return. Some of the new questions people may be asked to provide when filing their business, trust or estate client returns include:

- The name and Social Security Number of the company individual authorized to sign the business return. Is the person signing the return authorized to do so?
- Payment history – Were estimated tax payments made? If yes, when were they made, how were they made, and how much was paid?
- Parent company information – Is there a parent company? If yes, who?
- Additional information based on deductions claimed.
- Filing history – Has the business filed Form(s) 940, 941, or other business-related tax forms?

To help businesses and business return preparers, the IRS has created a new *Identity Theft Guide for Business, Partnerships and Estate and Trusts* which can be found at www.irs.gov/individuals/identity-theft-guide-for-business-partnerships-and-estate-and-trusts

10. IRS Criminal Investigations

The nationwide Law Enforcement Assistance Program provides for the disclosure of federal tax return information associated with the accounts of known and suspected victims of identity theft with the express written consent of those victims. Therefore, if your client is contacted by the IRS Criminal Investigation unit it would be beneficial for them to cooperate with the special agent. In many instances, they will be called upon to testify in the criminal proceedings.

The Identity Theft Clearinghouse (ITC) continues to develop and refer identity theft refund fraud schemes to Criminal Investigation (CI) Field Offices for investigation. Since its inception in FY12, it has received over 10,750 individual identity theft leads. These leads involved approximately 1.72 million returns with over $11.4 billion in refunds claimed. The average jail sentence for those convicted of identity theft is 38 months, with the longest sentence being 27 years.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

11. Form 14039

Form **14039** (September 2023)	Department of the Treasury - Internal Revenue Service **Identity Theft Affidavit**	OMB Number 1545-2139

This affidavit is for **victims** of identity theft. To avoid delays do not use this form if you have already filed a Form 14039 for this incident.

Form 14039 can also be completed online at https://apps.irs.gov/app/digital-mailroom/dmaf/f14039/.

The IRS process for assisting victims selecting **Section B**, **Box 1** below is explained at irs.gov/victimassistance.

Get an IP PIN: We encourage everyone to opt-in to the Identity Protection Personal Identification Number (IP PIN) program. If you don't have an IP PIN, you can get one by going to irs.gov/ippin. If unable to do so online, you may schedule an appointment at your closest Taxpayer Assistance Center by calling (844-545-5640). Or, if eligible, you may use IRS Form 15227 to apply for an IP PIN by mail or FAX, also available by going to irs.gov/ippin.

Section A - Check the following boxes in this section that apply to the specific situation you are reporting *(required for all filers)*

☐ 1. I am submitting this Form 14039 for myself

☐ 2. I am submitting this Form 14039 in response to an IRS Notice or Letter received
- Provide 'Notice' or 'Letter' number(s) on the **line to the right** ____________________
- Check box 1 in **Section** B and see special mailing and faxing instructions on reverse side of this form.

☐ 3. I am submitting this Form 14039 on behalf of my dependent child or dependent relative *(include that person's information below in Section C and D)*
- Complete **Sections** A-F of this form. Do not use this form If dependent's identity was misused by a parent or guardian in filing taxes, this is not identity theft.

☐ 4. I am submitting this Form 14039 on behalf of another person living or deceased *(other than my dependent child or dependent relative)*
- Complete **Sections** A- F of this form.

Section B – How I Am Impacted *(required when reporting misuse of Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN))*

Check all boxes that apply to the person listed in **Section** C below. If the person in Section C has previously submitted a Form 14039 for the same incident, there's no need to submit another Form 14039.

☐ 1. I know or suspect that someone used my information to fraudulently file a federal tax return

☐ I/My dependent was fraudulently/incorrectly claimed as a dependent *(use that person's information for Section C & D)*

☐ My SSN or ITIN was fraudulently used for employment purposes

Note: If you are a victim of Identity theft but it does not involve your federal tax return, you should request an IP PIN to protect yourself. Get An Identity Protection PIN | Internal Revenue Service (irs.gov)

Provide an explanation of the identity theft issue, how it impacts your tax account, when you became aware of it and provide relevant dates. If needed, attach additional information and/or pages to this form

Section C – Name and Contact Information of Identity Theft Victim *(required)*

Victim's last name	First name	Middle initial	**Taxpayer Identification Number** *(provide 9-digit SSN or ITIN)*

Current mailing address *(apartment or suite number and street, or P.O. Box)* If deceased, provide last known address	Current city	State	ZIP code -
Address used on last filed tax return *(if different than 'Current')*	City *(on last tax return filed)*	State	ZIP code -

Telephone number with area code. The IRS may call you regarding this affidavit Home phone number ____________ Cell phone number ____________	Best time(s) to call

Language in which you would like to be contacted ☐ English ☐ Spanish ☐ Other ____________

Section D – Tax Account Information: Last tax return filed (year shown on the tax return) and Returns Impacted *(Do not complete Section D if you selected **Box 2 in Section B** above)*

☐ **I was not required to file a return or filed a return with no income information**

Names used on last filed tax return	**The last tax return filed** ***(year shown on the tax return)***

What Tax Year(s) you believe were impacted by tax-related identity theft (example: 2020 is input for citing the 2020 tax return though filed the next year(s). (if not known, enter 'Unknown' below))

Submit this completed form to either the mailing address or the FAX number provided on the reverse side of this form.

Catalog Number 52525A www.irs.gov Form **14039** (Rev. 9-2023)

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Section E – Penalty of Perjury Statement and Signature *(required)*

Under penalty of perjury, I declare that, to the best of my knowledge and belief, the information entered on this Form 14039 is true, correct, complete, and made in good faith.

Signature of taxpayer, or representative, conservator, parent or guardian	Date signed

Section F – Representative, Conservator, Parent or Guardian Information *(required if completing Form 14039 on someone else's behalf)*

Check only ONE of the following five boxes next to the reason you are submitting this form

☐ **1. The taxpayer is deceased, and I am the surviving spouse**
- No attachments are required, including death certificate.

☐ **2. The taxpayer is deceased, and I am the court-appointed or certified personal representative**
- Attach a copy of the court certificate showing your appointment.

☐ **3. The taxpayer is deceased, and a court-appointed or certified personal representative has not been appointed**
- Attach copy of death certificate or formal notification from a government office informing next of kin of the decedent's death.
- Indicate your relationship to decedent: ☐ Child ☐ Parent/Legal Guardian ☐ Other ____________

☐ **4. The taxpayer is unable to complete this form and I am the appointed conservator, or I have been authorized to act on behalf of the taxpayer per Form 2848, Power of Attorney and Declaration of Representative**
- Attach a copy of documentation showing your appointment as conservator or Power of Attorney authorization.
- If you have an IRS issued **Centralized Authorization File (CAF) number, enter the nine-digit number**:

☐ **5. The person listed above is my dependent child or my dependent relative**

By checking this box and signing below you are indicating that you are an authorized representative, as parent, guardian or legal guardian, to file a legal document on the dependent's behalf.
- Indicate your relationship to person ☐ Parent/Legal Guardian ☐ Power of Attorney
  ☐ Fiduciary per IRS Form 56, Notice of Fiduciary Relationship ☐ Other ____________

Parent's/Representative's name

Last name	First name	Middle initial

Parent's/Representative's current mailing address *(city, town or post office, state, and ZIP code)*

Parent's/Representative's telephone number

Instructions for Submitting this Form

Submit this completed and signed form to the IRS via **Online, Mail** or **FAX** to specialized IRS processing areas dedicated to assist you.
In **Section** C of this form, be sure to include the Social Security Number in the 'Taxpayer Identification Number' field.

Help us avoid delays:
- Do not use this form if you have already filed a Form 14039 for this incident.
- Choose one method of submitting this form either Online (preferred method), by Mail, or by FAX, not all methods.
- Provide clear and readable photocopies/images of any additional information you may choose to provide.
- Submit the original tax return to the IRS location where you normally file your tax return. Do not use the following address or fax number to file an original tax return.

Online (Preferred Method)
- https://apps.irs.gov/app/digital-mailroom/dmaf/f14039/

Submitting by FAX
- **Always include a cover sheet marked "Confidential".**
- **If you checked Box 2 in Section A of Form 14039 and are submitting this form in response to a notice or letter received from the IRS. If it provides a FAX number, you should send there.**
- If no **FAX** number is shown on the notice or letter, follow the mailing instructions on the notice or letter.
- For all others, FAX this form toll-free to:
  855-807-5720

Submitting by Mail
- **If you checked Box 2 in Section A in response to a notice or letter received from the IRS**, return this form and if possible, a copy of the notice or letter **to the address contained in the notice or letter**.
- **If you checked Box 1 or 2 in Section B of Form 14039 and are unable to file your tax return electronically because the SSN/ITIN of you, your spouse, or dependent was misused, attach this Form 14039 to the back of your paper tax return** and submit to the IRS location where you normally file your tax return.
- **All others should mail this form to:**
  Department of the Treasury
  Internal Revenue Service
  Fresno, CA 93888-0025

Privacy Act and Paperwork Reduction Notice

Our legal authority to request the information is 26 U.S.C. 6001. The primary purpose of the form is to provide a method of reporting identity theft issues to the IRS so that the IRS may document situations where individuals are or may be victims of identity theft. Additional purposes include the use in the determination of proper tax liability and to relieve taxpayer burden. The information may be disclosed only as provided by 26 U.S.C. 6103. Providing the information on this form is voluntary. However, if you do not provide the information it may be more difficult to assist you in resolving your identity theft issue. If you are a potential victim of identity theft and do not provide the required substantiation information, we may not be able to place a marker on your account to assist with future protection. If you are a victim of identity theft and do not provide the required information, it may be difficult for IRS to determine your correct tax liability. If you intentionally provide false information, you may be subject to criminal penalties. You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103. Public reporting burden for this collection of information is estimated to average 15 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send this form to this address. Instead, see the form for filing instructions. Notwithstanding any other provision of the law, no person is required to respond to, nor shall any person be subject to a penalty for failure to comply with, a collection of information subject to the requirements of the Paperwork Reduction Act, unless that collection of information displays a currently valid OMB Control Number.

Catalog Number 52525A www.irs.gov Form **14039** (Rev. 9-2023)

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Trust Fund Recovery Penalty

Learning objective	*1*
I. Persons liable for the 100-percent penalty on under-withheld trust-fund taxes	*1*
A. In general	**2**
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	**4**
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	**7**
F. Manager of nursing homes was liable for trust fund recovery penalty	**7**
G. Company co-owner responsible party and reasonable cause exception not applicable	**8**
H. Taxpayer responsible party despite PEO contract	**9**
I. Nonprofit organization	**11**
J. Franchisee vice president liable for trust fund recovery penalties	**13**
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	**22**
P. Company president liable for trust fund penalty despite taking action upon learning of deficiency	**23**
Q. Taxpayer was responsible person who acted willfully when he loaned money to business to make payroll	**25**
R. Business owner's wife was not responsible person despite bank signatory authority	**26**

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Trust Fund Recovery Penalty

Learning objective

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.

In November 2023, James C. Jones, Jr., was found guilty of evading the payment of employment taxes, filing false returns, and obstructing the IRS, and was later sentenced to 78 months in prison. Jones owned and operated Lifeline Ambulance Services Inc. The business withheld employment taxes from their employees but failed to remit them. When the business did not remit the payroll taxes, the IRS found Jones to be the responsible party who acted willfully, and assessed the trust fund recovery penalty against Jones. Jones told the IRS that he did not have assets to pay the monies when the IRS tried to collect those taxes from him. The Department of Justice indicted Jones because the IRS found numerous assets totaling millions of dollars from which he could have paid the taxes. He was also indicted for filing false tax returns and obstructing the IRS during collection attempts.

---

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.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

In a similar case, in May 2024, Christopher Jason Smyth was found guilty of failing to remit the payroll taxes that his company, Stat EMS LLC, withheld from employees. Previously, Smyth also ran another ambulance service and accumulated millions of dollars of employment taxes that he failed to remit. The IRS determined that he was the responsible party who acted willfully and assessed the trust fund recovery penalty against him. Smyth used the employment taxes he collected to further enhance his personal financial position. Like James C. Jones, Smyth stated he had no assets but turned out to be hiding his assets. After the IRS found assets that were being held by relatives, Smyth was indicted and subsequently found guilty of failing to pay over the employment taxes withheld from the employees of Stat EMS LLC as well as obstructing the IRS. Smyth faced up to five years in prison for each of the quarters the employment taxes were not paid and an additional three years for obstructing justice.

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]

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 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.

---

5 *United States v. Jepsen.* 87 AFTR2d ¶2001-467 (W.D. Ark. 2001).
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.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 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 his 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).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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' 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.

---

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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.

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.

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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 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.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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

The trust fund recovery penalty against a 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. The taxpayer's argument that the 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 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

---

[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.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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. One owner's 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: (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.

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

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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, 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 1120-S, *U.S. Income Tax Return for an S Corporation*, for the years in issue and did not claim any deductions for officer

[15] CCA 201724025.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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. The 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.
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.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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. The taxpayer agrees the workers were their employees.

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 to 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

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

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.
2. Even if the 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 were not provided to 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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 the 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"). The 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. The 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 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.

---

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

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).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

a. Although not an officer or director of the company, the 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 for 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 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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 the 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 the 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 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.

---

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.").

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).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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. The 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."

The 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 the taxpayer became aware that such payroll taxes had not been paid. The 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 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

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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.
- 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.

---

[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).

[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.").

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.
   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. The 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

---

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)).

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)

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.

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

---

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).
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).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 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.

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

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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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. The 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 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

[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).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 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

[43] *Moser v. United States*; No. 4:12-cv-00607 (E.D. Ark. 2014).
[44] See *Kenagy v. United States*, 942 F.2d 459 (8th Cir. 1991).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.

The 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

---

[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).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

filing it. She did not present taxpayer with the returns for his review and had not done so in the past. The 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. The taxpayer approved other payments and checks to 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.

The 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.

---

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).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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.

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.

The 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.

---

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

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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 the 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 the taxpayer's husband. Because of his busy schedule, the taxpayer's husband directed her to carry out some of those responsibilities. Pre-opening responsibilities involved checking the site premises during 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 for finding 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

[56] *Christina M. Fitzpatrick v. Commissioner*, TC Memo 2016-199.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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. The 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. The 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.

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.

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

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

The 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 to determine 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 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 the 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 did not need to determine whether the taxpayer willfully failed to collect, account for, or pay over the trust fund taxes at issue. However, for the sake of completeness, the Court chose to do so. The willfulness requirement is satisfied

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

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. The 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 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.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Worker Classification Audits

Learning objectives ***1***
I. Introduction ***1***
A. Areas of suspected high noncompliance **1**
1. In general *1*
2. Worker misclassification *2*
3. Audit *2*
4. Tactics *5*
5. Walk through *6*
B. Voluntary Classification Settlement Program **8**
1. Worker classification *8*
2. IRS VCSP *10*
C. Classification Settlement Program **13**
1. In general *13*
2. CSP offer *14*

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Worker Classification Audits

Learning objectives

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

- Describe the factors involved in a worker classification audit;
- Identify the options available in the Voluntary Classification Settlement Program in connection with independent contractors versus employee classification liabilities; and
- Identify options available in the Classification Settlement Program in connection with independent contractors versus employee classification liabilities.

I. Introduction

A. Areas of suspected high noncompliance

1. In general

Perhaps spurred by the soaring deficits, the federal government is looking for sources of revenue, and, given the political realities, it is far easier to do this stealthily and administratively, i.e., through the IRS examination and audit process, than it is through enacting new legislation that explicitly raises taxes. The Service looks more intently at areas of suspected high noncompliance, so that they can apply the Willie Sutton rule to managing its fund-raising efforts.[1] One such area is worker classification and misclassification.

a. Although §530(b) prohibits the Treasury from issuing guidance "clarifying the employment status of individuals for purposes of employment taxes," the Service issued a ruling that listed 20 descriptive factors that should be used to determine whether an employment relationship exists between the worker and the employer for employment tax purposes.[2] It later issued internal guidelines for revenue agents in the form of a three-factor test.[3]

Note:

> The 20-factor test is cumbersome and difficult to apply with any degree of certainty in many cases because the weighing of that many factors makes the accurate classification determinations unclear. The 20 factors are very fact-intensive and would make any audit exhausting if they were applied at that level. The three-factor test is used in audits, but the full 20-factor common-law test continues to be used in judicial proceedings. The three-factor test takes into consideration behavioral control, financial control, and the relationship of the parties.

b. Congress continues to look for legislative efforts to combat worker misclassification and the IRS continues to use many resources, including state auditors, to assist Congress in combating the issue. Yet the issue is still one of the biggest ones the IRS faces. The IRS continues to target those employers that issue both Forms W-2 and Forms 1099-NEC to workers.

---

1 When Willie Sutton, a notorious bank robber of the 1940s and 1950s, was asked why he robbed banks, his reputed reply, commemorated in Bartlett's Quotations, was, "Because that's where the money is." Activity-based costing (ABC), widely used in the public sector, is a costing model that identifies activities in an organization and assigns the cost of each activity resource to all products and services according to the actual consumption by each. The Willie Sutton rule holds that ABC should be applied "where the money is," meaning where the highest costs are incurred, and thus the highest potential of overall cost reduction is. The current proposals each identify the tax expenditure problem by seeking a solution where the money is.

2 Rev. Rul. 87-41, 1987-1 C.B. 296.

3 Internal Revenue Manual 4.23.10.9.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

2. Worker misclassification

Employers have a financial incentive to misclassify workers as independent contractors rather than employees because the costs associated with hiring independent contractors are significantly less and the reporting and record-keeping requirements are also less burdensome. The employer's costs in hiring an independent contractor are much less than the costs associated with hiring an employee. In contrast to the requirements for employees, companies are not required to withhold federal income taxes for independent contractors and are not responsible for paying the employer's share of FICA tax or unemployment taxes for independent contractors. Independent contractors generally do not qualify for health and welfare benefits, pension plans, or unemployment compensation.

Note:

> There is a lack of symmetry in the self-employed and employees in respect of income and employment taxes. The Treasury collects much less in taxes from independent contractors than from taxpayers treated as employees, largely because individuals filing as if they are operating an unincorporated business are able to deduct expenses (above-the-line) relating to that business more easily than employees (below-the-line). Employees deducting work-related expenses must deduct them as itemized deductions, which are subject to limitations that do not apply to business expenses. Also, because there is higher compliance when taxes are withheld at the source, the fact that employees are subject to withholding by the employers while independent contractors are not, results in different degrees of compliance.

3. Audit

Clearly, the Service continues to use as many members of its enforcement staff as possible to conduct worker classification and employment tax audits.

a. To prepare for likely IRS audits of worker classification, employers must properly identify workers and properly document relationships with workers treated as independent contractors. Employers should also conduct annual reviews.

b. Ideally, the employer will document its relationship with a worker as an independent contractor when it hires the individual but initiating a review of existing relationships can still prove a proactive defense against later audit challenges. Unfortunately, most employers do not do this, and consequently, come into examination without much more than their own self-serving assertions about the nature of the relationship.

   (i) For "one-shot" workers with projects lasting only a few days, this is not fatal, so oral agreements with individuals can continue with little real fear on audit. But for others who have a longer, more continuing relationship with the employer spanning multiple projects, the employer should have written (even if from) contracts with the worker. The auditor will ask for the written agreement.

Note:

> Those contracts should reflect by their terms that the worker is not an employee, including factors that demonstrate that the **worker controls the terms of the performance** of the work to a sufficient extent to be considered an independent contractor. For example, the contract might reflect that the worker is responsible for setting the hours of work, providing his own tools and materials, and hiring any assistants or subordinates or any of the other 20 factors in the common law test. If the work does not have to be performed on the company premises, the worker should be given the freedom to choose where to perform it. The contract should allow the worker to control the work as much as possible under the business guidelines of the arrangement while still allowing the employer sufficient control to obtain the results it needs from the worker.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(ii) In addition, the agreements must reflect **reality**: the worker arrangement must conform to the agreement to prove the contractual relationship is **bona fide**. Ideally, to substantiate the real working relationship, the employer has a file with evidence of the worker (or group of workers) as an independent contractor. The auditor will appreciate a written document but will examine whether or not the actual relationship between the employer and the worker demonstrates that the worker is in fact an employee.

(iii) An employer should make the proper determination by having professional advice on classification; payroll and human resources should understand and stick to the distinction between employees and independent contractors.

Note:

In preparing for an IRS worker classification audit, a company should review its relationships with independent contractors. This review should include an assessment of all contracts and employment agreements with independent contractors. If possible, the company might renegotiate contracts to make it clearer that workers identified as independent contractors have sufficient control over the work to qualify as such.

c. The Service identified the 20 factors to be used to distinguish an employee from an independent contractor, but these factors are only guides and the relevance and importance of each factor varies based on the facts and circumstances in the case at issue. These 20 factors are:

- Instructions to the worker;
- Training for the worker;
- Integration of the worker's services with the company's business operations;
- Required performance of the services personally by the worker;
- Control of the hiring and paying of assistants;
- A continuing relationship between the company and the worker;
- Mandated work hours for the worker;
- Required full-time work for the company;
- Performance of the work on the company's premises;
- Establishment of the order and sequence of tasks to be performed by the worker;
- Required oral or written reports on the work;
- Payment by the hour, week, or month, in contrast to paying by the job;
- Payment or reimbursement of the worker's business expenses;
- Furnishing of the necessary tools and materials;
- A significant investment in performing the work;
- The worker's ability to realize a profit or loss from the work;
- Work for more than one employer;
- Availability of the services to the public;
- Retention of the right to discharge the worker; and
- The worker's retention of the right to terminate his employment with the company.

Note:

These factors used in distinguishing an employee from an independent contractor have been developed in common law through extensive cases, whose decisions are not easily reconciled.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

d. The three-factor test that agents use is not in fact much different from the 20-factor test as the former contains as subsets within it separate criteria that correspond to the latter.

(i) **Category 1: Behavior control.** Key behavioral control factors include the instructions and training provided to the worker by the employer. For this purpose, the more instructions and training the employer provides with respect to how the work is done (rather than the end result), the more behavioral control the employer will generally be considered to have exercised.

(ii) **Category 2: Financial control.** With respect to financial control, key factors include the extent of the worker's own investment in the services he or she provides, the worker's ability to make services available to the relevant market while also providing services to the employer, and the worker's own opportunity for profit or loss with respect to his or her services (as evidenced by reimbursement of expenses, method of payment, and the like). The more economically independent the worker is of the employer, the less likely the employer will be considered to be exercising financial control over the worker.

(iii) **Category 3: Relationship of the parties.** With respect to the relationship of the parties, the key factors include the actual intent of the parties with respect to how the worker is to be classified, as shown, for example, through the parties' contractual relationship, the employer filing Form 1099 information returns or W-2 employee wage statements with respect to the worker, and the employer providing (or not providing) the worker with benefits traditionally associated with employee status. In this category, the extent to which the worker's services are a crucial aspect of the regular business of the employer will also be considered, with the IRS viewing services that are more heavily integrated into the employer's regular business as more likely to be controlled by the employer. The extent to which either party may terminate the relationship is also designated as a key factor in this category, but the IRS has recognized that the significance of this factor is often unclear and should be considered only with great caution.

Note:

The three-category paradigm is reflected in Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, Parts II, II, and IV. Such Form may be used by current workers or the employer with respect to the Service's initial determination. In general, the auditor will consider such requests from workers to determine what the Service's view is, but some advisors caution against a firm's use of the form as an audit trigger. A favorable classification in such form probably goes a long way toward concluding an audit. The information provided on Form SS-8 may be disclosed to the firm, worker, or payer to assist the IRS in the determination process. For example, a worker may disclose the information provided on Form SS-8 to the firm or payer named above.

e. How the employer has handled 1099s and W-2s will be another focus of the examination. The company should identify particular classes of workers that have been classified as independent contractors and begin to document and collect evidence to support the determination of that classification.

(i) The company should determine whether it has properly filed all Forms 1099.

(ii) The company should cross-reference Forms 1099 filed for a class of worker against Forms W-2 for the same class or similar classes of workers to verify that it has been **consistent** in treating **all similar classes of workers** as independent contractors.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

4. Tactics

If the audit identifies worker classification issues, the employer may consider the following.

a. If the company has properly documented its determination of the worker's status, and its contracts and other files support that classification, the company may wish to challenge the IRS's determination by raising objections at the administrative appeal level. If this is unavailing, the issues could be litigated, but, even apart from that cost, the highly factual nature of the issue makes the litigation particularly expensive and uncertain.

b. For purposes of determining an employer's employment tax obligations, a worker is deemed not to be an employee of the employer if the employer meets each of the following three requirements.

   (i) **Reporting consistency.** The employer will satisfy the reporting consistency requirement if it filed all required federal tax returns with respect to the workers at issue in the audit, including information returns such as Form 1099, on a basis consistent with the employer's treatment of the workers as nonemployees.[4]

   (ii) **Reasonable basis.** The employer will satisfy this requirement if it had a reasonable basis for not treating the workers as employees.[5]

   (iii) **Substantive consistency.** To satisfy the substantive consistency requirement, the employer must not only have consistently treated the workers themselves as nonemployees for employment taxes purposes, but the employer must not have treated any worker in a "substantially similar" position as an employee for employment tax purposes.[6] For a substantially similar position to exist between workers, their job functions, duties, and responsibilities must be substantially similar, as well as their relationships with the employer.[7]

Note:

> If an employer meets each of these consistency and reasonableness requirements, §530 will provide the employer with relief from employee tax obligations regardless of the employer's actual relationship with the workers as determined under the general tax rules.[8] The IRS has indicated that, in any worker classification audit, the agent should explore the applicability of §530, even if the employer itself does not claim entitlement to such relief.[9]

Note:

> This bypasses the 20 factors and puts in its place a matching of Forms W-2 and Form 1099 (albeit over an extended period of time). The employer must establish which workers are similarly situated with the worker and then determine whether W-2s or 1099s were filed. Like yeast, one W-2 can leaven an otherwise all-1099 loaf. This may prove much less administratively cumbersome than a full examination of the 20 factors.

Note:

> Prior to 1996, the taxpayer was permitted to rely on an IRS income-tax audit of the company as a blessing of its treatment of workers as independent contractors even if the IRS did not address that issue during the audit. Legislation in that year, however, now requires the IRS explicitly to review worker classification as part of the audit before a taxpayer may rely on the audit as a basis for continuing to treat workers as independent contractors.

---

[4] Act of 1978, §530(a)(1).
[5] Act of 1978, §530(a)(2).
[6] Act of 1978, §530(a)(3).
[7] Act of 1978, §530(e)(6).
[8] Act of 1978, §530(e)(3).
[9] IRS, "Independent Contractor or Employee? Training Materials" (October 1996).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

c. Alternatively, the employer could try to reduce its liability for the federal withholding taxes and employment taxes that should have been withheld and paid over to the IRS, plus applicable penalties with respect to certain retroactive recharacterizations of workers. If Forms 1099 are filed with respect to the workers, there is a 1.5-percent liability for income-tax withholding and the employer's share of FICA plus 20 percent of the employee's share of FICA. If no Forms 1099 are filed with respect to the workers, there is a 3.0-percent liability for income-tax withholding and the employer's share of FICA plus 40 percent of the employee's share of FICA. This relief does not apply, however, if the employer's failure to withhold and pay the applicable employment taxes is because of its intentional disregard of its obligation to do so.

d. The IRS also has a settlement initiative, the classification settlement program (CSP), under which the employer can qualify for reduced employment taxes for recharacterized workers if the employer agrees to change their classification to employees for future periods. Only employers who are under examination for a worker classification issue who also filed Forms 1099 for the class of worker being reclassified as employees are eligible. Under the CSP, the IRS will only assess the employment taxes for a one-year period (the most recent year).

   (i) If the business meets the §530 reporting consistency requirement, but either does not meet the substantive consistency requirement or cannot meet the §530 reasonable basis test, the employer will be assessed one year of employment taxes under the reduced rates.

   (ii) If the employer meets the reporting consistency requirement of §530 and has a colorable argument that it meets the substantive consistency requirement and the reasonable basis test, it will qualify for a one-year assessment of 25 percent of the employment tax liability computed at the reduced rates.

Note:

> The IRS is considering creating a process by which employers who discover worker classification errors on their own and who are not under audit could get a closing agreement. There are two avenues for correction of worker classification errors: (i) filing a Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*; and (ii) the classification settlement program (CSP). Those avenues are independent of each other. Form 941-X is used for correcting errors that an employer discovers on its own but does not currently provide for a closing agreement on classification issues. The CSP is available only when an employer is under audit for classification issues.

5. Walk through

a. The employer that has engaged workers that he classified as employees and workers that he classified as independent contractors in the same general job category is inviting an audit. There may be important distinctions that must be demonstrated in an examination.

Note:

> During the preliminary stages of the audit, the IRS auditor will focus primarily on internal case building by examining the employer's Forms 941, as well as the Forms 1099 and the Forms W-2 that the employer had filed, and various other employer documents, such as the independent contractor agreements and employment contracts the employer executed with its workers.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(i) An auditor will deny §530 relief for failure to meet the substantive consistency prong because the employees and independent contractors were in **substantially similar positions** yet classified differently if the employer had **behavioral and financial control** over the classified independent contractors.

(ii) Responding to an auditor's initial proposal will, because of the inherently factual nature of the worker classification rules, require a fact-intensive approach. The employer must obtain facts in support of his workers' classifications that involve the details of the workers' job duties and responsibilities and their relationships with the employer. Essential to develop are the following:

- Who could decide when and where the workers performed their services?
- Who could decide what tasks were performed and how those tasks were accomplished?
- What benefits, if any, did the employer provide to the workers?
- Did the employer or the workers bear the cost of the workers' expenses?
- Did the workers hold themselves out to the employer as independent contractors?
- Did the workers hold themselves out to other employers as independent contractors while working for the employer?
- How did the employer classify the workers for federal tax purposes?
- What, if anything, did the employer rely on in making its classifications?
- How did the answers to each of these questions differ when the workers were classified as independent contractors and when the workers were classified as employees?

b. An IRS worker classification auditor will determine whether the employer satisfies §530 before applying the factor test to the employee or class of employees at issue. In most cases, the focus of the audit will be on whether the employer had satisfied §530's substantive consistency requirement or whether the employer had consistently treated any workers in "substantially similar" positions to the independent contractors as employees for employment taxes purposes.

(i) An employer could provide specific evidence of how employees in the same general job category were not in substantially similar positions, by establishing their differing responsibilities and relationships with respect to the employer through particular facts and documentation such as supervisor statements, training manuals, and non-compete agreements to support its treatment of these workers. The employer could establish the disparities in the types of work the workers were required to provide, in their abilities to control when and how their work was done, in their abilities to turn down work and work for others while working for the employer, and in a number of the other control and relationship factors generally used to determine whether a common law employer-employee relationship exists.

(ii) If the employer had not consistently treated these workers as nonemployees in the manner required for relief, the §530 safe harbor would not apply. The employer must establish that the classification of these workers as independent contractors is justified under the 20-factor test. To make this argument, the employer will need to engage in an intensive fact-gathering process.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Note:

> An employer selected for audit must be able to demonstrate, to the extent possible, that he is entitled to retain his workers' classification under both sets of rules permitted under either §530 or the general 20-factor test.

B. Voluntary Classification Settlement Program

1. Worker classification

A solely owned law firm's president, associate attorneys and law clerk were, for tax purposes, employees, and not independent contractors.[10]

a. President was statutory employee where he made corporate decisions with respect to, received draws from, and performed fundamental management services for taxpayer; and fact that he delegated day-to-day tasks to taxpayer's office manager was irrelevant.
   (i) He selected the associate attorneys who would work for taxpayer;
   (ii) He hired law clerks to provide legal services to taxpayer;
   (iii) He hired taxpayer's support staff, which included an investigator, a receptionist, and several secretaries;
   (iv) He set the support staff members' hours;
   (v) He determined whether taxpayer's workers would receive bonuses and in what amounts;
   (vi) He approved taxpayer's payroll; and
   (vii) He decided whether to make advance payments or reimburse taxpayer's workers for case-related and work-related expenses.

b. Also, although associate attorneys bore no risk of loss with respect to their work and performed essential, everyday professional tasks in taxpayer's business, factors weighed toward common-law employee status. Key factors included:
   (i) Taxpayer's ability to affect course of litigation by its decisions about funding of litigation, work assignments, and supervision of associate attorneys who worked on cases generated by taxpayer or president;
   (ii) Attorneys' permanent and exclusive relationship with taxpayer and de minimis investment in facilities; and
   (iii) Fact that work they performed was integral part of taxpayer's business.

---

10 *Cave A Prof. Law Corp. v. Commissioner*, TC Memo 2011-48.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Note:

In determining the existence of an employer-employee relationship, the crucial test is the principal's right to control the worker not only as to the result to be obtained but also as to the manner in which the service is to be performed.[11] The level of control necessary to find employee status generally is lower when applied to professionals than when applied to nonprofessionals.[12] Whether taxpayer had the right to control the details of the associate attorneys' work is an intensely factual question.

On balance, IRS concluded that the analysis regarding control tips in favor of an employer-employee relationship. Taxpayer's ability to affect the course of litigation by its decisions regarding the funding of litigation, work assignments, and working conditions, including the supervision of associate attorneys who worked on cases generated by the company and its president, weighed in favor of an employer-employee relationship. This factor is indicative of an employer-employee relationship.

The fact that a worker provides his or her own tools generally indicates the worker is an independent contractor. Conversely, the fact that a worker has no investment in the facilities used in the work is indicative of an employer-employee relationship. Taxpayer provided the associate attorneys with all of the tools and facilities necessary to complete their work, including office space, office furniture, computers, telephones, fax machines, copying machines, and office supplies. Taxpayer also provided the associate attorneys with secretarial services, telephone and internet service, and access to the computer server, law library, and online legal research services. In some instances, taxpayer even paid or reimbursed the associate attorneys' automobile expenses. This factor is indicative of an employer-employee relationship.

A compensation arrangement in which an individual works on commission may be indicative of an independent contractor relationship. Conversely, a compensation arrangement in which an individual cannot increase his profits through his own efforts and is not at risk for loss is indicative of an employer-employee relationship.[13] The associate attorneys' compensation consisted of a percentage of the gross fees that taxpayer collected in the cases they handled. The percentage varied depending on who secured the case. Thus, the associate attorneys could increase their profit by developing new clients and cases and by securing larger fees in the cases they handled. However, the associate attorneys bore little, if any, risk of loss from taxpayer's cases and clients that they handled, even if they brought them into the firm. Taxpayer paid or reimbursed the associate attorneys for most case-related expenses and absorbed the loss if a case never generated a fee. This factor is neutral.

Taxpayer did not require the associate attorneys to sign written contracts of employment or covenants not to compete, but the relationship between taxpayer and the associate attorneys was continuous, permanent, and exclusive. Although the associate attorneys were not required to work exclusively for taxpayer, there was no evidence that any of the associate attorneys ever provided or offered to provide services to another law firm during the periods at issue, nor did they offer services directly to the public other than in their capacity as attorneys working for taxpayer. This factor is indicative of an employer-employee relationship.

A worker's minimal skill argued against a finding of independent contractor status. However, the associate attorneys were highly educated professionals. On the other hand, the associate attorneys, who were newly licensed lawyers when first hired by taxpayer, were not specialists called in to solve a particular problem but instead performed the essential, everyday professional tasks in the business. This factor is neutral.

Fees generated from the provision of legal services were taxpayer's only source of income and it hired the associate attorneys to provide legal services to existing clients and to develop new clients. The services the associate attorneys provided taxpayer were an integral part of the business. This factor suggests the associate attorneys were taxpayer's employees.

---

[11] *Weber v. Commissioner*, 103 T.C. 378 (1994), aff'd. 60 F.3d 1104, 76 AFTR 2d 95-5782 (4th Cir. 1995); Treas. Regs. §31.3121(d)-1(c)(2).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

The record did not reveal whether taxpayer had the right to discharge the associate attorneys and, if so, whether there were any limitations on this right. This factor is neutral.

Three of the five specific factors—degree of control, investment in facilities, and permanence of the relationship—indicate an employer-employee relationship, and the remaining factors are neutral. In addition, the fact that the work performed by the associate attorneys was an integral part of the business supported this conclusion.

2. IRS VCSP

An initiative by the IRS will allow small businesses to properly reclassify their workers as employees while paying minimal back taxes and avoiding interest and penalties altogether. The Voluntary Classification Settlement Program (VCSP) is part of the Service's Fresh Start initiative and seeks to get small businesses to become and remain compliant with their worker classifications.[14] While the Commissioner indicated that the voluntary compliance program is not indicative of any change in the number of worker classification audits, this may mean more, not fewer, examinations. The announcement came two days after the IRS signed a memorandum of understanding with the Department of Labor that will permit greater information sharing between the agencies.

a. Employment classification audits can be expensive for a business and the VCSP would "offer such firms an opportunity to eliminate that risk by proactively reclassifying the individuals -- who can be legitimate independent contractors -- as employees," one commentator noted.

   (i) Section 530 of the Revenue Act of 1978 prevents the IRS from reclassifying independent contractors as employees and prohibits the Treasury Secretary from issuing substantive guidance, passed in response to complaints from businesses of aggressive worker classification exams from the IRS.

b. The Internal Revenue Service (IRS) has developed this program to permit taxpayers to voluntarily reclassify workers as employees for federal employment tax purposes. The Voluntary Classification Settlement Program (VCSP) allows eligible taxpayers to voluntarily reclassify their workers for federal employment tax purposes and obtain relief similar to that obtained in the current Classification Settlement Program (CSP). The VCSP is optional and provides taxpayers with an opportunity to voluntarily reclassify their workers as employees for future tax periods with limited federal employment tax liability for the past nonemployee treatment. To participate in the program, the taxpayer must meet certain eligibility requirements, apply to participate in VCSP, and enter into a closing agreement with the IRS.

Note:

For taxpayers under IRS examination, CSP is available to resolve federal employment tax issues related to worker misclassification as long as some criteria are met. To increase tax compliance and certainty for taxpayers, workers, and the government, the IRS is providing a program that allows for voluntary reclassification of workers outside of the examination context and without the need to go through normal administrative correction procedures applicable to employment taxes.

---

12 *James v. Commissioner*, 25 T.C. 1296 (1956) (noting that "there are many eminent lawyers who are full-time employees of corporations and who carry on their professional work with a minimum of direct supervision or control over their methods on the part of their employer").

13 See *Juliard v. Commissioner*, T.C. Memo. 1991-230 (characterizing an individual as an employee where, inter alia, he was paid a salary and reimbursed for expenses incurred with respect to his work).

14 Ann. 2011-64; 2011-41 IRB 1.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

c. The VCSP is available for taxpayers who want to voluntarily change the prospective classification of their workers. The program applies to taxpayers who are currently treating their workers (or a class or group of workers) as independent contractors or other nonemployees and want to prospectively treat the workers as employees. To be eligible:
   (i) The taxpayer must have consistently treated the workers as nonemployees, and must have filed all required Forms 1099 for the workers for the previous three years;
   (ii) The taxpayer cannot currently be under audit by the IRS; and
   (iii) The taxpayer cannot be currently under audit concerning the classification of the workers by the Department of Labor or by a state government agency. A taxpayer who was previously audited by the IRS or the Department of Labor concerning the classification of the workers will only be eligible if the taxpayer has complied with the results of that audit.

d. A taxpayer who participates in the VCSP will agree to prospectively treat the class of workers as employees for future tax periods. In exchange, the taxpayer:
   (i) Will pay **10 percent of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year**, determined under the reduced rates of §3509 of the Internal Revenue Code;
   (ii) Will **not be liable for any interest and penalties** on the liability; and
   (iii) Will **not be subject to an employment tax audit with respect to the worker classification of the workers for prior years**.

Note:

Additionally, a taxpayer participating in the VCSP will agree to **extend the period of limitations on assessment of employment taxes for three years for the first, second, and third calendar years beginning after the date on which the taxpayer has agreed under the VCSP closing agreement** to begin treating the workers as employees.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

The amount due under the VCSP is calculated based on compensation paid in the most recently closed tax year, determined at the time the VCSP application is being filed. Accordingly, the 10.68% effective rate applies under the VCSP in 2022 since the most recently closed tax year is 2021. The rate of 3.24% applies to compensation above the Social Security wage base in both situations. These effective rates constitute the sum of the rates as calculated under §3509(a), and are made up of the following:

Description	3509(a) Percentage in 2013 (For compensation paid for 2013 and prior up to the Social Security wage base)	3509(a) Percentage (For compensation paid in a year after 2013 up to the Social Security wage base)	3509(a) Percentage (For compensation paid above the Social Security wage base)
Federal Income Tax Withholding	1.5	1.5	1.5
Employee Social Security Tax	.84	1.24	0
Employer Social Security Tax	6.2	6.2	0
Employee Medicare Tax	.29	.29	.29
Employer Medicare Tax	1.45	1.45	1.45
Totals	10.28	10.68	3.24

Under the VCSP, the taxpayer then pays 10 percent of the amount calculated under §3509(a).

Example: In 2023 employer paid $1,500,000 to workers that are the subject of the VCSP. All of the workers that are the subject of the VCSP were compensated at or below the Social Security wage base (e.g., under $160,200 for 2023). Employer submits the VCSP application on October 1, 2024, and Employer wants the beginning date of the quarter for which Employer wants to treat the class or classes of workers as employees to be January 1, 2025. Employer looks to amounts paid to the workers in 2023 for purposes of calculating the VCSP amount, since 2023 is the most recently completed tax year at the time the application is being filed. Under §3509(a), the employment taxes applicable to $1,500,000 would be $160,200 (10.68% of $1,500,000). Under the VCSP, the payment would be 10 percent of $160,200, or $16,020.

Example: The facts are the same as in the example above, except that some of the workers that are the subject of the VCSP were compensated above the Social Security wage base in the amount of $250,000. Under §3509(a), the employment taxes applicable to $1,250,000 would be $133,500 (10.68 percent of $1,250,000) and the employment taxes applicable to the other $250,000 would be $8,100

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(3.24 percent of $250,000). Under the VCSP, employer's payment would be 10 percent of $141,600 ($133,500 plus $8,100), or $14,160.

e. Eligible taxpayers who wish to participate in the VCSP must submit an application for participation in the program. Information about the VCSP and the application will be available on www.irs.gov. Along with the application, the name of a contact or an authorized representative with a valid Power of Attorney (Form 2848) should be provided. The IRS will contact the taxpayer or authorized representative to complete the process once it has reviewed the application and verified the taxpayer's eligibility. The IRS retains discretion whether to accept a taxpayer's application for the VCSP. A taxpayer whose application has been accepted will enter into a closing agreement with the IRS to finalize the terms of the VCSP and will simultaneously make full and complete payment of any amount due under the closing agreement. Interested employers can apply for the program by filing Form 8952, *Application for Voluntary Classification Settlement Program*, and enter into a closing agreement with the IRS.

Question to Ponder:

What are some of the advantages and disadvantages of VCSP?

C. Classification Settlement Program

1. In general

The Classification Settlement Program (CSP) is a program for those businesses **under audit** for worker classification issues. It allows taxpayers and tax examiners to resolve worker classification cases as early in the administrative process as possible, reducing taxpayer burden. The procedures also ensure that the taxpayer relief provisions under §530 of the Revenue Act of 1978 are properly applied. Under the CSP, the Internal Revenue Service (IRS) examiners are able to offer taxpayers under examination a worker classification settlement using a standard closing agreement. As with VSCP, the examiner must first determine whether the taxpayer is entitled to relief from retroactive and prospective liability for employment taxes under §530 of the Revenue Act of 1978. To qualify for relief, the taxpayer must meet three requirements:

1. **Reporting consistency** -- All Federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period must have been filed by the taxpayer on a basis consistent with the taxpayer's treatment of the individual as not being an employee. This test must be applied to each worker separately, since, for example, the taxpayer may have filed a Form 1099-MISC for one worker in a class, but not for another worker in the same class.
2. **Substantive consistency** -- The taxpayer must have treated similarly situated workers consistently. That is, if the taxpayer (or a predecessor) treated a similarly situated worker as an employee, there is no §530 relief. This test must be applied to the class of workers having substantially similar job responsibilities and working under substantially similar conditions (e.g., supervisors vs. workers being supervised).
3. **Reasonable basis** -- The taxpayer must have had some reasonable basis for not treating the worker as an employee. This may consist of reasonable reliance on a judicial precedent, a published ruling, a private letter ruling, or technical advice memorandum issued to the taxpayer; the results of an employment tax audit of the taxpayer that takes place after 1996 (NOTE: An audit prior to 1997 can still qualify the taxpayer for the prior

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

audit safe haven); or a long-standing recognized practice of a significant segment of the industry in which the worker is engaged. Any other reasonable basis could also suffice.

If the business clearly meets the reporting and substantive consistency requirements and satisfies the reasonable basis test, the requirements of §530 are fully met. As a result, no adjustment will be made and the taxpayer may choose to continue treating its workers as independent contractors for purposes of its employment tax liability, as long as the facts remain the same and the taxpayer continues to meet the reporting requirement for that class of worker.

If the taxpayer does not satisfy the requirements of §530, the IRS examiner will determine whether the workers in question are employees under the usual common law rules previously discussed.

2. CSP offer

Because the IRS administrative procedures do not permit examiners to weigh the chances of success in court when proposing adjustments, taxpayers seeking to negotiate a settlement of the issue, including relief under §530, will generally take their cases to IRS Appeals or to the courts. This increases costs for both taxpayers and the government. The CSP can reduce these costs while preserving the government's interests in certain cases where the IRS determines that §530 relief is not available. If the examination includes a proposal to reclassify workers as employees and the taxpayer timely filed required Forms 1099, **it is mandatory that the examiner make a CSP offer** unless an exclusion applies. There are several exclusions that may apply, including but not limited to where the correct employer cannot be identified (leased workers), cases where other than Form 1099s were issued, and if a criminal investigation is involved. Under the CSP, a series of graduated settlement offers are available:

1. **100% CSP offer** -- If the taxpayer meets the §530 reporting consistency requirement but either clearly does not meet the §530 substantive consistency requirement or clearly cannot meet the §530 reasonable basis test, the offer will be a full employment tax adjustment for the most recent tax year under examination.
2. **25% CSP offer** -- If the taxpayer meets the reporting consistency requirement and has an argument that it meets the substantive consistency requirement and/or the reasonable basis test, the offer will be an adjustment of 25 percent for the most recent tax year under examination.

Example: Examination of a masonry construction company reveals the company makes payments to two brick layers. The two workers perform identical duties. The company timely filed a Form 1099 for one worker and a Form W-2 for the other. Because the company has treated the similarly situated workers inconsistently, the company is not entitled to relief under §530. However, a 100 percent CSP offer would be made regarding the worker who was not treated as an employee.

3. **No assessment CSP offer (§530 applied)** -- If a taxpayer clearly meets the reporting and substantive consistency requirements and satisfies the reasonable basis test, the requirements of §530 are fully met. However, the taxpayer may wish to enter into an agreement. A taxpayer that enters into such an agreement may begin treating the workers as employees currently or at the beginning of the next year.
4. In each instance, the taxpayer will agree to classify its workers as employees prospectively, thus ensuring future compliance.

A taxpayer may qualify for more than one CSP offer if several classes of workers are at issue. For example, a taxpayer may receive a 25 percent CSP offer for one class of workers and a 100 percent CSP

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

offer for another class. The same taxpayer may not have timely filed Forms 1099 for another class of workers, and therefore, may not qualify for any CSP offer for this class of workers. On yet another class, the taxpayer may satisfy all the requirements of §530 and would therefore be permitted to continue to treat those workers as independent contractors.

One of three standard closing agreements must be used for CSP, based on which of the following situations applies:

1. Form 14490, *Closing Agreement on Final Determination Covering Specific Matters for Taxpayers Entitled to Section 530 Relief*, used when taxpayers qualify for §530 relief but choose to treat the workers as employees prospectively.
2. Form 14491, *Closing Agreement on Final Determination Covering Specific Matters Regarding Worker Classification*, used when taxpayers do not qualify for §530 relief, are currently treating the workers as non-employees, and are eligible for a CSP offer.
3. Form 14492, *Closing Agreement on Final Determination Covering Specific Matters Regarding the Classification of Workers Currently Treated as Employees*, used when taxpayers do not qualify for §530 relief, are currently treating workers as employees, and are eligible for a CSP offer.

No changes will be made to any of the terms and conditions of the agreement. Examiners will insert certain taxpayer and return information when preparing the standard closing agreement. The taxpayer will sign, and the case closed.

If the taxpayer does not agree with reclassification and does not accept the examiners classification settlement offer or is ineligible for the program, the determination can be appealed though IRS Appeals or the through the courts. However, this may result in expanding the examination to include all other open tax years.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Form **8952** (Rev. November 2023) Department of the Treasury Internal Revenue Service

Application for Voluntary Classification Settlement Program (VCSP)

Do not send payment with Form 8952.
Go to *www.irs.gov/Form8952* for instructions and the latest information.

OMB No. 1545-2215

Caution: Taxpayer must make certain representations in order to be eligible to participate in the VCSP. These representations can be found in Part V on page 2.

Part I Taxpayer Information

1 Taxpayer's name

2 **Employer identification number (EIN)**

3 Number and street (or P.O. box number if mail is not delivered to a street address) | Room/Suite

4 City, town or post office, state, and ZIP code

5 Telephone number

6 Website address (optional)

7 Fax number (optional)

8 Email address (optional)

9 Type of entity. Check the applicable box:

- ☐ Sole proprietorship
- ☐ Joint venture
- ☐ Partnership
- ☐ C corporation
- ☐ S corporation
- ☐ Cooperative organization described in section 1381 of the Internal Revenue Code
- ☐ Tax-exempt organization
- ☐ State or local government (for worker class or position not covered under a section 218 agreement)
- ☐ Other (specify here) ______________

10 Are you a member of an affiliated group?
☐ Yes ☐ No
If "Yes," complete the common parent information on lines 11–14.
If "No," skip to Part II.

11 Name of common parent of the affiliated group

12 EIN of common parent

13 Number and street (or P.O. box number if mail is not delivered to a street address) of common parent

14 City, town or post office, state, and ZIP code of common parent

Part II Contact Person

Attach a properly completed Form 2848, Power of Attorney and Declaration of Representative, if applicable. Also see *Special instructions for Form 2848* in the instructions.

- Name and title of contact person ______________
- Contact person's number and street (or P.O. box number if mail is not delivered to a street address) ______________
- Contact person's city, town or post office, state, and ZIP code ______________
- Contact person's telephone number ______________
- Contact person's fax number (optional) ______________
- Contact person's email address (optional) ______________

Part III General Information About Workers To Be Reclassified

15 Enter the total number of workers from all classes to be reclassified. A class of workers includes all workers who perform the same or similar services.

16 Enter a description of the class or classes of workers to be reclassified. If more space is needed, attach separate sheets. See instructions

17 Enter the beginning date of the employment tax period (calendar year or quarter) for which you want to begin treating the class or classes of workers as employees. This date should be at least 120 days after the date you file Form 8952. See instructions

/ /

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37772H Form **8952** (Rev. 11-2023)

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Taxpayer's name	Employer identification number (EIN)

Part IV Payment Calculation Using Section 3509(a) Rates (see instructions)

18	Enter total compensation paid in the most recently completed calendar year to all workers to be reclassified. See instructions	18			
19	Multiply line 18 by 3.24% (0.0324)			19	
20	Enter any compensation included on line 18 that exceeded the social security wage base for any worker or workers for the most recently completed calendar year. See instructions	20			
21	Subtract line 20 from line 18	21			
22	Multiply line 21 by 7.44% (0.0744)			22	
23	Add lines 19 and 22			23	
24	Multiply line 23 by 10% (0.10). This is the VCSP payment you will submit with your signed closing agreement. See instructions			24	

Part V Taxpayer Representations

Caution: Since the representations include the penalty of perjury statement, the representations under Part V must be signed by the taxpayer, not the taxpayer's representative.

A Treatment of Workers

1. Taxpayer wants to voluntarily reclassify certain workers as employees for federal income tax withholding, Federal Insurance Contributions Act, and Federal Unemployment Tax Act taxes (collectively, federal employment taxes) for future tax periods.
2. Taxpayer is presently treating the workers as nonemployees.
3. Taxpayer has filed all required Forms 1099 for each of the workers to be reclassified for the 3 preceding calendar years ending before the date of this application.
4. Taxpayer has consistently treated the workers as nonemployees.
5. There is no current dispute between the taxpayer and the IRS as to whether the class or classes of workers are nonemployees or employees for federal employment tax purposes.

B Examination

1. Taxpayer or, if applicable, any member of the taxpayer's affiliated group, is not under employment tax examination by the IRS.
2. Taxpayer is not under examination by the Department of Labor or any state agency concerning the proper classification of the class or classes of workers.

3a. Taxpayer has not been examined previously by the IRS or the Department of Labor concerning the proper classification of the class or classes of workers; or

b. Taxpayer has been examined previously by the IRS or the Department of Labor concerning the proper classification of the class or classes of workers and the taxpayer has complied with the results of the prior examination.

Caution: Do not send payment with Form 8952. You will submit payment later with your signed closing agreement. If you submit payment with Form 8952, it may cause a processing delay.

Sign Here	Under penalties of perjury, I declare that I have examined this submission, including any accompanying documents, and to the best of my knowledge and belief, all of the facts contained herein are true, correct, and complete. Taxpayer's signature			Date	
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name			Firm's EIN	
	Firm's address			Phone no.	

Form **8952** (Rev. 11-2023)

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

S Corporation Compensation Issues

Learning objectives ***1***
I. S corporations and shareholder compensation issues ***1***
A. Overview **1**
B. Treasury Inspector General for Tax Administration Reports **1**
C. IRS Fact Sheet FS-2008-25 **2**
1. What's a reasonable salary? *2*
2. Medical insurance premiums treated as wages *3*
3. Identifying the factors *3*
D. Lateesa Ward v. Commissioner **4**
II. General compensation planning ***5***
A. S corporations -- No E&P **5**
1. Getting money out *5*
2. Tax consequences of distributions *5*
3. Tax consequences of compensation *5*
4. Cash distributions versus cash compensation payments *6*
B. S corporations -- With accumulated E&P **10**
1. Tax consequences of distributions *10*
2. Tax consequences of compensation *10*
3. Cash distributions versus cash compensation payments *10*
C. Check box on Form 1040 for S corporation reporting **13**
D. Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations* **13**
E. Planning **13**
III. Reallocation of income among family members ***14***
A. Power of reallocation **14**
1. In general *14*
2. Reasonably low compensation *14*
3. Reasonably high compensation *15*
4. Persons to whom allocated *15*
5. Reasonableness *15*

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

S Corporation Compensation Issues

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Explain the differing tax consequences of distributions and compensation payments to shareholder-employees.

I. S corporations and shareholder compensation issues

A. Overview

Corporate officers are specifically included within the definition of employee for FICA, FUTA and federal income tax withholding.[1] S Corporation flow through earnings are not subject to self-employment taxes due to the wage requirements. Subchapter S corporations have been known to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages. This has caused a great deal of concern to the IRS. As a result, the IRS has stepped up their enforcement activities to determine if S corporations are paying their shareholders reasonable compensation.

B. Treasury Inspector General for Tax Administration Reports

Over more than the last decade the Treasury Inspector General for Tax Administration (TIGTA) and Government Accountability Office (GAO) have issued numerous reports to Congress stating that S Corporation compensation does not get enough attention by the IRS. One such report identified 84 S Corp returns that had been examined by the IRS with results that showed that the average wages reported on Form W-2 was $5,300 with the average Schedule M-2 distribution of $343,323. This means that if these numbers were projected to 2025 there would be an average savings on payroll taxes (employee/employer) of over $31,000 per shareholder per year. This provides the incentive for S Corporations to treat the payments as anything but compensation. As a result, one of the top issues pursued by IRS is reasonable compensation issues between an S Corporation and its shareholders.

The IRS has become so focused on the issue, it includes additional information (some might say a "warning") on acceptance of the S **corporation** election on Form 2553. The letter states:

> *"Payments to shareholder-employees for services rendered: - You must determine a reasonable salary when a shareholder-employee of an S corporation provides services to the corporation. Payments to a shareholder-employee for services provided to an S corporation are wages and are subject to employment taxes. We may re-characterize distributions paid to a shareholder as salary if the distribution was paid in lieu of reasonable compensation (Revenue Ruling 74-44)."*

With a Social Security system that is broken and in dire need of money, it is obvious that the IRS will continue its enforcements in this area and the reason compensation planning is so important.

In its 2007 report to Congress, the National Taxpayer Advocate reports that in tax year 2005 almost one million of S corporations with one shareholder paid no officers' compensation. Had all profitable

---

[1] I.R.C. §3121(d).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

S corporations that reported no officers' compensation been Schedule C businesses, they would have paid an estimated $4.9 billion in self-employment tax. The report noted that for 2006, 56 percent of all S corporations maintained only one shareholder and of those one-shareholder S corporations, 58 percent reported zero compensation.

IRS continues to lose the battle when it comes to combatting S corporation reasonable compensation issues. TIGTA released an audit report to Congress on August 11, 2021,[2] identifying the delinquency in IRS auditing reasonable compensation issues in spite of the warning on the 1120-S acceptance letter. The report disclosed that for FY 2017-2019 examinations of 1120-S filed returns, although the IRS computers appropriately selected the returns where there was little to no officer's compensation, when the returns were actually examined, officers' compensation was seldom audited by examiners even when signification distributions were taken. TIGTA estimates that because of lack of compliance by S corporation officers and IRS's failure to address the issue, approximately $3.3 billion in employment taxes may have been avoided.

C. IRS Fact Sheet FS-2008-25

The IRS issued a fact sheet in 2008 on several areas regarding S corporations and shareholder salaries including what is reasonable and the factors for compensation.[3]

1. What's a reasonable salary?

The instructions to the Form 1120-S, *U.S. Income Tax Return for an S Corporation*, state "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

The amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go to the shareholder, a salary amount must be determined, and the level of salary must be reasonable and appropriate.

There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.

Some factors considered by the courts in determining reasonable compensation are:

- Training and experience;
- Duties and responsibilities;
- Time and effort devoted to the business;
- Dividend history;
- Payments to non-shareholder employees;
- Timing and manner of paying bonuses to key people;
- What comparable businesses pay for similar services;
- Compensation agreements; and
- The use of a formula to determine compensation.

---

2 TIGTA Audit Report 2021-30-042.
3 FS-2008-25.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

2. Medical insurance premiums treated as wages

The health and accident insurance premiums paid on behalf of the greater than two-percent S corporation shareholder-employee are deductible by the S corporation as fringe benefits and are reportable as wages for income tax withholding purposes on the shareholder-employee's Form W-2. They are not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. Therefore, this additional compensation is included in Box 1 (Wages) of the Form W-2, *Wage and Tax Statement*, issued to the shareholder but would not be included in Boxes 3 or 5 of Form W-2.

A two-percent shareholder-employee is eligible for an AGI deduction for amounts paid during the year for medical care premiums if the medical care coverage is established by the S corporation. Previously, "established by the S corporation" meant that the medical care coverage had to be in the name of the S corporation.

The IRS has stated that if the medical coverage plan is in the name of the two-percent shareholder and not in the name of the S corporation, a medical care plan can be considered to be established by the S corporation if the S corporation either paid or reimbursed the two-percent shareholder for the premiums and reported the premium payment or reimbursement as wages on the two-percent shareholder's Form W-2.[4]

Payments of the health and accident insurance premiums on behalf of the shareholder may be further identified in Box 14 (Other) of the Form W-2.

Schedule K-1 (Form 1120-S) and Form 1099 should not be used as an alternative to the Form W-2 to report this additional compensation.

3. Identifying the factors

The nature of the business is important because when professional services, such as law, accounting, or consulting are involved, profits are generated primarily by the personal efforts of the employees; as a result, a significant portion of the profits should be paid out in compensation rather than distributions. No reported cases involve a business typically driven less by a shareholder's personal efforts and more by the corporation's capital and assets when a lower salary for the shareholder-employees and a dividend as a return on invested capital may be justified.

A court will focus on what the principal was doing and not doing, so documentation of the extent of the principal's services must be considered in determining reasonable compensation. The corporation is not required to, and would not be penalized, paying salary to a shareholder who provides limited services. In addition, the greater the experience, responsibilities, and effort of the shareholder-employee, the larger the salary that will be required, but a reduced role for a once full-time shareholder-employee may justify a decrease in salary or compensation to less than industry norms.

A comparison of compensation to rank-and-file employees, if any, with that of the principal should not be unfavorable. Similarly, if a shareholder-employee has more responsibilities than the highest paid nonshareholder, the shareholder's wage should logically be higher than the nonshareholder's wage. If the corporation has enjoyed rising revenues but the shareholder-employee's salary has not increased, this may be an indication that compensation is unreasonably low. In addition, if the corporation recently

---

[4] Notice 2008-1, 2008-2 I.R.B. 251.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

elected S status and correspondingly reduced its amount of shareholder compensation, this will raise questions about whether the motivation behind the salary reduction was to avoid payroll taxes.

Basic benchmarking tools from sources such as Bureau of Labor Statistics wage data will be useful in determining the relative reasonableness of the shareholder-employee's compensation when compared with industry norms.

The financial ratios published in the RMA and industry-specific publications should be used to determine both the corporation's overall profitability and the shareholder/employee's compensation as a percentage of sales or profits. Whenever possible, these comparisons should be with similarly sized companies within the same geographic region. If the resulting ratios indicate that the S corporation is more profitable than its peers but is paying less salary to the shareholder-employee, in the absence of any other factors, such as the shareholder's reduced role or the corporation's need to retain capital for expansion, an increase in compensation to the industry and geographic norms provided for in the publications likely will be necessary.

While large distributions coupled with a small salary may increase the likelihood of IRS scrutiny, there is no requirement that an S corporation pay out all profits as compensation. There is some indication reading between the lines that a court may stop at the taxable wage base for reasonable compensation, allowing amounts in excess of that level to escape the Medicare tax.

If a careful analysis of the factors supports compensation equal to or above the Social Security wage base, setting a shareholder's compensation below that amount likely leaves a greater likelihood of IRS scrutiny. Conversely, as the salary amounts equal or exceed that wage base, the tax savings of the salary-for-distribution trade diminish greatly, and this may reduce the risk of an IRS challenge.

The Service implicitly recognizes that an S corporation must pay a reasonable compensation but up to the amount that is paid, regardless of what the corporation may call it, may be recharacterized as compensation. Forgoing distributions or making written documented bona fide loans from the corporation that are recognized by the shareholder as loans avoid the employment-tax issue. That said, payment of no compensation to officers is a clear audit red flag.

D. Lateesa Ward v. Commissioner

In *Lateesa Ward v. Commissioner*,[5] Ms. Ward was an attorney conducting business as the sole shareholder of S Corporation Ward & Ward Company. During the audit years, there were only two employees in the firm, Ward and another, unrelated attorney. In the 2011 audit year, the 1120-S showed a loss of $1,373; officer compensation of $62,388; and wages of $33,925. The firm reported employee compensation totaling $41,483.78 on its Forms 941. Ward's Form 1040 for that year, however, showed no wages or salaries received but the $1,373 loss on Schedule E. The 2012 and 2013 tax year audits had similar issues. For 2012, the 1120-S reported income of $5,309, officer's compensation of $73,448, and wages of $47,171 while the Form 941 had employee compensation of $52,198.60. For 2013, the 1120-S reported a loss of $17,402, officer's compensation of $0, and wages of $108,469 while the Form 941 had employee compensation of $77,444.64. Ward treated her payments as distributions.

---

5 *Lateesa Ward and Ward & Ward Company v. Commissioner*, T.C. Memo 2021-31.

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

The Court had to decide whether Ward was an employee and should have paid employment taxes on wages for the monies received or whether there were in fact, tax-free distributions. The Court's analysis began with Code §3121(d), which states that officers are employees. Any compensation paid to Ward in her role as an officer was thus considered wages and the Court stated that it is settled law that the firm is liable for employment taxes on wages. The Court found that there was no evidence other than Ward's own testimony that any of these payments were anything but compensation. As a result, the Court determined that the firm was liable for employment taxes on all amounts that the Commissioner identified as officer's compensation.

II. General compensation planning

A. S corporations -- No E&P

1. Getting money out

Shareholder-employees of S corporations may obtain remuneration for their services in two general ways: (i) cash or property **distributions** with respect to their S stock; or (ii) cash or other forms of **compensation** for their services. The payment of current cash compensation may have significantly different economic and tax consequences than a distribution with respect to stock.

2. Tax consequences of distributions

S shareholders are taxable on their ratable share (based on stock ownership) of S corporation net income and can claim a deduction (within limits) for their share of S corporation net loss.[6] In addition, when the S corporation has always been an S corporation with no E&P or previously taxed income (PTI), a distribution is generally tax-free to the extent of the shareholder's stock basis and is a capital gain to the extent it exceeds that stock basis.[7] If an S corporation makes a distribution of property with a fair market value in excess of the property's basis, gain must be recognized by the corporation to that extent.[8] Such gain increases each S shareholder's share of income from the corporation.[9]

3. Tax consequences of compensation

An S corporation shareholder-employee's compensation is taxable to the shareholder as ordinary income and is deductible by the corporation (provided such amount is not unreasonable).

- a. If the compensation is paid to a shareholder-employee acting in the capacity of an employee, the gross amount is subject to payroll taxes as follows:
  - (i) Federal (and possibly state) income-tax withholding is payable on the gross amount;[10]

---

6 I.R.C. §§1366(a)(1) and 1366(a)(2).
7 I.R.C. §1368(b).
8 I.R.C. §1368(d).
9 I.R.C. §1366(a)(1).
10 I.R.C. §§3401(a), 3121(a), and 3306(b). Not all forms of compensation are subject to payroll taxes (e.g., employer contributions to qualified retirement plans).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(ii) Social Security (FICA) taxes must be withheld and also paid by the employer S corporation, at a rate of 7.65 percent for the compensation paid to the shareholder-employee up to the maximum amount subject to the FICA tax, $168,600 in 2024 and $160,200 in 2023.[11] However, if an S shareholder has received compensation subject to FICA tax withholding from another employer during the same year and the total of the compensation paid to the shareholder by the S corporation and by the other employer is greater than the maximum FICA tax wage base, the shareholder can take a refundable tax credit equal to the FICA tax percentage multiplied by the amount of total taxable compensation in excess of the wage base limit. Thus, if an S shareholder has received compensation from another employer of at least the FICA wage limit amount, that shareholder will effectively not be subject to the employee FICA tax on the compensation received from the S corporation. This rule, however, does not apply to the employer's required payment of FICA taxes. In addition, there is a 2.9% Medicare tax that applies to all compensation ABOVE the taxable wage base, split equally between the shareholder and the corporation;

(iii) Federal unemployment (FUTA) taxes must be paid by the employer at a net rate of 0.6 percent on up to the first $7,000 of compensation paid to the shareholder-employee;[12] and

(iv) State unemployment taxes must be paid at a rate dependent on the state and circumstances of the employer S corporation on up to the first $7,000 of compensation paid to the shareholder-employee.[13]

b. FICA taxes, FUTA taxes, and state unemployment taxes paid by the S corporation are deductible in computing its taxable income[14] and thus reduce the net income or increase the net loss pass-through to the S shareholders.

4. Cash distributions versus cash compensation payments

The tax consequences of cash distributions versus current cash compensation depend not only on whether the S corporation has no C corporation E&P and the shareholders no PTI but also on: (i) whether the S corporation has net income or net loss; (ii) the S shareholder's stock basis as of the end of the corporation's taxable year; and (iii) whether the compensation is paid in proportion to the shareholder's relative stock ownership in the corporation.

a. Profitable corporation -- If: (i) the S corporation has net income; (ii) the shareholders have sufficient stock basis to cover a distribution; and (iii) compensation is paid to the shareholder based on relative stock ownership, then the fundamental difference between a cash distribution and cash compensation is in the payroll taxes.

Example 1: Three shareholders (Able, Baker, and Ross) own the ABC Corporation equally and have operated it as an S corporation since it was formed in 1985. In 2024, the corporation had $450,000 of net income (before payments to the shareholders).

If the shareholders receive only a cash distribution of $330,000, they will each be taxable on $150,000 (one-third of the $450,000 net income) but not on the

---

11 I.R.C. §§3101 and 3111.

12 Under §3301(1), the gross FUTA rate is 6.0 percent for 2015. However, a credit for state unemployment taxes is permitted and generally reduces the FUTA rate to 0.8 percent. See I.R.C. §3302.

13 The state unemployment tax rate usually depends on the experience rating of the employer (i.e., some relationship between taxes paid by the employer and unemployment benefits paid by the state to laid-off workers of the employer).

14 I.R.C. §§162(a) and 275(1).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

distribution, which is a tax-free return of capital (assuming, which will most likely be the case, that the distribution does not exceed the shareholders' bases).

On the other hand, if each shareholder is paid only $110,000 cash compensation, the results will be as follows:[15]

- The compensation will be taxable to the shareholders and deductible to the corporation, reducing the corporation's net income to $120,000 ($450,000 - $330,000).
- The corporation will have to withhold FICA taxes of $6,820 (0.062 x $110,000) from the compensation paid each of the shareholders. It also must withhold $1,595 of Medicare tax (0.0145 x $110,000), leaving them with a net cash receipt (before income taxes) of $101,585 each ($110,000 - $8,415).[16] However, if one or more of the shareholders has also received taxable compensation from another employer, they will receive some or all of the FICA withholding amount back in the form of a refundable tax credit when they file their income tax return for the year.
- The corporation will have to pay: (i) FICA taxes of $6,820 (0.062 x $110,000) and Medicare tax of $1,595 on the compensation paid each shareholder or a total of $25,245; and (ii) state unemployment taxes and FUTA taxes of $336 (assumed combined 4.8 percent x $7,000) on the compensation paid each shareholder or a total of $1,008.[17] The total payments of $26,253 ($25,245 + $1,008) are deductible in computing the net income of the corporation, leaving the corporation with net income of $93,747 ($120,000 - $26,253) to be reported by the shareholders.
- Thus, as a result of the payment of compensation, each shareholder: (i) is subject to income tax on one-third of $93,747 net income ($31,249) and on $110,000 of compensation; and (ii) has received $101,585 of cash (before income taxes) from the compensation. Furthermore, the corporation has had to pay out $26,253 in additional payroll taxes.
- In this example, the payment of compensation may not be advisable, unless other factors favor such payments. For example, the ability of a shareholder to take part in corporate retirement plans is dependent on his receiving compensation, since employer contributions to, or benefits payable from, a plan is dependent on the level of a participant's income.[18]
- Compensation payments may be advisable when the corporation wants to recognize that one shareholder's services are more valuable than another's, as in this case, and thus, a non-pro rata sharing of corporate net income is desired.[19] The payment of compensation to the shareholders on a non-pro rata basis will have significantly different tax results than a pro rata cash distribution.

---

[15] For convenience's sake, income-tax withholding is not specifically reflected in the examples. It is, however, taken into account in the statement that the compensation is taxable. It is also assumed that there is no state income tax and that the state unemployment tax is four percent.

[16] I.R.C. §3101.

[17] I.R.C. §§3111, 3301, and 3302; the state rate of four percent is assumed.

[18] See I.R.C. §415. Even where cash distributions are preferable, the payment of some amount of compensation may be useful since it may restrain the Service from claiming that wages should be imputed to a noncompensated or less-than-adequately compensated shareholder-employee. See I.R.C. §1366(e); Rev. Rul. 74-44, 1974-1 C.B. 287 (purported dividends to employees drawing no salaries were wages subject to payroll taxes). See the discussion below concerning family S corporation compensation problems.

[19] Non-pro rata distributions with respect to stock are not ordinarily advisable as they may produce unintended and unfavorable tax consequences including termination of the S election.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

Planning point:

Even though there may be savings in reduced payroll taxes upon the payment of a distribution, compensation payments may nevertheless be advisable for the following reasons: (i) to fund retirement plans; (ii) to establish Social Security benefits; (iii) to treat participating shareholders more favorably than nonparticipating shareholders; and (iv) to avoid an unreasonable-compensation argument that wages are too low.

Example 2: Assume the same facts as in **Example 1**. If $330,000 cash is distributed with respect to the shareholders' stock, Able, Baker, and Ross will each be taxable on $150,000 of net income (one-third of $450,000), will receive $110,000 cash, and should not be taxable on the cash distribution.

If the services of Able are worth $92,000, those of Baker $100,000, and those of Ross $138,000, and compensation is paid in these respective amounts, then the FUTA and state unemployment taxes ($336 each, $1,008 in total) would stay the same but the FICA taxes would change from those paid on the compensation in the prior example.[20] Able employer FICA and Medicare would be limited to $7,038.00 (his share $7,038); Baker to $7,650.00 (his share $7,650); and Ross would amount to $10,542.75 (his share $10,542.75). The employer match would be $25,230.75 plus the unemployment taxes of $1,008, totaling $26,238.75. Thus, the S corporation would have net income of $93,761.25 ($450,000 - $330,000 - $26,238.75), of which each shareholder is taxed on $31,354. However, Able would receive net cash of $84,962.00 ($92,000 - $7,038.00) before income taxes rather than $110,000; Baker would receive $92,350.00 ($100,000 - $7,650.00) before income taxes, and Ross would receive $127,457.25 ($138,000 - $10,542.75) before income taxes. Although the shareholders are collectively slightly worse off if compensation is paid as above, the result may be preferable if Ross's services for the corporation are more valuable than those of the other shareholders.

If one or more shareholders of the S corporation do not have stock basis sufficient to cover a cash distribution, they will have capital gain income equal to the excess of the distribution over their basis.[21] In such a case, the payment of compensation (even pro rata based on stock ownership) may be preferable to distributions with respect to stock.

Example 3: Assume the same facts as in **Example 1**, except that Able has no stock basis, and the corporation owes him $250,000, the basis of which is $75,000 as a result of loss pass-throughs in prior years.[22] If a $330,000 cash distribution was made, Able would be taxable on his $150,000 share of the corporation's net income and on the $110,000 cash distribution, because his share of the net income of $150,000 must be used to restore his basis in the debt owed him before it can increase stock basis.[23] That is, Able uses the $150,000 to restore his debt basis to $225,000 ($75,000 + $150,000); as there is no increase to stock basis, making the $110,000 cash distribution in excess of Able's stock basis and causes Able to recognize a $110,000 capital gain.

If, instead, compensation of $110,000 to each shareholder was paid by the corporation, Able would be taxed only on his one-third share ($31,354) of net income and on $110,000 of compensation, of which he receives a net of $101,585. In this case, the economic result favors the payment of compensation.

---

20 The same maximum FICA wage limit applies. See I.R.C. §§3101 and 3111.

21 I.R.C. §1368(b)(2).

22 I.R.C. §1367(a)(2).

23 I.R.C. §1367(b)(2).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

b. Loss corporation -- If the S corporation has a loss, but the shareholders have sufficient basis to absorb any cash distribution, then the only basic difference between the cash distribution and the payment of compensation is in the payroll taxes on the payment of compensation.

Example 1: The Black and Blue Corporation was formed as an S corporation in 1990 by its two equal shareholders, Dee and Doe. In 2024, Black and Blue has a net loss of $40,000 and wants to pay $30,000 to each shareholder. Assuming the shareholders have sufficient stock basis to absorb the loss and the distribution, they will not be taxed on the distribution.

If $30,000 compensation each were paid to Dee and Doe, FICA and Medicare taxes of $2,295 ($30,000 x 0.0765) (employee's share $2,295) would have to be withheld by the corporation and paid on each shareholder's salary. Assuming a 4-percent state unemployment tax, state unemployment taxes and FUTA taxes of $336 ($7,000 x .048) would have to be paid by the corporation on the compensation paid to each person (a total of $672). Thus, each shareholder would receive net cash of $27,705 (after FICA taxes) and would be taxable on $30,000. The corporation's net loss would increase to $105,262 ($40,000 + the $60,000 of total compensation and $5,262 of FICA and unemployment taxes). Each shareholder would be able to deduct $52,631 of that loss.[24] In this instance, as long as they have basis to take the loss and the individual income taxes saved exceed the employee and employer FICA and Medicare taxes paid, it may be beneficial to pay the compensation. An analysis should be performed when making the determination as all taxes paid, not just FICA and Medicare should be considered.

Once again, the payment of compensation may or may not result in an advantageous or non-advantageous economic result. Nevertheless, other reasons may exist for paying compensation, and compensation may be desirable if the services of the shareholders are of unequal value as illustrated by the example with Able, Baker, and Ross.

If the S corporation has a net loss and any of the shareholders has an insufficient basis to absorb cash distributions, the payment of compensation may cause slightly different results than the making of a cash distribution with respect to stock.

Example 2: Assume the same facts as in **Example 1**, except that both Dee and Doe have a pre-loss stock basis of $5,000. A cash distribution of $30,000 to each shareholder would be taxable as capital-gain income to the extent of $25,000 because each shareholder's stock basis would be reduced to zero by the distribution by the first $5,000 with the excess treated as gain from the sale or exchange of the stock. Because there is no remaining basis, neither shareholder will be able to currently deduct any part of the corporate net loss.

If compensation of $30,000 each were paid to Dee and Doe, after FICA tax of $2,295, each shareholder would receive net cash of $27,705 and be taxable on $30,000 as ordinary income. The net loss of the corporation would increase to $105,262 ($40,000 + $60,000 + $5,262). However, Dee and Doe would each be able to deduct only $5,000 -- the amount equal to their pre-loss stock basis. The rest of the net loss would be suspended until they built up future basis.

---

24 I.R.C. §§1366(a)(2) and 1366(d).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

B. S corporations -- With accumulated E&P

1. Tax consequences of distributions

S shareholders are taxable on their ratable share (based on stock ownership) of S corporation net income and can claim a deduction (within limits) for their share of a net loss incurred by the S corporation.[25] Distributions made with respect to stock owned by shareholders of S corporations with accumulated E&P are treated as follows:[26]

- Tax-free to the extent of the shareholder's share of the corporation's accumulated adjustment account (AAA)[27] (except to the extent they exceed the shareholder's stock basis); then
- Tax-free to the extent of the shareholder's share of the corporation's previously taxed income (PTI)[28] (except to the extent they exceed the shareholder's stock basis); then
- Taxed subject to capital gain rates to the extent of the shareholder's share of the corporation's accumulated E&P; then
- Tax-free to the extent of the shareholder's stock basis; and then
- Taxable as a capital gain.

If an S corporation distributes appreciated property with respect to stock, gain must be recognized by the corporation to the extent of the appreciation.[29] Such gain increases the S shareholder's recognized income from the corporation.[30]

2. Tax consequences of compensation

Compensation paid to a service-performing shareholder of an S corporation is ordinarily taxable to the shareholder as ordinary income and deductible by the S corporation.

3. Cash distributions versus cash compensation payments

The tax consequences of cash distributions versus cash compensation to shareholder-employees in an S corporation with accumulated E&P depend on: (i) whether the S corporation has net income or net loss; (ii) whether the corporation has a positive balance in its AAA; (iii) what the amount is of each S shareholder's stock basis; and (iv) whether the compensation is paid in proportion to the S shareholder's relative stock ownership percentage.

a. Profitable corporation -- If: (i) the S corporation with accumulated E&P has net income; (ii) the shareholders have sufficient stock basis to cover a distribution; and (iii) compensation is paid to the shareholders based on relative stock ownership, then the fundamental difference between a cash distribution and cash compensation is in the payroll taxes. The result is similar to what would occur in an S corporation without accumulated E&P.

Example 1: Short and Long each own 50 percent of the stock of an S corporation, with $180,000 accumulated E&P from its days as a C corporation. In 2024, the

---

25 I.R.C. §§1366(a)(1) and 1366(a)(2).

26 I.R.C. §1368(c). Under I.R.C. §1368(e)(3), an S corporation can elect to treat distributions as being made first from accumulated E&P rather than from AAA.

27 I.R.C. §1368(e) provides that the AAA equals (prior to making any distributions) the cumulative total of the S corporation's net income and gains after 1982 (not including tax-exempt income) minus: (i) all expenses and losses (not related to tax-exempt income); and (ii) cash distributions and FMV of property distributions made in previous years.

28 PTI represents taxable income of the S corporation earned prior to 1983 and not yet distributed to the shareholders.

29 I.R.C. §1371(a).

30 I.R.C. §1366(a)(1)(A).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

S corporation had $300,000 net income (before considering payments to shareholders).

If the shareholders receive a cash distribution of $250,000, they will each be taxable on $150,000 net income of the corporation (one-half of the $300,000 net income) but not on the distribution because it is a tax-free distribution of AAA.

If Short and Long each receive $125,000 of cash compensation, however, the results will be as follows (assuming there is no state income tax and that the state unemployment tax rate is four percent):

- The compensation will be taxable to the shareholders and deductible by the corporation, reducing the corporation's net income to $50,000 ($300,000 - $250,000).
- The corporation will have to withhold FICA and Medicare taxes $9,562.50 (0.0765 x $125,000) from the compensation paid to each shareholder, leaving them each with a net cash receipt (before income taxes) of $115,437.50.
- The corporation will have to pay: (a) FICA and Medicare taxes of $9,562.50 (0.0765 x $125,000) or a total of $19,125.00; and (b) state unemployment taxes and FUTA taxes of $336 (4.8 percent x $7,000), or a total of $672. The total payments of $19,797.00 ($19,125 + $672) are deductible in computing the net income of the corporation, leaving the corporation with net income of $30,203 ($300,000 - $250,000 - $19,797) to be reported by the shareholders.
- Thus, as a result of the payment of compensation, Short and Long each: (a) is subject to income tax on one half of $30,203 net income ($15,101.50) and on $125,000 of compensation; and (b) only received $115,437.50 of cash compensation (before income taxes). Furthermore, the corporation has had to pay $19,797.00 in additional payroll taxes.
- If the payment of compensation is not made on the basis of the shareholder's relative stock ownership (but rather, for example, to provide remuneration according to the value of services rendered), the payment of compensation rather than a pro rata cash distribution may cause significantly different economic and tax results depending on the amounts distributed.
- If the shareholders in the S corporation do not have sufficient stock basis to cover a cash distribution, they will have capital gain to the extent their cash distribution out of AAA is not covered by their stock basis.[31] In such a case, the payment of compensation (even on a pro rata basis according to stock ownership) may be preferable to distributions with respect to stock. The results are similar to what would occur in an S corporation without accumulated E&P.

Example 2: Assume the same facts as in **Example 1**, except that Long has no stock basis and the corporation owes him $175,000, the basis of which is $100,000 as a result of loss pass-throughs in prior years.[32] If a $250,000 cash distribution were made to the shareholders ($125,000 to each), Long would be taxable on: (i) his $150,000 share of the corporation's net income; and (ii) $50,000 of his $125,000 cash distribution because $75,000 of the $150,000 is used to restore the basis in his debt back to $175,000 from $100,000. Thus, Long gets only $75,000 of stock basis. The remainder of the distribution is tax-free from AAA.

---

[31] A shareholder's stock basis and the AAA balance are not always the same.
[32] I.R.C. §1367(a)(2).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

If, instead, cash compensation of $125,000 were paid by the corporation on a pro rata basis, Long would be taxable on only his one-half share ($15,101.50) of the net income and on $125,000 compensation, of which he receives $115,437.50 before income taxes.

b. Loss corporation -- If an S corporation with accumulated E&P has a net loss but has AAA from prior years and the shareholders have sufficient stock basis to absorb a reasonable cash distribution, the only difference between making a cash distribution or payment of cash compensation on a pro rata basis is the payroll taxes on the compensation. Again, this result is the same as for an S corporation without accumulated E&P in similar circumstances.

Example 1: An S corporation with $250,000 accumulated E&P has two equal shareholders, Barber and Allen. In 2024, the S corporation: (i) has a net loss (before any payments to shareholders) of $60,000; (ii) has AAA of $150,000; and (iii) pays $40,000 cash to each shareholder. If the shareholders have sufficient stock basis to absorb the loss and distribution, the distribution will be totally tax-free out of AAA.

If Barber and Allen each receive $40,000 of compensation, FICA taxes of $3,060 ($40,000 x 0.0765) would have to be withheld from each shareholder and also paid by the corporation. Assuming a four-percent state unemployment tax, state unemployment taxes and FUTA taxes of $336 ($7,000 x 0.048) would have to be paid by the corporation on the compensation paid to each person (a total of $672). Each shareholder would receive net cash of $36,940 (after FICA taxes and before income taxes). The corporation's net loss would increase to $146,792 ($60,000 + the $80,000 of compensation paid and $6,792 of payroll taxes). Barber and Allen would each be able to deduct $73,396 of that loss.[33]

(i) If a loss S corporation has AAA and accumulated E&P but one or more of the shareholders has an insufficient basis to absorb both the loss of the S corporation and a cash distribution, the payment of compensation will cause a slightly different result from the making of a cash distribution with respect to stock.

Example 2: Assume the same facts as in **Example 1**, except that Barber has a stock basis of only $20,000 (prior to considering the corporate net loss and any distributions with respect to stock), while Allen still has sufficient stock basis. A cash distribution of $40,000 to each shareholder would result in $20,000 of capital gain income to Barber because his stock basis would be reduced to zero by the first $20,000, with the balance treated as gain from the sale of the stock. Since Barber has no remaining basis, his share of the net loss is suspended until Barber has sufficient basis. Allen will not be taxed on the distribution because it is out of AAA and he will be able to deduct his full share of the net loss (one half of the $60,000 net loss of the corporation).

If compensation of $40,000 each were paid to Barber and Allen, each shareholder would receive net cash of $36,940 and be taxable on $40,000 ordinary income. The net loss of the corporation would increase to $146,792. Allen would be able to deduct $73,396 of that loss. Barber, on the other hand, would only be able to deduct $20,000 of that loss (limited to his stock basis). The remaining $53,396 of loss would be suspended until basis is built up in the future.

---

[33] I.R.C. §§1366(a)(2) and 1366(d).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

(ii) If the loss S corporation does not have AAA from prior years or its AAA is not sufficient to offset the current loss, some, or all of the cash distribution with respect to stock will be a dividend out of accumulated E&P, and thus, will be ordinary income to the recipient shareholder. In such case, the payment of compensation will result in less income being taxed to the shareholders than if a cash distribution is made. The payment of compensation clearly will be preferable to the making of a cash distribution.

Example 3: Assume the same facts as in **Example 2**, except that the corporation has no AAA from prior years. In that case, the cash distribution of $40,000 each will be fully taxable to Barber and Allen as ordinary dividend income out of accumulated E&P. Each will be able to deduct his $30,000 share of the $60,000 corporate net loss.

On the other hand, if compensation of $40,000 is paid to each, the results will be the same as in **Example 2**. Each shareholder will receive net cash of $36,940 (before income taxes on the $40,000) and will be able to deduct $73,396 of net loss.

Question to Ponder:

When AAA had been depleted to zero and there are current year distributions, what are the implications of treating those distributions as loans to shareholders rather than a distribution on Schedule K?

C. Check box on Form 1040 for S corporation reporting

For tax year after December 31, 2017, Schedule E reporting for S corporations has a check box in Part II of the Schedule E (Form 1040). Taxpayers who own an interest in an S corporation and report a loss, receive a distribution, dispose of stock, or receive a loan repayment from the S corporation must check the corresponding box under line 28, column (e), and attach a computation detailing their S corporation basis. Although the 2017 instructions for Schedule E also had the requirement, there was no formal box to check as there is for tax years after 2017.

D. Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*

IRS published Form 7203, *Shareholder Stock and Debt Basis Limitations* for shareholders to calculate their tax basis in their stock holding and loans to their S Corporation. It is required to be attached to every Form 1040 where the S Corporation shareholder claims an aggregate loss from an S Corporation, received a non-dividend distribution from an S Corporation, disposed of S Corporation stock or received a loan repayment from an S Corporation. In years prior to 2021 shareholders were required to attach a basis schedule for the same reasons discussed above but there was no formal form. After 2020 shareholders will use Form 7203.

E. Planning

Being prepared in the event of an audit is the key to success. Every year the S Corporation should document its strategy for compensation planning. Actions that the S Corporation should undertake in preventing the IRS from declaring that dividends distributed by an S corporation to a shareholder/employee should be treated as compensation and subject to withholding and employment taxes include:

1. Develop a salary or wage policy (e.g., per month or per hour) and compensate the shareholder/employee in accordance with the policy.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

2. Consider the following nonexhaustive list of factors when setting compensation in order to maintain reasonable levels of compensation:
   - Employee qualifications;
   - Nature, extent, and scope of work performed;
   - Nature and size of business;
   - Comparison of salaries with financial results; and
   - Compensation paid for similar work in comparable companies.
3. Document the above elements in the corporate minutes.

III. Reallocation of income among family members

A. Power of reallocation

1. In general

Section 1366(e) authorizes the Service to reallocate income among family members if one or more of them is not paid reasonable compensation for services rendered to an S corporation.[34] The principal purpose of the provision is to prevent the payment of inadequate compensation to a high-tax-bracket family member in an effort to shift income to a low-tax-bracket family member. Section 1366(e) also applies to loans made to the corporation at below-market rates of interest.

a. Even if a family member-lender does not own stock in the S corporation, the Service apparently has the right to increase the lender's gross income to reflect a market rate of interest.[35] Any increase in interest income to the family member could result in a corresponding increase in interest expense to the other family members owning shares of the S corporation.[36]

b. Family members often make gifts of property (especially property they anticipate will appreciate in the future) to other family members. In those cases, in which shareholders have been ill-advised or they continue to treat the property as their own, the courts have held that the donors continue to remain the beneficial owners of the property transferred. Those making transfers of S corporation stock for estate-planning purposes should therefore be cautioned that the transfers must have economic reality and be fully effective if the estate-planning goals are to be achieved.[37]

2. Reasonably low compensation

For planning purposes, compensation should be based on the low end of reasonable compensation for the older-generation shareholders. Even if there is a readjustment for income-tax purposes, the allocable shares of income are passed to the other younger-generation shareholders without any apparent incidence of transfer (estate or gift) tax.

---

[34] I.R.C. §1366(e) also authorizes the Service to reallocate income among family members if one of them furnishes capital without receiving reasonable compensation therefor.

[35] This power apparently exists in addition to the rules of relating to below-market loans.

[36] The shift in the allocation may cause a change in the character of interest for deductibility purposes.

[37] Regulations adopted under former I.R.C. §1373 warn: "A donee or purchaser of stock in the corporation is not considered a shareholder unless such stock is acquired in a bona fide transaction and the donee or purchaser is the real owner of such stock. The circumstances, not only as to the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the bona fides of the transfer. Transactions made between members of a family will be closely scrutinized." Treas. Regs. §1.1373-1(a)(2).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

3. Reasonably high compensation

In addition, the technique of paying reasonable compensation on the high end of reasonableness to younger-generation employees has benefits as well.

a. First, the more compensation that is reasonably paid out, the lower the taxable income that will be distributed to the shareholders. In some cases, the compensation payments may create a taxable loss. Such a loss may be deductible to the shareholders if there is sufficient basis in stock or debt. In a situation in which the corporation is owned solely or predominantly by an older-generation family member, the payment of compensation to the younger generation has the effect of shifting income in a manner that gives the older generation a current deduction while causing the younger generation to pay tax on a similar amount of income.

b. Second, the payment of such compensation may reduce the net worth of the corporation and to some extent the value of the shares in the S corporation without any immediate gift-tax consequences.

4. Persons to whom allocated

If unreasonable compensation is paid, the Service may make adjustments to the income of the employee and any member of the employee's family who is a **shareholder** of the S corporation.[38] The power of the Service to reallocate income among members of a family group is broad. Specifically, if an individual who is a "member of the family of one or more shareholders of an S corporation performs services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, adjustments may be made in the items of income, losses, deductions, and credits taken into account by such individuals and shareholders to properly reflect the value of such services or capital."[39]

a. The family of an employee for this purpose includes a spouse, ancestor, lineal descendant, or any trust for the primary benefit of any of the foregoing.[40]

b. The individual who provided the services need not, however, be a shareholder of the S corporation for the adjustments to be made.

5. Reasonableness

Many of the same criteria used to determine whether salary is reasonable for purposes of §162 would control. The Tax Court, for example, has focused on the nature of the services performed; the responsibilities involved; the time spent; the size and complexity of the business; the prevailing economic conditions; the compensation paid by comparable firms for comparable services; and the salary paid to individuals who perform similar services.[41]

a. The taxpayer presumably has the burden of proof to demonstrate that the compensation paid is reasonable.[42] The precise standard to be satisfied is, however, unclear.[43] In keeping with the Subchapter K family-reallocation rule, the Subchapter S reallocation rule can apply to an undercompensated family member who does not have an ownership

---

38 I.R.C. §1366(e).

39 I.R.C. §1366(e).

40 I.R.C. §§1366(e) and 704(e). The term "family" is defined by reference to I.R.C. §704(e)(3). I.R.C. §704(e)(3) provides that the family of any individual includes "only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons."

41 *Roob v. Commissioner*, 50 T.C. 891 (1968) (prior law). See also former Treas. Regs. §1.1375-3(a) (factors to be considered include managerial responsibilities of employee and amount ordinarily paid to obtain comparable services from person without proprietary interest in corporation).

42 *Krahenbuhl v. Commissioner*, T.C. Memo. 1968-34 (prior law).

43 See *Roob v. Commissioner*, 50 T.C. 891, 898 (1968), *acq.* (taxpayers must prove by a preponderance of evidence that Service's determination was incorrect); *Rocco v. Commissioner*, 57 T.C. 826, 832 (1972), *acq.* (assertion by the Service that taxpayer must demonstrate its determination to be unreasonable, arbitrary, or capricious).

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

interest in the S corporation and who did not transfer any ownership interest to another family member.[44] The reallocation rule was intended to prevent family members from shifting income among themselves to minimize tax liability.

b. If one family member is undercompensated for capital provided to the corporation, §1366(e)(3) permits the Service to reallocate items of income. Apparently, the Service could reallocate income if a parent provides capital to the family-owned corporation but receives an insufficient amount of stock in exchange for the property. In those same circumstances, the regulations under the gift-tax provisions provide that the parent is treated as making a gift and is potentially liable for gift tax.[45] It seems that if the gift-tax rules apply, a shareholder could be treated as having transferred a share of the contributed property or a share of stock to another family member. Viewed in this manner, the contributions of the shareholders would be proportionate and not trigger application of the family S corporation rules.

Note:

The finalized regulations offer some guidance in the application of the family S rules that attribute some reasonable level of compensation to any individual family member who renders services for or provides capital to an S corporation.[46] All the circumstances are considered in determining a reasonable allowance for services rendered for, or capital furnished to, the S corporation, including the amount that ordinarily would be paid to obtain comparable services or capital from a person who is neither a member of that family nor a shareholder in the S corporation. They extend this rule to cases when the services are rendered, or capital furnished, to an S corporation through a pass-through entity in which a member of a shareholder's family owns an interest. The proposed regulations direct the IRS to prescribe adjustments to the pass-through entity and the corporation to reflect the value of the services rendered or capital furnished.[47] For these purposes, the family of any shareholder includes only the shareholder's spouse, ancestors, lineal descendants, and any trust for the primary benefit of any of these persons.

Example 1: The stock of an S corporation is owned 50 percent by F and 50 percent by T, the minor son of F. For the taxable year, the corporation has items of taxable income equal to $70,000. Compensation of $10,000 is paid by the corporation to F for services rendered during the taxable year, and no compensation is paid to T, who rendered no services. Based on all the relevant facts and circumstances, reasonable compensation for the services rendered by F would be $30,000. In the discretion of the Service, up to an additional $20,000 of the $70,000 of the corporation's taxable income, for tax purposes, may be allocated to F as compensation for services rendered. If the Service allocates $20,000 of the corporation's taxable income to F as compensation for services, taxable income of the corporation would be reduced by $20,000 to $50,000, of which F and T each would be allocated $25,000. F would have $30,000 of total compensation paid by the corporation for services rendered.

Example 2: The stock of an S corporation is owned by A and B. For the taxable year, the corporation has paid compensation to a partnership that rendered services to the corporation during the taxable year. The spouse of A is a partner in that partnership. Consequently, if based on all the relevant facts and circumstances the partnership did not receive reasonable compensation for the services rendered to the corporation, the Service, in its discretion, may make adjustments

---

44 I.R.C. §§704(e) and 1366(e).

45 See Treas. Regs. §25.2511-1(h)(1). Read literally, I.R.C. §1366(e) and the gift-tax regulations may mean that a shareholder who contributes excess capital to an S corporation could have both gift-tax liability and an additional share of income allocated to him.

46 I.R.C. §1366(e).

47 Treas. Regs. §1.1366-3(a).

 Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2

to those items taken into account by the partnership and the corporation as may be necessary to reflect the value of the services rendered.

Copyright © 2024 Surgent McCoy CPE, LLC – EXI4/24/V2