

Top Tax Practice and Procedure Blunders That Can and Should Be Avoided

By Michael G. Goller and Harvey Coustan

Michael Goller and Harvey Coustan discuss the top tax practice and procedure blunders.

I. Do Not Inadvertently Waive a Privilege

It is critical that a practitioner does not inadvertently waive the attorney-client privilege or the tax practitioner privilege under Code Sec. 7525. The later privilege is a sub set of the attorney-client privilege.

A. What Is Attorney-Client Privilege?

1. Elements of the Attorney-Client Privilege

The elements of the attorney-client privilege are as follows: (i) Where legal advice of any kind is sought (ii) from a professional legal advisor in his or her capacity as such, (iii) the communications relating to that purpose (iv) made in confidence (v) by the client (vi) are at his or her insistence permanently protected (vii) from disclosure by the client or the legal advisor, (viii) except if the privilege is waived.¹

2. Legal Services Requirement

The privilege literally applies only in the case of legal (e.g., not business) advice. There is no privilege for communications relating to investment or business advice. Further, there is no privilege with respect to a lawyer's actions in receiving or transferring money or other property in connection with a business transaction.

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3. Confidential Communications of the Client

The client communication must be made in confidence. If there is no confidentiality, there is no privilege. Thus, communications made in the presence of nonclients, such as investors or other parties to a business transaction, are not privileged.²

There is no confidentiality (and thus no privilege) for a communication that has been made known to one outside the attorney-client privilege. Hence, traditionally, copies of communications provided to persons other than the client (such as an accountant) will destroy the privilege as to the communications.³

The privilege applies only to communications of the client. A lawyer's communication is normally not privileged unless it discloses legal advice or the confidential communication of the client.⁴

4. Waiver

Generally, the attorney/client privilege is forever waived if documents or testimony are provided to anyone outside the attorney/client privilege.⁵ For example, allowing a Revenue Agent to read a memorandum or opinion forever waives the privilege (for all purposes) as to that document. Even an inadvertent disclosure of a privileged document will constitute a waiver.⁶ A voluntary disclosure of confidential information to a third party is generally a waiver of the privilege as to that communication.⁷

A voluntary disclosure can also constitute a waiver of the privilege as to all other such communications on the same subject.⁸

5. The Privilege Extends Communications with the Attorney's Agents

So long as a client's communication is made to an agent of an attorney (*i.e.*, a CPA that has been retained by the attorney) in confidence, for the purpose of obtaining legal advice from the lawyer, it is privileged.⁹

B. Tax Practitioner Privilege

1. The Privilege

Effective for communications made on or after July 22, 1998, the attorney-client privilege was extended to communications between clients and certain individuals who are authorized to practice before the IRS.

With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.¹⁰

2. Limitations on the Accountant-Client Privilege

a. Tax Advice. The privilege only applies to "Tax Advice" between a taxpayer and a Federally Authorized Tax Practitioner. A Federally Authorized Tax Practitioner is any individual who is authorized to practice before the IRS.¹¹ Tax Advice means advice given by "a federally authorized tax practitioner with respect to a matter that is within the scope of the practitioner's authority to practice."¹² Circular 230¹³ defines a practitioner's authority to practice as encompassing "all matters connected with presentation to the [IRS] or any of its officers or employees relating to a client's rights, privileges, or liabilities under laws or regulations administered by the [IRS]."¹⁴

3. Other Limitations

a. Noncriminal Matters. The privilege applies only to noncriminal tax proceedings before the IRS or in a federal court.¹⁵

b. State Matters, Third-Party Matters and Matters Before Other Federal Administrative Agencies. The privilege does not extend to proceedings before other federal or state administrative agencies, or in connection with issues arising out of transactions and lawsuits brought by third parties. Thus, regulatory bodies (other than the IRS) may compel the production of information pertaining to accountant/client communications.

c. Tax Shelters. The privilege does not apply to any written communication between a tax practitioner and any person, director, officer, employee, agent or representative of the person, or any other person holding a capital or profits interest in the person in connection with the promotion of the direct or indirect participation of the person in a tax shelter.¹⁶

II. Examination of Tax Returns—Control the Flow of Information

A. Control the Flow of Information

One of the most important things a practitioner can do is control the flow of information. Information can be controlled in a number of ways:

- Control the timing when giving information, bearing in mind that excessive delays may anger the revenue agent and may constitute an ethical violation under Circular 230.
- Control the format and presentation of information. Do the agent's job for him or her. Control what access the IRS has to key personnel and records.
- Submit written responses to the revenue agent. Create documents that allow the revenue agent to settle the case, without being second-guessed by his or her group manager.

B. Be Mindful of Potential Preparer Penalties

IRS Large and Midsize Business division (LMSB) issued a memorandum to Industry Directors in April 2008. The memo gave guidance on preparer penalties. Small Business and Self-Employed division (SBSE) quickly adopted it:

- The team manager's approval must be obtained to begin the return preparer examination.
- The LMSB Return Preparer Coordinator (RPC) must be contacted at the start of the preparer penalty examination.
- If the preparer's conduct appears to be pervasive and widespread, consideration will be given to opening a Program Action Case (PAC)—preparer investigations where tax returns of clients of questionable preparers are examined to determine whether preparer penalties and/or injunctive actions against the preparer are warranted.
- During every field examination, examiners should determine if return preparer violations exist. If a decision is made that a penalty is not warranted, a "simple statement to that effect in the workpapers ... is sufficient."

- The examiner must gather pertinent information from the audit.
- The imposition a tax preparer penalty invokes a mandatory referral to the Office of Professional Responsibility. (The preamble to the proposed Code Sec. 6694 regulations indicates that the IRM will be amended to eliminate this instruction.)

The memorandum indicates that the income tax examination is to be “separate and distinct” from the return preparer violation case and “... examiners will not propose or discuss conduct penalties *per se* in the presence of the taxpayer [emphasis supplied].” The memorandum indicates that the interview of the taxpayer serves a dual purpose: first, to further the examination, and second, to identify violations by a tax return preparer. The memorandum goes on to give examples of questions which may be appropriate to ask the taxpayer in a given situation:

- Did you meet with the preparer?
- What documentation was provided to the preparer?
- Did you receive a copy of the return or claim?
- How was the preparer compensated?
- Was there any discussion regarding whether the transaction is under disclosure under Rev. Proc. 94-69¹⁷ (qualified amended return disclosure procedures for taxpayers subject to the Coordinated Examination Program (CEP))?
- Are you aware of any errors, omissions or mistakes on the return under examination?
- Did you disclose this transaction on your tax return? Why? Why not?
- Were there any concerns about how the transaction was reported?

According to a July report prepared by the Treasury Inspector General for Tax Administration (TIGTA), there were penalties assessed on only 529 individual tax return preparers between January 1, 2004, and February 17, 2007, a period of more than three years. This number represented less than one percent of the return preparers identified on individual tax returns during that period. The TIGTA report found several areas where IRS had not followed the process established for assessing preparer penalties. These findings included poor documentation and lack of management involvement. Substantial changes have been introduced to increase the quality and quantity of preparer penalty assertions:

- Monthly conference calls that include the Preparer Program National Analyst and the RPC from each Area Office to discuss trends identified during operational reviews and visitations.
- National Office staff conducts reviews and as-

sistance visits to Area Offices. These actions are designed to provide the National Analyst with information on the effectiveness of the Preparer Program and processes that need improvement.

- RPC Quarterly status reports for open and closed Program Action Cases and other preparer penalty cases. These reports are sent to the National Analyst who uses the input to identify Area Offices to visit for operational reviews and who prepares a national report to measure the Program as a whole.
- A Return Preparer Web page on the IRS intranet contains links to reference materials and other essential information that examiners can use to obtain information about preparer penalty cases.
- In addition, the IRS is in the process of developing a Servicewide Return Preparer Strategy. The goal of the strategy is to “enhance tax administration through collaboration with return preparers, by providing clear guidance and support while ensuring compliance with the tax laws.”

III. Often Practitioners Fail to Make Freedom of Information Act Request

A taxpayer is entitled to receive most of the government’s file under the FOIA. After the audit, as a routine

Exhibit A. Summary of Critical Blunders

1. Privilege waiver
2. Failure to control the flow of information audit
3. Failure to make an FOIA request
4. Failure to file protest within 30-day period
5. Blowing the 90 days on a 90-day letter
6. Not filing a refund claim on time
7. Making a qualified offer too early or too late in the process
8. Not laying the groundwork to switch the burden of proof
9. Failure to make a protective refund claim
10. Signing a Form 870-AD without knowing the ramifications of using the form
11. Not asking for an interest fee adjustment in an employment tax case
12. Missing the 30 Days On A Collection Due Process Appeal

matter, a representative should file a FOIA request. See Exhibit B. A FOIA request should be made BEFORE filing a petition in Tax Court. Otherwise the IRS may insist that all information be produced in accordance with the Tax Court's more restrictive discovery rules.¹⁸

IV. Don't Blow Critical Deadlines

A. 30-Day Letter

At the close of an examination, if an agreement cannot be reached, a revenue agent will issue what is commonly referred to as a "30-day letter." The formal title is "Notice of Proposed Assessment." The document is referred to as a 30-day letter because, generally speaking, the taxpayer's representative has 30 days within which to file a "Protest" with the IRS. An audit report will be attached to the 30-day letter, which shows the agent's proposed adjustments.

A Protest is a written document that contains a brief statement of facts supporting the taxpayer's position and generally outlines the law. This will lead to an appeals conference.

If the taxpayer misses the 30-day deadline, the IRS appeals office will most likely still grant the appeals conference. There is no law prohibiting the appeals office from holding a conference if the 30-day deadline is missed. However, this is a deadline that should still be met by the practitioner.

B. 90-Day Letter

When the statute of limitations is about to expire, or if the taxpayer has already gone to the IRS Appeals Office (*via* the protest route) and a resolution cannot be reached, the IRS will issue a Statutory Notice of Deficiency. This notice is normally referred to as a "90-day letter" because a taxpayer *must* file a Petition in Tax Court within 90 days of the date of the Statutory Notice of Deficiency in order for the Tax Court to hear the case. Thus, if a Petition is not filed within this 90-day period, the Tax Court lacks jurisdiction. This is a hard deadline.

C. Refund Claims Must Be Adequate and on Time

The IRS has prescribed forms to be used in seeking a refund of tax. While it is not absolutely necessary to use such forms, some courts have rejected informal claims that failed to contain the requisite elements. The three principal Claim for Refund forms are as follows:

- Form 1040X is used to claim a refund of individual income taxes.
- Form 1120X is used to claim a refund of an overpayment of corporate income tax.
- Form 843 is used to claim a refund of any tax other than income tax as well as penalties and interest.

Comment. A tentative NOL claim is not a refund claim.

Courts will only allow a taxpayer to bring suit on a claim for refund on the grounds raised in the claim for refund. Thus, care should be taken to assure that all grounds have been stated in the claim for refund. Code Sec. 6511 provides that a claim for refund must be filed within three years of the date the underlying return was filed or within two years of the date the tax was paid, whichever is later.

If a return is filed or the tax is paid prior to the due date, for statute of limitations purposes, the return is treated as filed and the tax is treated as paid on "the last possible day" the return could have been filed without being delinquent. The early payment of the tax rule occurs when a taxpayer's wages are subject to withholding or estimated tax payments are made. The amount of the claim is limited by whether the taxpayer has fallen under the three-year statute of limitations or two-year statute of limitations.

If the taxpayer falls under the three-year statute of limitations, the amount that can be claimed is the portion of the tax that was paid within the three-year period immediately preceding the filing of the claim plus the period of any extension of time for filing the return (e.g., for a Form 1040 there is a three-year and six-month look back period). It is necessary to include the additional time period between the original due date and the extended date because Code Sec. 6513(a) provides that if an amount is paid in through withholding or estimated tax payments, it is deemed paid on the due date for filing the return, without extensions. Thus, if the taxpayer paid tax through withholding and extended his individual tax return twice (*i.e.*, until October 15 and the return was filed on this date), three years from payment would run three years from the original due date of the return (April 15). If a refund claim was filed three years after the return was actually filed, the taxpayer would not be able to recapture the amount that was paid *via* withholding because that was treated as being paid on April 15. For this reason, the extension period needs to be included.

If the three-year look-back period does not apply, the amount of the creditor refund shall not exceed the portion of the tax paid during the two years immediately preceding the filing of the claim. For example, if the taxpayer filed a tax return on April 15, 2002, and made a subsequent payment to the IRS on that return on April 15, 2004, the taxpayer would have until April 15, 2006, to request the return of the subsequent payment. However, the statute of limitations on seeking funds that accompanied the originally filed return would have run on April 15, 2005.

Example 1. The 1998 Form 1040 is double extended until October 15, 1999. The taxpayer files the Form 1040 on October 10, 1999. The three-year period on filing a refund claim runs on October 10, 2002, not October 15, 2002. If an amended return (*i.e.*, refund claim) is filed by October 10, 2002, the taxpayer can receive a refund of all tax paid within the previous three and one-half years (*i.e.*, tax paid after April 10, 1999). Since 1998 tax paid *via* withholding or estimated tax payments is deemed paid on April 15, 1999, the taxpayer could receive a refund of all 1998 tax payments.

If the taxpayer consents to extend the statute of limitations on assessment, the time within which the taxpayer may file a claim for refund is also extended for an additional six months from the date the extension expires.

V. Consider Making a Qualified Offer (to Recover Certain Costs)

In certain situations, a taxpayer may recover litigation costs. The use of a qualified offer is an important way to recover these costs.

A. Obtaining Costs and Fees

In addition to the net worth requirements discussed below, in order to establish that a taxpayer is a prevailing party entitled to litigation costs, the taxpayer must establish that it had:

- substantially prevailed with respect to the amount and controversy or with respect to the most significant issue or set of issues presented; and
- exhausted all available administrative remedies.¹⁹

B. Net Worth Limitations

Only parties that meet the net worth requirements can seek attorneys fees. Individuals cannot have a net worth exceeding \$2 million (\$4 million in the case of a joint

return). Businesses cannot have a net worth in excess of \$7 million or have more than 500 employees.

C. Qualified Offers

1. Increasing the Likelihood of Obtaining Legal Fees

Taxpayers who meet the net worth requirements will automatically be treated as the prevailing party if a court determines that the taxpayer's liability is equal to or less than the amount it would have been had the government accepted the taxpayer's last Qualified Offer. Accordingly, an award of fees and costs is much more likely if a taxpayer has made a qualified offer that the IRS rejects.

A qualified offer is a written offer to the United States that specifies the offered amount of the taxpayer's liability (without regard to interest), is designated as a qualified offer at the time it is made, and remains open during the period beginning on the date it is made and ending on the earliest of the date the offer is rejected, the date trial begins, or the 90th day after the date the offer is made.²⁰

A qualified offer must be made during a "qualified offer period." This is the period that begins on the date on which the first letter of proposed deficiency that allows the taxpayer an opportunity to go to the Appeals Office that sent the letter (typically a 30-day letter or a 90-day letter) and ends 30 days before the calendar call for trial.²¹

D. What Costs Can Be Recovered?

The taxpayer can only recover reasonable administrative and litigation costs incurred on or after the date of the last qualified offer.²² Reasonable litigation costs include reasonable court costs, expert witness costs, reasonable fees paid or incurred for the services of a representative in connection with any court proceeding, except that such fees shall not be in excess of \$125 per hour, indexed for inflation since 1996, unless a court deems that higher rate is appropriate.

VI. Make Sure During the Audit That the Burden of Proof Will Switch at Trial

In the past, in most civil controversies, a rebuttable presumption existed that the IRS's determination of tax liability is correct (*i.e.*, the taxpayer has the burden of proving the IRS is wrong). Code Sec. 7491 switched the burden to the government in any

noncriminal court proceedings, regarding a factual issue, if the taxpayer introduces credible evidence, which is relevant to determination of its liability.

Code Sec. 7491, which switches the burden of proof to the IRS, applies only to litigation in the courts between the taxpayer and the IRS. In order to obtain a shift in the burden of proof, the taxpayer must first comply with all requirements of the Code section. Taxpayers must do the following:

- Comply with substantiation requirements contained in the Code and Regulations
- Cooperate fully with the IRS
- Exhaust all administrative remedies available to the taxpayer, such as going to the IRS Appeals Office
- Produce credible evidence at trial

The requirement to produce credible evidence means that the burden technically starts out on the taxpayer, but shifts to the government when the taxpayer produces evidence that would enable the court to find in favor of the taxpayer, absent any contrary evidence being produced by the IRS and ignoring the judicial presumption of IRS correctness.

Finally, the shift in the burden of proof applies to all income, gift, estate, generation-skipping, taxes and all penalties in addition to tax. However, it does not apply to corporations, partnerships or trusts with the net worth exceeding \$7 million (book value), or 500 employees. The Rule also does not apply to trusts with a book value of more than \$2 million.

VII. File a Protective Refund Claim

Be aware of the concept of a protective claim for refund and that protective claims must be filed within the prescribed time period. The protective refund claim should be used in a situation where an audit adjustment of one taxpayer could result in a refund claim another taxpayer or on another tax form. If a protective claim is not filed, the statute of limitations on the refund claim could run prior to the termination of the audit.

Example 2. Assume that there is an audit of the C corporation, the IRS is examining payments from the C corporation to the sole shareholder's children. These payments were treated as deductions on the corporation's Form 1120 and wage income on the children's Forms 1040. If the IRS disallows the deduction, they would most likely treat the expenses as a constructive dividend to the sole shareholder and a gift to the children.

A protective refund claim should be filed with regard to the children's Forms 1040. If this is not done, they run the risk of not getting the tax they on this amount back and the sole shareholder also has to pick up the same amounts as income.

Protective refund claims that reflect aggressive positions should be filed just prior to the expiration of the statute of limitations on additional deficiencies. This will limit the adjustments made by IRS to the amount of the claimed refund.

VIII. Be Careful About Settling a Case with a Form 870-AD

A. Form 870

Where a taxpayer and a revenue agent have reached an agreement on some or all of the issues, generally the agent will request the taxpayer to sign a Form 870.

B. Form 870-AD

An appeals settlement is usually memorialized on a Form 870-AD. This special Form 870-AD differs from the normal Form 870 in a number of ways:

- The Form 870-AD agreement contains pledges against reopening (e.g., paying the tax and filing a refund claim) Form 870 does not contain such a pledge.
- The normal 870 becomes effective as a Waiver of Restrictions on Assessment when received by the IRS, whereas the 870-AD is effective only upon acceptance by or on behalf of the IRS.
- Under Code Sec. 6601(c), the running of interest is suspended 30 days after a Form 870 is received, whereas with a Form 870-AD, interest is not suspended until 30 days after the agreement actually becomes effective.

When using a Form 870-AD consider the possibility of an NOL carryback.

Example 3. Assume that we are in the process of settling the case with an appeals officer to go over a result in deficiencies for years 2007 and 2006. You are aware of the fact that year 2008 will be a loss year, which could normally be carried back to 2006 and 2007. If you settle the case with a Form 870-AD, you run the risk of the IRS refusing to honor any carryback because Form 870-AD was used. This problem can be solved by simply asking the appeals

officer to draft right on the Form 870 a statement that says: this agreement does not preclude the taxpayer from claiming a refund for years at issue due to a net operating loss carryback.

IX. Avoid Paying Interest in an Employment Tax Case

A. General

For employment taxes (*i.e.*, Form 941 obligations), if the adjustment to the Form 941 (*i.e.*, the tax deficiency) is paid on or before the due date of the 941 for the period in which the error is “ascertained,” interest is not charged on the deficiency. If, however, the deficiency is paid after the due date of the Form 941, interest accrues.²³

B. Can a Taxpayer Challenge a Deficiency Before the Appeals Office and Obtain an Interest-Free Adjustment?

Yes. Rev. Rule 75-464²⁴ states that generally, if the taxpayer cannot resolve the matter at examination, but resolves the case for the Appeals Office, because the error on the Form 941 is not deemed to be “ascertained” until the conclusion of the ap-

pellate proceedings, so long as the taxpayer pays the tax by the due date of the 941 for the period in which the matter is resolved, the deficiency is interest free. If, however, the case is not resolved at Appeals and the taxpayer receives a notice and demand for payment from the IRS, the adjustment will not be interest free.

Finally, the ruling stresses that the taxpayer will not be allowed an interest free adjustment in the case where the taxpayer’s returns for prior years were audited and additional tax was found to be due with respect to the same issue currently under audit.

X. Do Not Miss the Deadline on a Collection Due Process Appeal

When a taxpayer receives a Final Notice of Intent to Levy, that notice apprises the taxpayer of a right to a Collection Due Process (CDP) Hearing. Generally, the IRS cannot levy on the taxpayer’s property while the CDP hearing is pending.²⁵ Under Code Sec. 6630(b), the Request for Collection Due Process Hearing must be filed within 30 days of the notice. This is a hard deadline. It is critical that this deadline is met.

ENDNOTES

¹ *E. Brown*, CA-7, 73-1 USTC ¶9427, 478 F.2d 1038, 1040, quoting, 8 WIGMORE EVIDENCE §2292.

² See *Burlington Industries v. Exxon Corp.*, 65 F.R.D. 26, 37 (D. Md. 1974).

³ See *R.H.W. Leathers*, CA-9, 57-2 USTC ¶10,058, 250 F.2d 159, 166.

⁴ *Upjohn Co.*, S.Ct., 81-1 USTC ¶9138, 449 US 383, 390.

⁵ 8 J. WIGMORE EVIDENCE §2311.

⁶ *Id.*, at §2326.

⁷ *Vardon Golf Co., Inc. v. Karsten Manufacturing Corp.*, 213 F.R.D. 528, 532 (N.D. Ill. 2003); *Weil v. Investment/Indicators, Research and Management, Inc.*, 647 F.2d 18, 25 (9th Cir. 1981).

⁸ *BASF Aktiengesellschaft v. Reilly Industries,*

Inc., 2004 U.S. Dist. LEXIS 14723, 7 (S.D. Ind. July 29, 2004) (unpublished); *Vardon Golf Company, Inc. v. Karsten Manufacturing Corp.*, 213 F.R.D. 528, 532 (N.D. Ill. 2003); see also *In re Consolidated Litigation Concerning International Harvester's Disposition of Wisconsin Steel*, 666 F. Supp. 1148 (N.D. Ill. 1987).

⁹ *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989).

¹⁰ Code Sec. 7525(a) (emphasis added).

¹¹ Code Sec. 7525(a)(3)(A).

¹² Code Sec. 7525(a)(3)(B).

¹³ 31 CFR Part 10. Circular 230 contains the rules that govern practice before the IRS.

¹⁴ Circular 230 §10.2(a).

¹⁵ Code Sec. 7525 (a)(2) (A) and (B).

¹⁶ Code Sec. 7525(b); A tax shelter is defined in Code Sec. 6662(d)(2)(C)(iii) to mean any partnership, entity, investment plan or any other plan or arrangement, if the principal purpose of the partnership, entity, plan or arrangement is the avoidance or evasion of federal income tax.

¹⁷ Rev. Proc. 94-69, 1994-2 CB 804.

¹⁸ See *NLRB v. Robbins Tire & Robber*, 437 U.S. 214 (1978).

¹⁹ Code Sec. 7430(c)(4)(A).

²⁰ Code Sec. 7430(g)(1).

²¹ Code Sec. 7430(g)(2).

²² Code Sec. 7430(c)(1) and (2).

²³ See Code Sec. 6205(a) and Reg. §31.6205-1(b)(2)(i).

²⁴ Rev. Rul. 75-464, 1975-2 CB 474.

²⁵ Code Sec. 6330(e).

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