PILLA TALKS TAXES

DAN PILLA'S MONTHLY TAX AND FINANCIAL BULLETIN

February 2019 Vol. E3 Issue 94

WHY TAX REFUNDS ARE DOWN
No, It's Not Because of Tax Cuts for the Rich

Democrats are up in arms over a recent Treasury Department report showing that tax refunds are down thus far in 2019 compared to last year. The report indicates that of the 27 million tax returns filed through February 8, the average refund is down about 9%.

Quite predictably, Dems—with the reliable help of the media—blame President Trump's Tax Cuts and Jobs Act, which took effect on January 1, 2018. The Dems claim that the report is proof that the Jobs Act was nothing but tax cuts for the rich. The fact that lower refunds has been twisted into a claim that the middle class pays higher taxes because of the Jobs Act is proof that the Left has no regard for truth when it comes to tax policy.

It is also proof that the typical person has no idea what they actually pay in taxes.

First of all, a tax refund, by itself, is no measure whatsoever of whether your tax liability went up or down. The refund is simply a measure of what you *overpaid*. In my work as a tax litigator, I regularly ask people what they paid in taxes the previous year. The answer I typically hear is, "I didn't pay anything. I got a refund."

But when I examine that person's Form W-2, *Wage and Tax Statement* or the tax return itself, I find that they paid thousands in taxes through wage withholding and received only a fraction of that back in a refund. Thus, they did in fact pay taxes but had no idea how much. That's one of the key problems with our current tax system. Taxes, especially social security taxes, are hidden, and people just don't know what their tax burden actually is.

The fact that refunds are lower this year is not necessarily a bad thing. You do not get a refund because government got religion and decided to do you a favor and send you free money. You get a refund only because you paid in too much to begin with. If your refund is down, that likely means you didn't overpay as much as last year. And that's a good thing.

The big reason the typical person probably paid in less in 2018 than in prior years is the fact that on January 1, 2018,

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"Dan Pilla probably knows more about the IRS than the commissioner of the IRS." Associated Press.

the IRS adjusted the withholding tables in light of the changes made by the Jobs Act. Given that about 80% of Americans will see a tax cut (not an increase) for 2018, the IRS adjusted the tables so that employers would take less money out of the paychecks of their workers. But even at that, the data that is causing the alarm bells shows that the typical refund is down by just 9%, to about $2,730. The average refund was about $3,000. Due to the adjustment in the withholding tables, people got the remaining $270 in their paychecks every month. Your refund is smaller because the government didn't have as much of your money to begin with.

About 75% of all tax filers get a refund every year. It happens for two reasons. First, people have no idea how to properly adjust their withholding so they don't overpay in the first place—which means they overpay. Second, they treat the withholding system as some kind of savings account. Either way, it's the world's worst way to manage your money.

For one thing, the IRS doesn't pay you a nickel's worth of interest on your money when you overpay. For another thing, you can't get your own money back until you file your tax return, and by the time you do that, you are three or four months into another pattern of over-withholding for the *next* year. As such, the IRS always has more of your money than you really owe.

When you manage your tax payments properly, you have the money in your hands, where it belongs. That money is available for you to use and enjoy in a manner that best suits you and your family. That way, you can save or invest in real wealth-building vehicles, or pay down debt, or fund business needs, or just pay for fun and recreation. In any event, you—*not the government*—is in charge of your own money.

THE UP-FRONT TAX SYSTEM IN MOTION

IRS Making Progress on Getting Out of the Business of Talking to Taxpayers

Over the last couple of years, the IRS has been working behind the scenes to develop what it calls the "Up-front Tax System." I have written and talked about this extensively. Under this program, the IRS essentially removes opportunities for live interaction with the agency and replaces them with strictly electronic contacts. In the case of an audit, for example, citizens do not interact directly with an auditor or manager. Rather, they submit their documents over the Internet via a "secure portal." On the other end, some person examines the documents and presents either a thumbs up or thumbs down on the issue.

To this end, in December 2016, the IRS launched "The Taxpayer Digital Communications" pilot. This program is pointed at correspondence-audit notices in particular. It allows citizens to answer IRS demands for documents and information electronically, without having to mail in the responses. It's part of an overarching effort to get the IRS out of the business of talking with taxpayers.

The IRS now intends to expand this pilot program. Under the pilot program, about 3,000 citizens signed up out of 28,000 invited to do so in their audit notices. According to the IRS, about 40,000 of the 2019 correspondence audit notices will contain an invitation to use the secure-messaging process. The notices will come from the agency's Brookhaven, N.Y., campus.

According to an IRS spokesman, a survey of the pilot program found that 82% of participating taxpayers were satisfied with it. Apparently, they very much appreciated the fact that they didn't have to talk with an auditor. Rather, they just scanned and uploaded their documents along with the needed explanations.

I can imagine some benefit to such a system in simple verification cases. For example, if a correspondence audit is pointed at Schedule A items, it would be a simple matter to scan your documents showing items such as charitable contributions, mortgage interest, etc. Problems will surface, however, in more fact-intensive exams that might question, for example, profit motive or material participation issues. You might respond by pointing out that such issues are not typically the subject of correspondence audits anyway. And that's true—so far. To date, the program targets only itemized deductions for employee business expenses, credits for education and child care credits, and the earned income tax credit.

But the IRS has made it clear that they intend to move the entire exam process away from personal interactions with citizens and counsel, and into this electronic process. As the agency is asked to perform more non-tax related tasks, such as enforcing the personal responsibility elements of the Affordable Care Act, they have fewer resources to dedicate to tax administration and enforcement. They are looking for ways to do more with less, and washing face-to-face interactions out of the exam environment is one way to do it.

IRS analysis indicates that while people generally favor the program, it takes longer for the IRS to get cases resolved. The secure-message option added 1.7 hours to the 2.5-hour average it takes to resolve a correspondence audit. Supposedly they are working to drive down the time it takes to resolve such cases but it is unclear what that would involve.

A new feature the IRS is now employing as part of the program is the use of an embedded link in the messaging system that connects citizens to a YouTube video. The video shows people how to organize their documents for submission. I have not reviewed the video so I can't comment

on how well it explains a persons' duty to provide documents to support the claimed deduction. The agency's stated goal is to reduce the total time on such audits by communicating to people on the front end what they need to do to prevent appeals and audit reconsiderations. For better help in this regard, see my book, ***How to Win Your Tax Audit***.

WHAT'S HAPPENING WITH WAYFAIR
Will Congress Act on State Sales Tax Laws?

In the October-November 2018 issue of this newsletter, I discussed at length the Supreme Court's decision in the case of *South Dakota v. Wayfair*. That is the case in which the Supreme Court killed the long-standing "physical presence" sales tax rule. This is the rule requiring a retail seller to have a physical presence within a state before that state could assess sales taxes against the seller. Instead, the Court adopted a much more nebulous "substantial nexus" test. Without clearly defining what that means, the Court held that just about any connection between a seller and a state—even just an Internet connection—could trigger a state sales tax obligation.

Excited by the *Wayfair* decision, states almost immediately began queuing up laws to allow them to tap into the $450+ billion per year (and growing) e-commerce industry. Twenty-five states are already enforcing laws requiring remote sellers to collect and pay sales and use taxes. The question now is whether Congress will act to provide definitive guidance to prevent a free-for-all among state legislatures.

Four Senate Democrats introduced legislation to do that. Senator Jeanne Shaheen (D-N.H.) introduced S. 3725 that would prohibit states from imposing sales tax collection duties on remote sellers for any sale that occurred prior to June 21, 2018—the day the Supreme Court released the *Wayfair* decision. She is joined on the bill by Senators Maggie Hassan (D-N.H.), Ron Wyden (D-Ore.) and Jeff Merkley (D-Ore.). The four senators represent states that have no sales tax. They claim it would be "unfair and impractical" to force states that have no sales tax "to adopt and adhere to a new, complicated tax collection system." A companion bill in the House is H.R. 6824, which was introduced by Rep. Jim Sensenbrenner (R-Wis.).

Personally, I don't understand why states with no sales taxes have to worry about sales taxes. *Wayfair* addressed itself to states *with* sales tax laws.

Colorado Moved Quickly

Very shortly after the *Wayfair* decision was announced, the State of Colorado adopted rules requiring out-of-state sellers that do not have a physical presence in the state to get a state sales tax license in order to collect and pay state sales taxes. The deadline for doing so was December 1, 2018. However, the CO Department of Revenue (DOR) announced an extension of the deadline until May 31, 2019. Mike Hartman, executive director of the DOR, said that the extra time was needed to give the legislature "an opportunity to find innovative solutions to streamline and simplify our sales tax collection laws."

At a public hearing in late November, DOR officials were inundated with objections and complaints about the state's rules. Notably, there was apparently very little time or consideration invested in the process of crafting the rules. A representative from the Council On State Taxation appeared at the hearing and warned the DOR against proceeding without legislative input. In response, Hartman said, "It is important for the state to take the time to get this right." Hence, the extension to May 31 was announced.

States are Moving Ahead

Wayfair-related legislation is brewing in states across the nation. The Oklahoma legislature has a bill before it and Louisiana's Sales and Use Tax Commission for Remote Sellers drafted a definition of "remote seller" that is quite broad. It reads:

General Definition of Remote Seller. A remote seller means a seller who sells for sale at retail, use, consumption, distribution, or for storage to be used for consumption or distribution any taxable tangible personal property, products transferred electronically, or services for delivery within Louisiana but does not have physical presence in Louisiana. LA DOR, Remote Sellers Information Bulletin No. 18-002, November 27, 2018.

An example of a remote seller per the above definition reads as follows:

Example 1: Company A sells tangible personal property for delivery to purchasers in Louisiana through only remote means through its Internet website, catalogs, telephone, television shopping channel or other communication systems. Company A has no physical stores, affiliates or salespersons in Louisiana. Ibid.

If the above is any example of what constitutes "nexus" for purposes of state sales taxes, there is no company that will not be liable for sales taxes in all state jurisdictions that enforce sales tax obligations.

What to do Next

If your business engages in Internet commerce, you need to pay attention to what the various state agencies are doing

about sales tax obligations. I would start by contacting professional associations or trade organizations relevant to your business. They may already have guidance available on how to proceed.

In the meantime, do an analysis of your sales on a state-by-state basis. If your sales are concentrated to a just few states, check their websites immediately and frequently to determine whether they have or are adopting sales tax rules for out-of-state sellers. It is unreasonable to believe they will not do so since we know that states are moving quickly already. Keep in mind that forty-one states and the District of Columbia joined South Dakota in the *Wayfair* lawsuit.

If you are uncertain about your liability for sales taxes in the jurisdictions in which you sell, *consult counsel*. Do not try to go this alone.

The bottom line is plain: All states will tax online sales by out-of-state sellers. The only question is the extent to which they will do so.

THE GREEN NEW DEAL AND A 70% TAX RATE
Who is She Kidding?

As part of her so-called "Green New Deal," New York socialist Representative Alexandria Ocasio-Cortez expressed the wish to impose a top marginal tax rate of 70%. She would assess the tax rate on incomes above $10 million. The idea is to, among other things, fund her bombastic plan to eliminate fossil fuels in the U.S. by 2030. Never mind the wisdom (or even feasibly) of such a goal for just a minute. Would such a rate raise the needed revenue?

The Washington Post claimed that the tax would raise $700 billion over ten years. Even if that's correct, that would be woefully insufficient to build just the generating facilities needed to replace fossil fuels. Experts say that would cost into the trillions.

But such a tax rate wouldn't raise nearly the amount claimed. The Post's estimate was based on "static" scoring principals, which do not take into account the reality that taxes affect behavior. What you tax, you get less of. Taxes create distortions in the market place. Taxes make people do things they otherwise would not do, or fail to do things they otherwise would be included to do. The higher the tax, the less economic activity there is, and thus, the less revenue is collected, even at higher rates.

Think of it this way: how much revenue would the government collect with a tax rate of 100%? They wouldn't collect any revenue because people will not work for nothing.

The non-partisan Tax Foundation released a report in January in which they estimate that if the 70% rate is applied across the board to income, capital gains and dividends, the tax would actually cost the government $63.5 billion due to reduced economic activity. If the rate were applied only to income, the tax would raise just $292 billion, a far cry from the claimed $700 billion, and nowhere near what would be required to build even just the generating facilities needed to replace fossil fuels.

In the meantime, I intend to address various aspects of this "Green New Deal" over time. It is, in a word, remarkable. Indeed, it has very little to do with correcting alleged catastrophic climate change, and more to do with "economic transformation" of the U.S. It is in every sense a comprehensive plan to remake the U.S. economy into an abject communist society.

One goal of the plan is for the federal government, over the next ten years, to upgrade "all existing buildings in the United States and build new buildings to achieve maximum energy efficiency, water efficiency, safety, affordability, comfort, and durability, including through electrification." Let's focus for the moment on just the aspect of "upgrad[ing] all existing buildings in the U.S."

If we are to upgrade every single building to achieve just energy efficiency (never mind "safety" and "comfort") where would you start? You would need new windows in just about every building over 25 years old. You would need insulation in most buildings that old. And you'd likely need to upgrade HVAC equipment. At what cost? No one seems to care either about the cost or who would pay it. After all, as co-sponsor Senator Ed Markey (D-MA) stated, "This is going to be a mission to save all creation."

So it's official. U.S. Leftists do indeed believe they are God.

The plan promises federal government intervention into our lives at an unprecedented level. For example, the goal to upgrade all existing buildings in the United States is also pointed at achieving maximum "safety, affordability and comfort." That will surely require a new government agency: meet the "U.S. Department of Home Safety, Affordability and Comfort."

Imagine the river of regulations flowing from such an agency. If you think IRS regulations are voluminous, you ain't seen nothin' yet. One concern is how they will define the operative terms. For example, who decides what constitutes "maximum comfort" in a personal residence? Does not the owner decide what attributes and amenities he wishes to fund to suit his own needs? Apparently not, since Leftists believe people are wholly incapable of deciding for themselves what's best for their families.

What level of inspections and certifications will be required—and at what cost—before a person can continue to occupy a home? If a federal inspector decides that the carpet is not sufficiently "comfortable," who pays for new carpet? One thing is for sure, I search in vain for the

article of the Constitution that authorizes systematic home invasions by the federal government.

The plan also mentions that all building upgrades must include "electrification." As I read that, I wondered out loud, "What do they mean by 'electrification?'" Then it hit me: America must have a problem with homes and offices lacking electricity. Millions of people must be using whale oil lamps to find their way to the bathroom at 2 AM.

My ignorance of the problem and its scope led me to do a little research. What I discovered is that according to data published by The World Bank and the International Energy Agency (so it must be correct), as of 2016, 100% of U.S. residents have access to electricity. Apparently, every home in America is already "electrified." Who knew?

In her zeal for the government to make everybody's life as carefree and painless as possible, Alexandria Ocasio-Cortez's Green New Deal offers a solution for which there is no problem. Now I wonder, "Does she have any idea at all what she's talking about?"

NINTH CIRCUIT DOUBLES DOWN ON BANKRUPTCY LIMITATION

Another Decision Against Discharge

By Scott MacPherson

In the April/May 2018 issue of *PTT*, we reported on the status of various recent appellate court interpretations of Bankruptcy Code §523 (11 U.S.C. §523). The cases address the question of whether a return filed by the taxpayer after the IRS makes a substitute for return (SFR) assessment, qualifies as a "return" for purposes of a tax debt discharge. We reported that the Ninth Circuit took the position that a post-SFR return is not a "return" because it violates the *Beard* test. For a detailed discussion of the Beard test, see ***How to Get Tax Amnesty***, pg 176.

Unfortunately, in the case of *In re Fremont*, 2019 WL 181327 (9th Cir. Jan. 14, 2019) (unpublished), the Ninth Circuit doubled-down on its interpretation of Bankruptcy Code §523(a)(1)(B).

In *Fremont*, the taxpayer appealed an order affirming summary judgment for the United States, and the Ninth Circuit affirmed. In a one-paragraph explanation, the appellate court said that there was no genuine issue of material fact. On "the undisputed facts," the court said Fremont "failed to provide the information required by a tax return until three to five years after the IRS assessed deficiencies for these tax years." Consequently, Fremont failed to file a return for the tax years at issue.

In other words, Fremont filed post-SFR tax returns. The consequence, according to the Ninth Circuit, is that he does not get a discharge of those tax debts in bankruptcy. "Such a 'belated acceptance of responsibility,'" the court said, "does not qualify as 'an honest and reasonable attempt to comply with the tax code.' *Smith v. U.S. Internal Revenue Serv.* (*In re Smith*), 828 F.3d 1094, 1097 (9th Cir. 2016)."

Said more plainly, according to the Ninth Circuit, a post-SFR return is not a "return" within the meaning of 11 U.S.C. §523(a)(1)(B). As such, Fremont was considered by the court to have not filed his returns. In turn, his tax debts were not discharged in bankruptcy.

This case points up the need for clients to file on time, or at the very least, they must file before the IRS can make SFR assessments against them.

For a detailed analysis of the rules for discharging taxes in bankruptcy, see chapters 13 and 14 of ***How to Get Tax Amnesty***.

IRS ANNOUNCES NEW VOLUNTARY DISCLOSURE PROGRAM

Participants Face Higher Penalties

The IRS's Offshore Voluntary Disclosure Program closed at the end of September 2018. That was the program that allowed people with undisclosed offshore bank accounts to step forward—generally without the risk of criminal prosecution, and with the promise of lower penalties for failure to disclose the accounts than would otherwise apply. In exchange, a citizen had to full pay all the taxes and interest attributable to the undisclosed income.

Voluntary disclosure, as a concept, is not a new thing and never did apply solely to offshore issues. The IRS has a long-standing practice of allowing citizens with criminal exposure to make a voluntary disclosure, come back into compliance with the tax laws and potentially avoid criminal prosecution. See IRM part 9.5.11.9. See also, chapter 3 of ***How to Get Tax Amnesty***, in which I discuss the voluntary disclosure concept generally.

Under the new disclosure rules, individuals with offshore assets who want to come clean will face higher penalties and

new disclosure hurdles. The new rules apply to both domestic and international disclosures made after September 28, 2018. The program's terms are explained in an IRS memorandum identified as LB&I-09-1118-014, November 20, 2018. I will break down the precise terms of the memo in the next issue of this newsletter. The memo supplements IRM part 9.5.11.9.

IRS WARNS OF NEW SCAM

This One Uses Emails

The IRS and the National Security Summit issued a warning to the public of a recent surge in fraudulent emails. The scam involves impersonating the IRS and uses the promise of obtaining one's tax transcripts as bait to entice users to open documents containing malware. This might be especially troublesome for businesses whose employees might open the malware. It can be quite expense to successfully remove malware from a computer system. The malware in question is known as Emotet.

The scammers generally pose as specific banks and financial institutions in an effort to trick people into opening infected documents. However, in the past few weeks, the scam masqueraded as the IRS, pretending to be from "IRS Online." The scammer's email carries an attachment labeled "Tax Account Transcript" or something similar. These clues change with each version of the malware.

Don't open these emails and do not to open the attachment. If using a personal computer, delete the email or forward the scam email to phishing@irs.gov. If you see these emails using an employer's computer, notify the company's technology professionals.

Keep in mind that the IRS does not send emails to the public under any circumstances. It is rare that the IRS will interact using emails even in pending cases. But under no circumstances will the IRS use email as an initial contact or an unsolicited contact. Moreover, the IRS will never use email to send a sensitive document such as a tax return or account transcript.

The United States Computer Emergency Readiness Team (US-CERT) issued a warning in July 2018 about earlier versions of the Emotet in Alert (TA18-201A) Emotet Malware. US-CERT has labeled the Emotet Malware "among the most costly and destructive malware affecting state, local, tribal, and territorial (SLTT) governments, and the private and public sectors."

For more information, see IRS bulletins IR-2018-226; IR-2018-245; and IR-2018-243; and IRS Tax Tip 2018-186.

FORMER U.S. TAX COURT JUDGE CONVICTED OF FRAUD

Sentenced to Nearly 3 Years in Prison

In April 2016, I reported in this newsletter that former U.S. Tax Court Judge Diane Kroupa was indicted on six counts of tax fraud and conspiracy to commit fraud. Earlier this month, she and her husband Robert Fackler, after entering into plea agreements, were sentenced by a federal judge. Kroupa was sentenced to 34 months in prison and Fackler was sentenced to 24 months in prison. They were sentenced in St. Paul, Minnesota. Kroupa was appointed to the U.S. Tax Court on June 13, 2003 for a term of 15 years.

In commenting on Kroupa's extensive tax fraud, which she committed while she was a sitting U.S. Tax Court Judge, the sentencing judge stated, "When a person in a position of trust violates that trust, the public is a victim." The court further noted that Kroupa's fraud undermined the trust in the justice system.

The acting United States Attorney, Gregory Brooker, stated that, "Over a nearly ten-year period, the defendants engaged in a deliberate and brazen tax fraud scheme. Considering Ms. Kroupa's position of public trust as a U.S. Tax Court Judge, her crime is particularly egregious. Ms. Kroupa used her knowledge of the tax laws to further their fraud scheme, conceal their criminal conduct and maintain their acquisitive lifestyle. Diane Kroupa held a position of public trust as a federal tax court judge and made rulings based on the very tax laws she broke."

The facts revealed that Kroupa and her husband engaged in juvenile-minded tax evasion, carried out by deducting a myriad of personal living expenses as bogus business expenses. During the audit, as their various trumped-up expenses came under scrutiny, she told the auditor that she failed to keep adequate records (a claim that is simply impossible to believe coming from the lips of a federal Tax Court judge with more than a decade of experience on the bench). Kroupa made false and misleading statements to the tax auditor and provided false and misleading documents to the auditor in an effort to persuade the auditor that their personal living expenses somehow constituted legitimate business expenses.

According to the plea agreement, between 2002 and 2012, Kroupa and Fackler conspired to obstruct the IRS from accurately determining their tax liability. As part of the conspiracy, they worked together each year to compile numerous personal expenses they claimed as "business

expenses" for Fackler's lobbying business. Those expenses included: rent and utilities for a second home; utilities, upkeep and renovation expenses of their Minnesota home; Pilates classes; spa and massage fees; jewelry and personal clothing; wine club fees; Chinese language tutoring; music lessons; personal computers; and expenses for vacations to Alaska, Australia, the Bahamas, China, England, Greece, Hawaii, Mexico and Thailand.

In total, from 2004 through 2010, they fraudulently deducted at least $500,000 of personal expenses as purported Schedule C business expenses. At times, Kroupa prepared and provided to Fackler summaries of personal expenses falsely described as business expenses. On other occasions, Kroupa herself compiled and provided to their tax preparer the fraudulent personal expenses.

Kroupa also failed to report about $44,520 that she received from a 2010 land sale in South Dakota. Rather, she supposedly falsely claimed that it was part of an unrelated inheritance. The plea agreement states that the defendants falsely claimed financial insolvency to avoid paying tax on $33,031 of cancellation of debt income. It seems they would have been better served by reading my book, How to Eliminate Taxes on Debt Forgiveness. But, then again, an experienced Tax Court judge should have known what legal arguments might have been available, as opposed to simply lying.

During the audit, Kroupa also falsely denied receiving money from the 2010 land sale. Later, when they learned the 2012 audit might progress into a criminal investigation, Kroupa instructed Fackler to lie to the IRS about her involvement in preparing their tax returns.

The irony in this case is that Kroupa—among all the Tax Court judges that I have appeared before—was extremely anti-taxpayer. She was unduly rough on counsel representing taxpayers, and would often browbeat taxpayers who appeared in front of her. On the other hand, she would excessively dote on IRS counsel attorneys—to the point of embarrassment. Her doting far exceeded simple politeness or professional courtesy. I found myself wondering what the heck that was all about. It seems it may well have been her guilty conscience bubbling over.

According to the plea agreement, between 2004 and 2010, the two purposely understated their taxable income by approximately $1,000,000 and purposely understated their tax liability by at least $450,000.

The next step in the process for Kroupa is enforced collection action. I'm sure the IRS will mail a Notice of Deficiency to Kroupa and Fackler while they are in prison.

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Pilla Talks Taxes is a monthly publication designed to enlighten the American public on matters tax law, procedure, philosophy, accounting and general financial issues.

Subscription Rate:
One Year/10 issues … $99
Editorial and Subscription Offices:

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Publisher: Winning Publications, Inc.
TaxHelpOnline.com

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Write the word "newsletter" in the subject line.

DID YOU MISS THE 2018 TAXPAYERS DEFENSE CONFERENCE?

SELF-STUDY MATERIAL IS NOW AVAILABLE

If you missed the 2018 Taxpayers Defense Conference, our self-study material is now available. The set includes audio recordings of all the teaching sessions and all Dan's lecture notes and other hand-out material. Topics for the conference include the following:

- The future state of the IRS, featuring an in-depth look at the latest compliance initiatives,
- Section 199A—the new 20% deduction for small businesses created by the Tax Cuts and Jobs Act,
- How to deal with passport revocation—the IRS's latest enforcement scheme,
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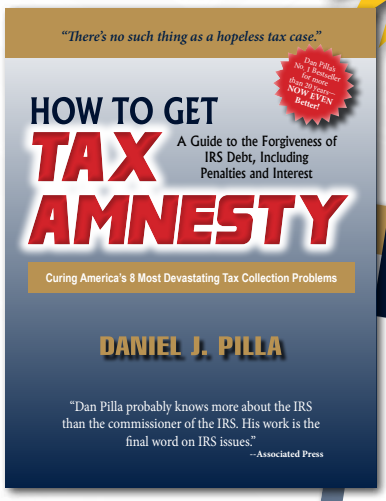

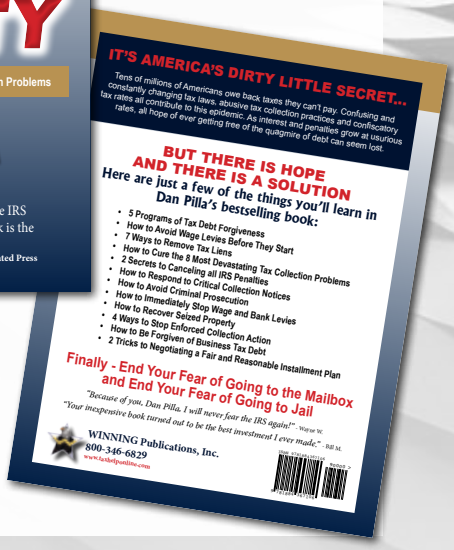

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