Pilla Talks Taxes

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Understanding The IRS's Grand Enforcement Initiative

Enforcement Funding Outpaces Service by a Ratio of 10 to 1

As I reported in the June issue of PTT, the IRS's Inflation Reduction Act Strategic Operating Plan (SOP) was released in May, and sets forth details on how the IRS will spend the $60 billion appropriated in August 2022. Recall that the initial appropriation was to be $80 billion, but that number was reduced by $20 billion earlier this year. However, the numbers set forth in the SOP are based on the $80-billion-dollar number.

The SOP lays out five broad objectives for improving IRS systems and operation, as well as taxpayer services and the agency's interaction with tax professionals. The overall idea is to "make it easier" for citizens to meet their tax responsibilities, improve data and analytics to target enforcement to known areas of non-compliance, and to make the IRS the "employer of choice across government and industry" in order to attract and retain qualified employees going forward. See: SOP, pg 10.

The five objectives laid out in the SOP are:

1. Dramatically improve services to help taxpayers meet their obligations and receive the tax incentives for which they are eligible;

2. Quickly resolve taxpayer issues when they arise;

3. Focus expanded enforcement on taxpayers with

IN THIS ISSUE

complex tax filings and high-dollar noncompliance to address the tax gap;

4. Deliver cutting-edge technology, data, and analytics to operate more effectively; and

5. Attract, retain, and empower a highly skilled, diverse workforce and develop a culture that is better equipped to deliver results for taxpayers.

For purposes of this discussion, I focus on Objective 4, which is to expand enforcement on those with complex tax situations and high-income taxpayers. Under the heading of "expanded enforcement," the IRS lays out seven specific initiatives they intend to pursue in order to achieve their goal.

At the outset, the SOP repeats the administration's claim that nobody earning under $400,000 will be targeted under the enforcement initiative. Indeed, the SOP states plainly that, "[s]mall businesses and households earning $400,000 or less will not see audit rates increase *relative to historical levels*" (emphasis added); SOP, pg 62.

Equally plain in this language is the qualifying statement emphasized above. That is, the audit rate for those earning less than $400,000 will not increase "relative to historical levels." As I have documented at length in prior articles, historically, small businesses, sole-proprietorships, subchapter S corporations, and small partnerships collectively, make up about 60% of the IRS's enforcement caseload. The other 40% is divided between fourteen other categories of tax return filers. So if we take the administration at its word, the increased enforcement activity will most certainly focus on this category of business activities.

Now let's examine the seven initiatives the IRS will pursue to achieve its goal of expended enforcement.

1. Centralize the process of selecting compliance cases. The enforcement selection process is currently decentralized, with each separate unit of the IRS making its own decisions on case selection, based on its own criteria. The goal is to use a vast data-driven system to analyze all data across the entire spectrum tax filers, and to make enforcement selections based on such data. This is intended to allow the IRS to respond quickly and efficiently to developing compliance issues. An element of this initiative is to substantially improve the "Whistleblower Program," under which citizens may report alleged tax violations by fellow citizens and get rewarded for the claim.

2. Expand enforcement for large corporations. The goal is to increase audit coverage for large corporations from its current rate of about 2% to 10%. Because of the great complexities involved in the financial activities of large corporations, including international issues, the IRS will have to focus on hiring and training people with the proper skills to accurately carry out highly technical examinations. It will also be necessary to hire and train the Appeals Officers and attorneys needed to address the litigation issues sure to flow from such audits.

3. Expand enforcement for large partnerships. The audit rate for partnerships in 2019 was .05%. However, the number of partnerships increased by 32% since 2010, to a total of 4.3 million by 2020. Like corporations, partnerships can be complex structures, sometimes involving hundreds, even thousands, of individual partners. The same issues regarding large corporations are at play with regard to large partnerships.

4. Expand enforcement for high-income and high-wealth individuals. IRS and Treasury research claims that about one-third of the tax gap is attributable to high-income individuals not paying the tax they owe. The data come from research audits, the results of which are highly suspect. I have written about this at length in the past. The audit rate of those earning $1 million or more fell from 7.2% in 2011 to under 1% in 2019. The IRS intends to use its advanced analytics discussed above to substantially increase the audit rate for such citizens.

5. Expand enforcement coverage generally. This is a proposal to expand enforcement "across all taxpayer segments" with the goal of ensuring that "all taxpayers comply with tax laws." And while it is clear that this constitutes a very broad sweep, the IRS continues to insist that it will comply with the Treasury's directive to "not increase rates relative to historical levels for small businesses and households earning $400,000 per year or less." SOP, pg 74. We already know that small businesses historically capture 60% of the IRS's enforce-

ment attention and resources. So to say that no business earning under $400,000 will be affected is simply not true. Moreover, one of the key enforcement targets of this initiative is employment tax compliance generally. That is, any business with employees, regardless of the income of its owners, can and will be subjected to "a variety of robust [enforcement] mechanisms, including audits and non-audit contacts." Ibid.

6. Increase enforcement for complex, high-risk issues. Using the data-driven analytical tools mentioned above, the IRS will identify and target emerging compliance issues that require enforcement attention. On the top of the list currently are the following: a) digital currency, b) tax shelter-type transactions, and c) certain international issues. These and other areas involve complex transactions that raise the potential for civil non-compliance and criminal fraud. IRS will focus on detecting and identifying such schemes, and responding with suitable enforcement initiatives.

7. Promote fairness in enforcement activities. Washington insiders went crazy when a recent study suggested that the IRS was targeting Black Americans for audit at rates far in excess of non-Black Americans. See my articles in the March 2023 and July 2023 issues, regarding the alleged racism built into the IRS's audit selection computers. This initiative makes assurances that the IRS's enforcement machine "does not focus disproportionately on any particular area or population." SOP, pg 78. The guarantee is that the agency's data and research alone will be used to "enforce the tax laws as they apply to all taxpayers…" Again, the agency assures us that the new money will not be "used to increase the share of small businesses or households below the $400,000 threshold that are audited relative to historical levels." Ibid. The general idea here is to increase the public's trust in the IRS, and in turn, increase voluntary compliance.

WHERE THE MONEY WILL BE SPENT

The SOP provides for the expenditure of $80 billion, which was the appropriation granted by the Inflation Reduction Act. The plan has not been adjusted for the fact that Congress cut that number by $20 billion last summer. Regardless, the reduction in the appropriation will be made up by future appropriations in any event.

Based on the SOP as written, here's how the numbers break down:

1. Improve taxpayer services and assistance – $4.3 billion
2. Issues resolution – $3.2 billion
3. Enforcement – $47.4 billion, plus $25.3 billion for operations support
4. Technological improvements – $12.4 billion, and
5. Workforce enhancement – $8.2 billion

As you can see, 60% of the funding is targeted directly to enforcement. Including the operations support amount of $25.3 billion, the amount directed to enforcement is about 90% of the total appropriation. By contrast, the amount allocated to taxpayer assistance and education is just .05%. This is a radical and, frankly, unacceptable imbalance.

Given the scope and breadth of the tax code, coupled with the frequent, mind-boggling changes to the code, the IRS's top priority should be taxpayer education, outreach and assistance. I've said this many times in my discussion of this plan, including challenging Commissioner Werfel to redirect spending to taxpayer assistance. See my article titled, "White House Nominates New IRS Commissioner," PTT, November 2022.

National Taxpayer Advocate Erin Collins agrees with me. In her blog of April 6, 2023, she highlights the imbalance between taxpayer assistance and enforcement. She stated that the resources are "disproportionally allocated for enforcement activities," and pointed out that "Congress should reallocate IRS funding to achieve a better balance between service needs and IT modernization." See: *https://www.taxpayeradvocate.irs.gov/news/nta-blog-irs-strategic-operating-plan-has-potential-to-transform-tax-administration/*

She went on to say exactly what I've been saying for years, and in almost the same words:

> In my opinion, the most efficient way to improve compliance is by encouraging and helping taxpayers do the right thing on the front end. That

is much cheaper and more effective than trying audit our way out of the tax gap one taxpayer at a time on the back end. The success of IT is instrumental in accomplishing the SOP's objectives of improving compliance. Allocating more funds to service and IT is key to taxpayers and tax administration. Ibid.

The SOP declares that it intends to make the IRS a service-centric organization. It is unlikely to achieve that goal when enforcement funding outpaces service by a rate of 10 to 1.

Tax Court Remands CDP Case to Develop a Record

Judicial Review Impossible Without an Adequate Record

The recent Tax Court case of *Bickel v. Commissioner*, Docket No. 22038-22L, provides great insight into the manner in which the IRS is to conduct Collection Due Process (CDP) appeals. Specifically, the case addresses how Appeals Officers are to perform their duties under Code § 6330(c)(3).

Section 6330(c)(3) lays out the so-called "Big Three" affirmative duties placed on the Appeals Office in CDP hearings. The law states that the Appeals Officer (AO) assigned to the case must: (1) verify that the requirements of any applicable law or administrative procedure were met, (2) consider any relevant issues raised by the taxpayer, including any request for collection alternatives, and (3) perform the required "balancing test."

The balancing test under § 6330(c)(3)(C) states that the AO must consider "whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary." In this regard, the AO has to weigh the equities, as it were, in an effort to strike a reasonable balance between the IRS's demand that all the tax be paid now, and the citizen's need that tax collection not grind him into powder.

In evaluating whether these three factors were met, the Tax Court reviews the Notice of Determination (NOD) issued by the Appeals Office. The NOD is the required statutory notice that expresses the final determination of the Appeals Office, and which gives the Tax Court the jurisdiction to review the decision. The Tax Court reviews the determination for abuse of discretion. The Court does not substitute its own judgment for that the Appeals Officer, but rather, considers whether the AO applied all applicable rules and procedures, and evaluated the facts property. As the *Bickel* Court stated, "An abuse of discretion exists when a CDP determination is arbitrary, capricious, or without sound basis in law or fact," citing *Murphy v. Commissioner*, 125 T.C. 301 (2005), and *Woodral v. Commissioner*, 112 T.C. 19 (1999).

The NOD, as the formal decision of the AO, must spell out the basis of the IRS's decision. As the Tax Court stated in *Serna v. Commissioner*, T.C. Memo. 2022-66, "We judge the propriety of the … determination … on the grounds invoked by the Office of Appeals." Said another way, the reasoning expressed in the NOD it the key factor the Court looks to in deciding whether the IRS abused its discretion or not. The *Bickel* Court noted that a court

“cannot uphold a notice of determination on grounds other than those actually relied upon by the Appeals Officer.” *Bickel*, pg 11.

In connection with this analysis, the Court looks at the contemporaneous memorandum included with the NOD and the AO’s case activity notes. These materials give the Court a view of the process followed and analysis performed by the AO. This review is intended to determine whether the AO evaluated the facts and circumstances of the case, and properly applied the law in reaching her decision on the Big Three affirmative duties under Code § 6330(c)(3).

The Tax Court reviewed the AO’s determination in the *Bickel* case under these guidelines. Ms. Bickel’s submitted an OIC as her proposed collection alternative. She owed about $140,000 of tax and she had substantial ability to pay, well in excess of the liability. The IRS’s initial determination of her reasonable collection potential placed it in excess of $730,000. The number was later reduced to about $500,000, still well in excess of what she owed. Because she didn’t qualify for an OIC based on doubt as to collectability, she argued that the OIC should be accepted based on Effective Tax Administration (ETA) grounds.

There are two potential settlement grounds to an ETA offer under Treas. Reg. § 7122-1(b)(3). First is whether full payment of the liability will cause economic hardship; that is, the inability to pay necessary living expenses going forward, after the tax liability is paid in full. The second is where “compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for compromising the liability.” Treas. Reg. § 7122-1(b)(3)(ii). In this regard, an OIC will be accepted when, “due to exceptional circumstances, collection of the full liability would undermine public confidence that the tax laws are being administered in a fair and equitable manner.” Ibid. See my book, ***How to Get Tax Amnesty*** for a detailed discussion of the ETA offer and how to argue one.

Ms. Bickel’s ETA OIC was first evaluated under the “economic hardship” standard by the IRS’s Centralized Offer Unit (COIC). The preliminary determination (subject to Appeals review) was that she would not suffer economic hardship if forced to full pay the $140,000 tax liabilities, given the scope of her financial wherewithal. The AO sustained the rejection of the OIC and notified Bickel's counsel of his decision. Shortly thereafter, by letter to the AO, counsel requested that the IRS reevaluate the OIC based on public policy and equity considerations, that is, non-economic hardship.

Counsel also pointed out that an OIC based on non-economic hardship grounds must be forwarded to a specialized group in Austin, Texas, that handles such offers. The IRM requires such handling to assure uniformity and consistency in its decisions on such offers. See: IRM 5.8.11.5(2).

Shortly after receiving the letter, the AO forwarded Bickel's OIC to the Austin unit for its consideration. The AO then sent an email to the manager of the Austin unit, explaining that the OIC was on its way. That same day, the manager of the Austin unit responded to the AO's email, stating that he "glanced" at the offer and "determined that there were no non-economic-ETA issues." *Bickel*, pg 6. It is unclear what the manager looked at in making this determination, as by that point, he didn't even have the file in his possession. Moreover, as the *Bickel* Court pointed out, the record of the case does not "contain an explanation of his reasoning on how he determined that there were no public policy or equity grounds for consideration." Ibid.

Based on the email the AO received from the Austin manager, the AO had a conversation with the Bickel's counsel and advised that the Austin unit rejected the OIC. Counsel reiterated to the AO that the OIC should be accepted. After further letters and discussion, Bickel increased her offer to $30,000, substantially higher than the initial offer.

The AO didn't respond to counsel's last letter reiterating the argument for accepting the OIC at the increased amount. Rather, he issued his NOD sustaining the IRS's proposed levy action and rejecting Bickel's OIC. Bickel filed a petition with the U.S. Tax Court challenging the determination.

As explained above, the Tax Court's job in a CDP appeal is to determine whether the AO abused her discretion in ruling against the citizen. In Bickel's case, the question was whether there was an abuse of discretion in connection with rejecting the ETA offer. The Court found "that the record is inadequate to support Appeals' rejection" of the OIC. *Bickel*, pg 11. For that reason, the case was remanded to the Office of Appeals for full and proper consideration of Bickel's offer.

Why was the record inadequate to support the AO's determination? Several reasons. First, the AO agreed the ETA should be evaluated by the Austin unit, whose expertise is specifically focused on these offers. However, the Austin manager merely "glanced" at the OIC and somehow determined that it did not meet ETA standards. But he made that determination without even looking at the OIC. As the Court pointed out, "The record contains no explanation other than a conclusory statement that ETA factors were not present in the case." *Bickel*, pg 12.

Second, the Austin manager noted to the AO that a preliminary calculation called for in the process was not completed. The manager stated that the case should be marked as a "per-mature referral." The AO did the required calculation but never sent the case back to the Austin unit for a follow up analysis. Instead, the AO merely relied on the manager's bald statement that the OIC didn't present any ETA factors. But, as stated above, the Court was unable to determine what, if anything, the manager relied on in drawing that conclusion. It certainly wasn't the OIC material submitted by Bickel because that wasn't even in his hands when he "glanced" at the case.

Third, the IRM requires that a taxpayer who submits an ETA offer must have the issues reviewed by the ETA team prior to rejection of the offer, or before the rejection is sustained. See: IRM 5.8.11.5.1(8). That did not happen in Bickel's case. The ETA manager stated the referral was premature and returned it to the AO to perform the required calculations, but the AO never re-submitted the case to the Austin unit after doing so. The AO merely adopted the opinion of the Austin manager which was made after merely “glancing” at the case. Even at that, the manager never prepared the ETA rejection memorandum required by the IRM setting forth the reasons for the rejection. See: IRM 5.8.11.5.1(6).

Finally, the AO apparently gave no consideration to the increased offer amount presented by Bickel following the phone conversation in which the AO stated that Austin “rejected” the OIC.

The Tax Court remanded the case because “the record is devoid of an explanation regarding Ms. Bickel’s public policy and equity argument…” *Bickel*, pg 13. The lack of such a record “frustrates the Court’s ability to discern Appeals’ reasoning and properly review its determinations.” Ibid.

The bottom line here is the AO must develop a record in CDP cases that is sufficient to support judicial review. See: *Hoyle v. Commissioner*, 131 T.C. 197 (2008), *supplemented* by 136 T.C. 463 (2011). Too often, especially in cases where the taxpayer seeks penalty relief, the AO does not support his conclusions with any analysis of the facts. Rather, just like the Austin manager did with Bickel’s ETA offer, they merely assert a conclusory statement saying that the taxpayer didn’t present reasonable cause facts. Such a bare record will result in a remand for full and proper consideration of the issues and the development of a proper record that will support judicial review.

States Can Have A Rainy Day Fund

Why Can’t Washington?

BY DR. MERRILL MATTHEWS

Wise and prudent individuals and families set aside some portion of their assets just in case some unexpected event—e.g., medical expenses, car or appliance problems, home repairs, etc.—needs to be addressed. And even those who live paycheck to paycheck may try to limit their current expenses so they can borrow money or use a credit card when needed.

Most states do the same thing, but not Congress and the White House. Washington spends every cent it takes in and borrows the rest.

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We wish we could say that only Democrats were behind the spending spree. But while Republicans talk fiscal responsibility, most of them don’t vote that way, even when they controlled the White House and both houses of Congress. President Trump proved to be nearly as big a spender as President Obama.

Most states are different. Forty-eight states have created a “rainy day fund.” (Note: Colorado and Illinois do not have a rainy day fund as defined by the Pew Charitable Trusts, even though surveys by the National Association of State Budget Officers claim the two states have rainy day balances.)

The Tax Policy Center reported last month that state rainy day fund balances have reached an all-time high. Even so, several states have very low balances, and you likely won’t be surprised at the slackers—New York, New Jersey, Illinois, Washington, Hawaii and Montana.

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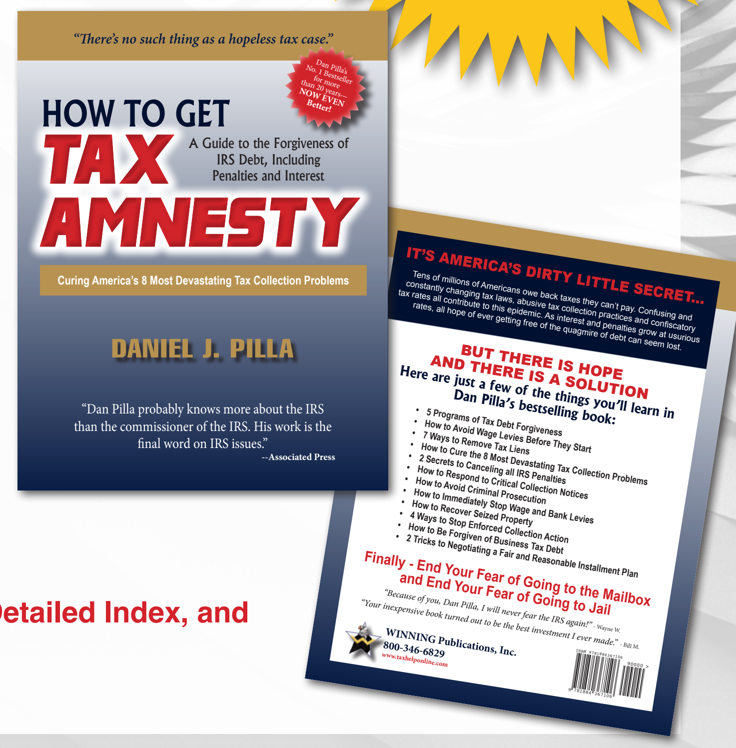

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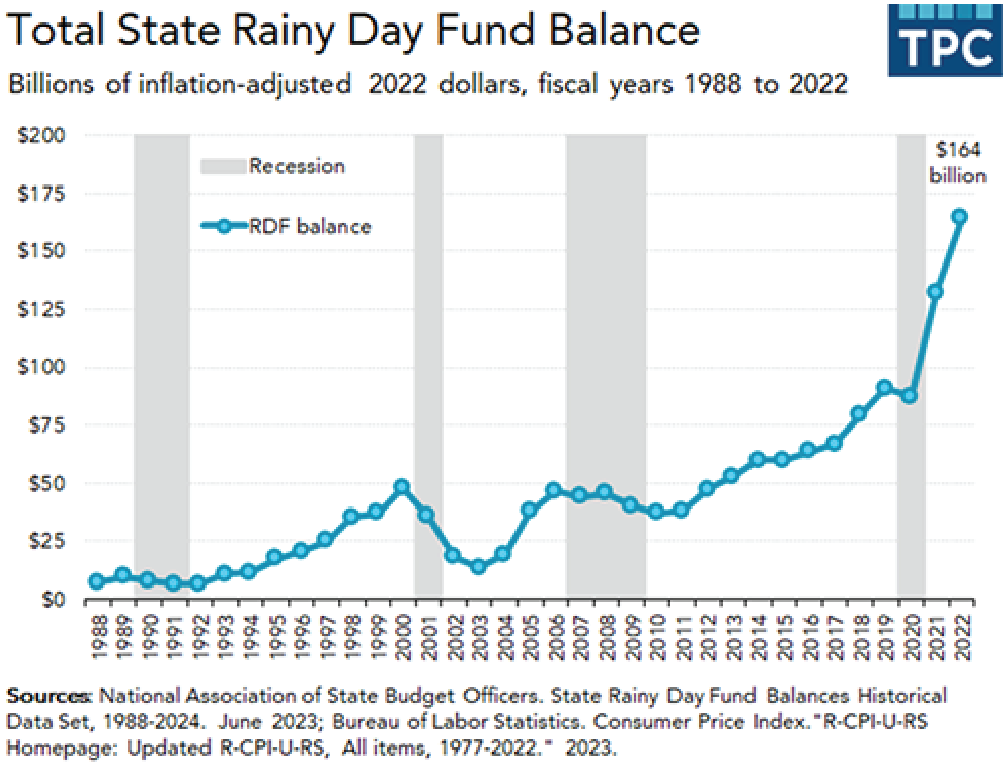

of the six slakers' equal less than 5 percent. Twelve states have rainy day funds between 15 percent and 25 percent of state spending. And five have rainy day funds over 25 percent of spending.

Even though many of the states with a rainy day fund cannot be considered "wise and prudent" in their spending, they still have at least some funds to fall back on in case of emergencies.

Not so our federal government in Washington. When emergencies arise—e.g., damaging weather events, the need to come to the aid of our allies, etc.—Congress's only option is to borrow even more money.

The fact that states can balance their budgets—even though they sometimes use accounting gimmicks to do it—and can still set money aside says something about them. The fact that Washington can't do it, says something about it too.

Dr. Merrill Matthews *is a resident scholar with the Institute for Policy Innovation.* IPI.org.

How You Can Ask Dan Pilla a Question

If you have questions or problems you'd
like Dan Pilla to address, please write to Dan at:

215 W. Myrtle Street
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