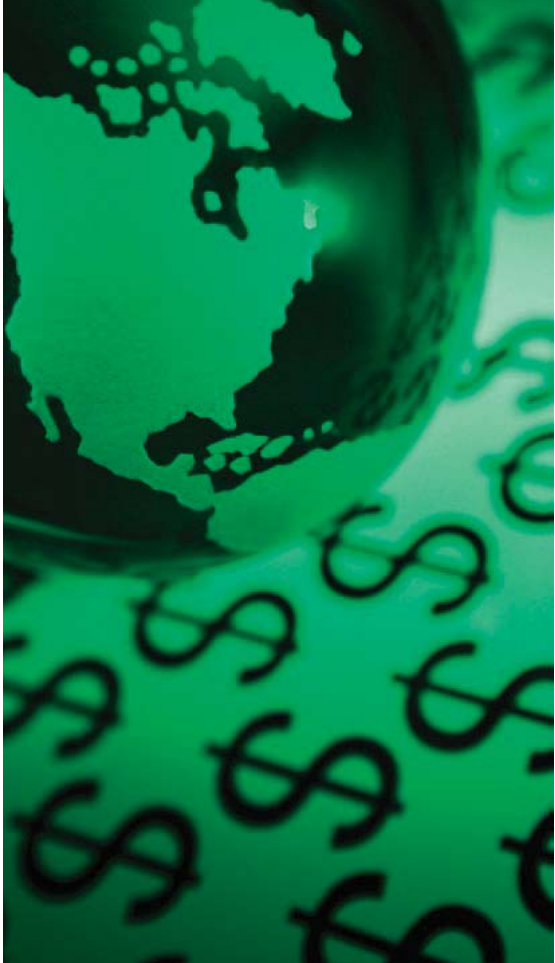


Tax Practice & Procedures

OPTIONAL SAFE-HARBOR TREATMENT FOR VICTIMS OF
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TAX ACCRUAL WORKPAPERS • NATIONAL TAXPAYER
ADVOCATE'S ANNUAL REPORT TO CONGRESS



IRS Issues Optional Safe-Harbor Treatment for Victims of Ponzi Schemes

The IRS recently issued two rulings about the tax treatment of victims of Ponzi schemes and similar financial frauds. Rev. Rul. 2009-9 addresses the standard tax treatment for losses from fraud or embezzlement. Rev. Proc. 2009-20 provides a safe-harbor treatment that allows deductions in the year of discovery where the amount of potential recovery is uncertain.

Rev. Rul. 2009-9

Rev. Rul. 2009-9 explains that a theft loss is allowed for a transaction in the year of discovery as long as it is not compensated by insurance or otherwise. If the taxpayer sustains the loss in a transaction entered into for profit, the loss is deductible under Sec. 165(e). Other theft losses are deductible as capital losses under Secs. 1211 and 1212.

Because the taxpayer sustains the loss in a transaction entered into for profit, it is not subject to the limitations of personal losses under Sec. 165(h). The loss is reported as an itemized deduction not

subject to the 2% adjusted gross income floor under Sec. 165(c)(2). If there is a claim for reimbursement where there is a reasonable prospect of recovery, the taxpayer cannot claim the loss until there is reasonable certainty of the reimbursement amount to be received.

The loss amount is generally the initial amount invested plus any other investments less withdrawals. In addition, the revenue ruling states that the loss also includes amounts reported as gross income on the taxpayer's federal income tax return and reinvested. Note that this is contrary to *Kaplan*, No. 8:05-cv-1236-T-24 EAJ (M.D. Fla. 2007), where it was ruled that the reported income was not includible in the theft loss.

Specifically, the *Kaplan* case held that the phantom income reported as a result of the Ponzi scheme on earlier tax returns now closed by statute could not be claimed as a theft loss deduction because there was no evidence that the income ever existed, so the plaintiffs could not show that such income was unlawfully taken. The IRS Office of Chief Counsel had issued a memorandum at the time of that Ponzi scheme's discovery,

concluding that investors who reported and paid taxes on phantom income could claim a theft loss deduction for the phantom income. The court reasoned that there was no evidence that the memorandum's conclusion was actually implemented by the IRS, and it denied the deduction. The court also denied the deduction for the taxes paid on the phantom income because that money was not unlawfully taken and therefore there was no theft.

Rev. Rul. 2009-9 goes on to explain the proper treatment of an NOL carry-back for these losses. It also explains that a taxpayer may not use the mitigating provisions under Sec. 1341 or Secs. 1311-1314 to adjust tax liabilities.

Rev. Proc. 2009-20

Rev. Proc. 2009-20 provides a safe-harbor treatment for victims of such frauds, which simplifies the determination of the loss. It applies to Ponzi-type fraud schemes where the lead figure is indicted under state or federal law.

The safe harbor provides that an investor may take a loss in the year of discovery in the amount of:

- 95% of the investment if the investor does not intend to pursue potential third-party recovery; or
- 75% if the investor is pursuing or intends to pursue potential third-party recovery less any amounts received or potential insurance/SIPC recovery.

If the investor subsequently has a recovery, he or she may have income. The revenue procedure instructs the taxpayer to mark "Revenue Procedure 2009-20" at the top of Form 4684, Casualties and Thefts, in the discovery year.

The IRS provides a statement in the appendix of Rev. Proc. 2009-20 to calculate the deductible theft loss. The taxpayer must sign the statement and attach it to a timely filed return. By executing the statement, the taxpayer agrees not to deduct any theft loss in excess of the permitted deduction or to file or amend returns to exclude or recharacterize income reported on the form. The taxpayer also may not apply the alternative computation under Sec. 1341 or the mitigation provisions in Secs. 1311-1314.

Any individual not using the safe-harbor provisions of Rev. Proc. 2009-20 must report the loss in accordance with Rev. Rul. 2009-9. The revenue procedure concludes by stating that "returns claiming theft losses from fraudulent investment arrangements are subject to examination by the Service." (For more on the tax treatment of defrauded investors, see Zimmerman, "Deducting Losses for Defrauded Investors," on p. 442.)

From Wendy Kravit, CPA, MBA, Annapolis, MD

Consent to Extend the Statute of Limitation

Sec. 6501(c) allows the IRS and a taxpayer to consent in writing to extend the statute of limitation to assess tax. Usually the Service makes the request to extend the limitation period because it cannot complete an examination within the normal three-year period for making an assessment against the taxpayer. The statute may be extended on all types of taxes except estate tax (Sec. 6501(c)(4)).

The internal procedures of the IRS can be found in the Internal Revenue Manual (IRM), available to the public at www.irs.gov. IRM Section 4.10.2.2.1 states that a group manager must give approval before an examiner may request a consent from the taxpayer. The Service's policy is that an examiner should secure a consent only in unusual circumstances (Rev. Proc. 57-6). The extension period should be only for the time necessary to complete the examination and administrative actions.

A list of some situations in which an examiner should request a consent is found in IRM Section 25.6.22.2.1. The most common circumstances are if (1) the limitation period will expire within 180 days and the taxpayer is asking that the matter be referred to Appeals or (2) there is not enough time in which to process an agreed case. Typically, the Service considers 120 days as the time frame needed to process an agreed case.

Form 872, Consent to Extend the Time to Assess Tax, is the document usually signed to extend the statute of limitation. The Service may ask a taxpayer to sign

Form 872-A, Special Consent to Extend the Time to Assess Tax, which is somewhat of an open-ended consent in that the statute does not expire until 90 days after the IRS or the taxpayer mails Form 872-T, Notice of Termination of Special Consent to Extend the Time to Assess Tax, or the Service issues a statutory notice of deficiency. Versions of the Form 872 series are used in other instances, such as cases involving TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) entities, partnerships, and return preparer penalties.

Taxpayer Options

Besides signing the form, what options are available to a taxpayer when presented with an extension request for an income tax case? The taxpayer can ask for a fixed statute date as opposed to an open-ended one. An open-ended statute of limitation tends to result in an examination being in process for a long time because there may be no urgency for the examiner to complete the audit. It also can expose a taxpayer to an unexpected assessment if the Form 872-T is not submitted. A taxpayer can extend a fixed extension date, if necessary, by signing a second consent. The taxpayer could ask for a shorter extension period than requested by the IRS so that the examination could be concluded quickly.

The taxpayer can also request a consent that is restricted to specific issues. The procedures for restricted consents are found in Rev. Proc. 68-31, as modified by Rev. Proc. 77-6. Examiners tend to not like restricted consents because the restrictive language must be approved by certain Service officials, necessitating procedures that result in delays. Such consents may not be obtained until examinations have been completed and the examination reports have been prepared. Restricted consents are normally limited to two issues.

Declining to sign the consent can result in a deficiency notice being issued, as mentioned above, but that may not be to the taxpayer's disadvantage. Before issuance, a notice is reviewed for accuracy by the appropriate IRS officials; once it is issued, it gives the taxpayer a clear picture of proposed adjustments. The taxpayer may file a petition with the U.S. Tax Court but may

also request Appeals consideration, which Appeals may grant at its discretion. Thus, an Appeals hearing may still be available without the taxpayer having to go to Tax Court. Appeals is generally precluded from raising new issues or adjustments that the examiner did not propose.

A practitioner may be authorized by a power of attorney from the taxpayer to extend the statutory period; however, the practitioner should have the taxpayer sign the consent to avoid a situation in which the client maintains that no such authority was given to the practitioner or that the form was signed without the taxpayer's knowledge.

From Joe Marchbein, CPA, Chesterfield, MO

Textron: A Still Uncertain Future for Tax Accrual Workpapers

In 1984, the IRS announced that it would not request tax accrual workpapers from taxpayers during an examination except in unusual circumstances (referred to as the "policy of restraint") (Announcement 84-46). In 2002, the IRS identified listed transactions as an unusual circumstance warranting an exception to its policy of restraint and began routinely requesting tax accrual workpapers when it believed the taxpayer had participated in a listed transaction (Announcement 2002-63; see also Internal Revenue Manual Section 4.10.20.3).

Since then, taxpayers have challenged IRS requests for tax accrual workpapers, claiming various protections against disclosure, including protection under the work-product doctrine. A significant case focusing on application of the work-product doctrine to tax accrual workpapers is *Textron Inc.*, 507 F. Supp. 2d 138 (D.R.I. 2007). As litigation on this question enters its fourth year, it remains unclear to what extent the work-product doctrine protects tax accrual workpapers and how to effectively invoke that protection.

Request for Tax Accrual Workpapers

During an examination, the IRS determined that a Textron subsidiary

participated in several sale-in, lease-out (SILO) listed transactions described in Notice 2005-13, 2005-1 C.B. 630, and requested Textron's tax accrual workpapers. When Textron refused to produce the documents, the government issued a summons and subsequently sought to enforce the summons. The lower court found that Textron's tax accrual workpapers for the year in question consisted entirely of a spreadsheet listing items on the return that Textron's counsel believed might be challenged by the IRS, counsel's estimate of the percentage likelihood of prevailing, and the dollar amount of financial statement reserves to reflect the possibility of not prevailing, along with backup workpapers for the spreadsheet.

Textron challenged the IRS request to produce these documents, claiming that they are protected by the work-product doctrine. The taxpayer also claimed that the attorney-client privilege applied. The lower court held and the appellate court affirmed that although the attorney-client privilege applied in this case, it was waived. Waiver of attorney-client privilege is not determinative with respect to waiver of work-product protection. The lower court agreed with Textron that the tax accrual workpapers in question were created in anticipation of litigation and that, as a result, the work-product doctrine protects the document from disclosure to the IRS.

The IRS appealed the case to the U.S. Court of Appeals for the First Circuit. A panel majority originally affirmed the lower court's decision that the work-product protection applied to the tax accrual workpapers, but it vacated the portion of the lower court decision relating to waiver and remanded that portion of the case to the lower court for additional factual development and consideration (see *Textron Inc.*, 553 F.3d 87 (1st Cir. 2009)). The First Circuit decision was withdrawn and judgment in the case was vacated when the First Circuit agreed to have the full panel for the court rehear the case.

In Anticipation of Litigation

Many commentators have stated that the district court decision in *Textron* was

a big win for taxpayers, and in some respects it was. One question in the case was the extent to which the document in question was prepared "in anticipation of litigation," a prerequisite for the work-product doctrine to apply. The IRS argued unsuccessfully that a document cannot be treated as prepared in anticipation of litigation if it can also be used for another business purpose (in this case preparation of financial statements). Although the IRS previously prevailed on this argument more than 25 years ago in the Fifth Circuit (*El Paso Co.*, 682 F.2d 530 (5th Cir. 1982)), the district court rejected the IRS's limited interpretation of the phrase "in anticipation of litigation." Whether the IRS can persuade the entire First Circuit on this point remains unclear, but it is central to whether Textron will ultimately prevail on this issue.

Waiver of the Work-Product Doctrine

Unlike waiver of attorney-client privilege, disclosure to a third party will not necessarily waive protection under the work-product doctrine. Waiver for purposes of the work-product doctrine occurs if disclosure is made to an adverse party. The district court concluded that there was no waiver of the work-product doctrine in the *Textron* case. If the First Circuit agrees with the district court that the work-product doctrine protects Textron's tax accrual workpapers from disclosure to the IRS, it will then be asked to address the government's argument that Textron waived protection under the work-product doctrine when it showed the tax accrual workpapers to its financial auditor.

Impact of Uncertainties

Given the legal maneuvering in this case, it is possible that it will remain in litigation for quite some time. Until the litigation has concluded, the extent to which the work-product doctrine protects tax accrual workpapers and how to effectively invoke that protection remains unclear. In light of such uncertainty, practitioners should keep abreast of developments in the *Textron* litigation and be prepared to work with

clients as they try to navigate this unsettled area.

From Rochelle L. Hodes, J.D., and Corina Trainer, J.D., Washington, DC

The National Taxpayer Advocate's Annual Report to Congress (Part I)

This item recaps the recommendations of Nina Olson, the National Taxpayer Advocate, for changes within the IRS as presented in her annual report to Congress. A second item, to be published in the October 2009 issue, will outline Olson's recommended legislative reforms to the tax code and review the most frequently litigated tax issues.

In January 2009, Olson presented her annual report to Congress, outlining the IRS system and legislative suggestions for improving the federal tax system. Some of her suggestions were implemented early in the current presidential administration (e.g., the discontinuation of private debt collection on behalf of the IRS), and more issues are outlined below.

Recommendations for the IRS

The five most serious problems encountered by taxpayers are:

1. The complexity of the tax code, which is both costly and "leads to perverse results";
2. The hardship effect of collection enforcement (especially levies and seizures) on economically distressed taxpayers (as opposed to making greater use of offers in compromise and installment agreements);
3. The correct reporting of income or exclusion on cancellation of debt, which requires the filing of the little-known Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), and the unwritten rule (in forms and publications, at least) that a taxpayer must also provide a statement of insolvency;
4. The lack of early intervention and the overreach of IRS employment tax policies even where education is likely more effective than enforcement; and

5. IRS improvements to assist victims of identity theft.

Note that the IRS has already established an Identity Protection Specialized Unit and a toll-free hotline for victims of identity theft (1-877-438-4338, or 1-877-IDtheft). However, the IRS could possibly give taxpayers the opportunity to review and monitor their tax accounts and allow IRS employees more latitude in determining the rightful owner of a disputed Social Security number.

Taxpayer Service Issues

Olson had several suggestions for improving taxpayer service, including establishing more face-to-face assistance centers in the United States and overseas, expanding the hours at existing sites, and increasing the live (as opposed to internet) education and outreach program for small business/self-employed taxpayers. She would also like the IRS to publicize an employee phone directory with a topical index, provide more toll-free overseas lines, staff efficient operators to route phone calls to the IRS, and provide more secure online access for overseas taxpayers. For domestic U.S. taxpayers ineligible for a Social Security number, Olson urges allowing online applications for individual taxpayer identification numbers.

Compliance Issues

Compliance issues continue to cause customer service problems, in part, says Olson, because the IRS's measures of success do not properly balance taxpayer service and enforcement. She recommends creating an IRS Cognitive Learning Lab and streamlining the tax system so that a taxpayer can work with one employee throughout the case. Olson also recommends that the IRS develop better measures and funding for local coordinated issue papers (CIPs) and disseminate those findings more widely. Better measures are also needed to evaluate customer service in the Automated Collection System. In particular, the IRS should examine taxpayer wait times, the inability to fax documents to IRS employees, and other overly burdensome procedures. One emerging issue is the proper reporting of transactions in virtual world economies for

which the IRS's failure to provide guidance could lead to unintended taxpayer noncompliance.

As examinations increase, audit coverage arguably extends to increasingly less-egregious offenders or nonoffenders. Olson argues that the IRS should assume good faith on the part of taxpayers and allow more opportunities to meet taxpayer preferences throughout the exam, including:

- Choosing whether an exam will be correspondence or face to face;
- Requesting a phone conference with the examiner; and
- Setting up a payment agreement for tax due.

Such changes not only increase IRS effectiveness but also reduce disparities between taxpayers that are sophisticated at navigating the tax system and taxpayers in similar situations that are not. Olson recommends five actions to address this problem, including the immediate elimination of the "combination letter" (a letter of initial contact with the taxpayer sent simultaneously with an official examination report). In the correspondence exam process (which represents about 83% of exams), there are disturbing patterns of emphasizing closings over cooperation with the taxpayer as well as delays in responding to taxpayer correspondence followed by premature assessment of tax; this pattern is uncomfortable for the taxpayer and creates needless re-work for the IRS. Instead, Olson urges the IRS to adhere to its own "longstanding quality (audit) standards."

In general tax administration, Olson cautions that the IRS needs to do a better job of measuring the indirect, "downstream" consequences of centralization for taxpayer service and compliance. The IRS could improve amended return processing if it allowed individual taxpayers to file amended returns electronically, eliminated unnecessary referrals to examination, and created a special unit to resolve cases in which two tax returns were filed with the same taxpayer identification number for a given period. In addition, the file management system (recently reclaimed from outside contractors) is also in need of improvement:

the IRS refunded over 40% of the photocopying fees collected because it could not locate the requested taxpayer files. The Service miscalculates the failure-to-pay penalty on approximately 2 million taxpayers per year, and manual calculations of interest are incorrect nearly one-third of the time. Olson recommends software programming to catch these errors and revising the Internal Revenue Manual to entitle all taxpayers to review the accuracy of penalties and interest. Finally, she recommends sending clarifying notices to employers when the IRS and the Social Security Administration have different wage numbers and providing a phone number for consultations to resolve these issues efficiently.

Olson's report also makes several legislative recommendations, lists the 10 most commonly litigated tax issues, and provides a summary of key research reports produced in connection with her office. These are available in the full text of the report, available at www.irs.gov/advocate/article/0,,id=202276,00.html.

From Valrie Chambers, Ph.D., CPA

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