

# TAX THIS!



**AN INSIDER'S GUIDE  
TO STANDING UP TO THE IRS**

**Scott M. Estill**

**Self-Counsel Press Inc.**

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USA      Canada

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# INTRODUCTION

*IRS. CID. DIF. RO. HIRE. BLS. OIC. IA. CNC. TCMP. IRP. FICA. RA. FOIA. IRC. IRM. SA. AGI. TCM. USTC. LLC. SFR. DLN. DD. BMF. IDRS. IMF. PRO. FUTA. TC. MSSP. TAO. PRP. EA. CPI. FTL. ACS. CTR. EIN. ES. FOIA. DLN. SSN. NRP. CDP. TDP. CAP. ETA.*

Dealing with the Internal Revenue Service is similar to waking up in a foreign country without speaking the language. Sure, you can often get by, but when push comes to shove, you know that you're going to be taken advantage of.

Anyone who deals with tax issues on a day-to-day basis understands that the vast majority of tax laws are hopelessly complex. For instance, the Economic Growth and Tax Relief Reconciliation Act of 2001, which President Bush signed into law on June 7, 2001, contained 85 major changes (and 441 total changes) to the Internal Revenue Code (IRC), all of which will be phased in (and possibly out) until 2011. The new law itself was 291 pages long! In addition, many tax law changes were proposed after the September 11, 2001 attacks on New York and Washington DC, in part to help the victims and also to stimulate a sluggish economy. Adding to this complexity are the Pension Protection Act of 2006 and the Tax Relief and Health Care Act of 2006, along with the Small Business and Work Opportunity Tax Act of 2007. And as if this weren't enough, there were many tax policy changes when the Emergency Economic Stabilization Act of 2008 (the economic "bailout") was signed on October 3, 2008, including the American Recovery and Reinvestment Tax Act of 2009. Congress even managed to include numerous tax provisions in the Health Care and Education Reconciliation Act of 2010 and the Small Business Jobs and Credit Act of 2010. President Obama is not immune to new

tax laws as well, recently passing The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010. As you can imagine, keeping track of all these changes is a major challenge — especially to the IRS! The IRS is often criticized, but in all fairness, its job is next to impossible to perform much of the time.

When I first began my employment with the IRS district counsel (the in-house legal staff for the IRS and now called "Area Counsel"), I was overwhelmed every day by the alphabet soup of acronyms, the piles of tax forms (of which at last count there were more than 1,000, with the number seeming to increase daily), and the fruitless attempt to interpret the IRC. Things never really got any better — only more manageable or tolerable.

This is what it's like on the inside. To you, the average American taxpayer who is undoubtedly on the outside, the bureaucratic maze of the IRS is downright impossible to figure out. The IRS knows it has the advantage if it makes the rules and keeps the other players (i.e., you, the taxpayer) in the dark, forced to learn those rules as the game is in progress. Since I left the IRS in 1994, there have been several internal reorganizations, moving employees from one old division to one new division, all in an attempt to find something that works. Of course, this has resulted in a great deal of confusion and stress for current IRS employees.

Imagine if a baseball player found out during the course of a baseball game that he or she had only three strikes before being out, while the pitcher knew this all along. Without a doubt, the pitcher would have a huge advantage. In the tax game, the IRS is the pitcher: the player that understands the game. The taxpayers are the batters: unsure how to play the game and not aware that three strikes make an out.

The purpose of this book is to update the rules and highlight the vast changes made since the eighth edition was published in 2011, and to put you on a level playing field with the IRS. Once everyone understands the rules of the game, it becomes much easier for the taxpayer to win. And winning is the name of the tax game when the opponent is the IRS.

After discussing the history and organization of the IRS in the first few chapters of this book, I will

take you step-by-step through the filing process, the audit, appeals, and court proceedings, and help you keep your hard-earned money and assets. I also include chapters on IRS penalties, collection and bankruptcy issues, and criminal investigations. I use real-life examples to explain many of the tax concepts and to demonstrate how to use various defenses and other weapons against the IRS. At the end of each chapter is a section called Tax Points. These sections provide a summary of the main points of the chapter and are an easy way to review and remember the information presented.

Education (or a lot of money to hire the best tax professionals!) is the only real chance you have to win the IRS game. I have written this book to give you the education you need to eliminate the fear of the IRS such that you will be able to fight and beat the IRS at both the administrative level and in the court system. Good luck!

# CHAPTER 1

## MEET THE IRS

*The Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.*

— 16th amendment to the United States Constitution (1913)

*The taxpayer — that's someone who works for the federal government but doesn't have to take a civil service examination.*

— Ronald Reagan, United States president (1980–1988)

### 1. A Brief History of Income Tax

There has not always been an income tax in the United States, and George Washington or Thomas Jefferson could never have imagined anything remotely resembling today's IRS. The first tax on income in this country was put in place in 1862, and was used to finance the civil war. Not surprisingly, this tax proved highly unpopular with Americans, especially after the war had ended. It was discontinued in 1872.

It was not until 1913 that the United States again instituted an income tax. Ever since then, Congress, the president, and US citizens/taxpayers have been fighting over how to efficiently and fairly tax the citizens to finance the operations of the national government. Tax reform and tax reduction have been campaign themes in nearly every presidential election since 1913 because most politicians realize that running a campaign on increasing taxes is a sure way to get defeated. Yet, while no one publicly admits to wanting to increase taxes, the reality of nearly all “tax reforms” is that taxes rise and the tax laws get more complex.

If anyone needs proof that revisions in the tax laws inevitably increase the average American's tax burden, all one has to do is look at the ever-changing Tax Freedom Day. This is the date each year when the average American has earned enough money to pay all federal, state, and local taxes. According to the Tax Foundation (a nonpartisan, nonprofit group that provides tax education to tax practitioners and the general public), in 1944, the average American had to work the first 90 days of the year (from January 1 to March 30) to pay all taxes owed to the government. By 1964, the number of days increased to 104 (all the way to April 13). The Tax Freedom Day in 1984 was April 15 (106 days), and by 2000 the day was pushed back to May 3 (123 days). This day retreated back into April during 2002, primarily as a result of the US recession and the 2001 tax cuts. In 2011, the Tax Freedom Day was April 12. However, it does make a big difference where you live, as state and local tax rates can greatly affect when your particular Tax Freedom Day occurs. For instance, Connecticut (May 2) and New Jersey (April 29) are the worst offenders, while people who live in Mississippi (March 26) and Tennessee (March 27)

get off relatively easy. So when you are working in January, February, March, April, and possibly May this year, remember that every minute spent at the office, on the road, in the factory, or wherever your job is located is going to feed the government and not you and your family. And this is a lot of money. Again, thanks to the Tax Foundation, Americans spend more time working for tax than they do for any other expense, as the following chart demonstrates:

---

Expense	Days worked in 2008 to cover expense
Federal/State/Local Taxes	113
Housing	60
Medical Care	50
Food	35
Transportation	29
Recreation	21
Clothing	13
All Other Expenses	44
Total	365

---

Politicians today continue to spread an anti-tax, anti-IRS message, presumably because such rhetoric is popular with the voters. However, in any alternative plan these politicians offer, the average American will continue to pay taxes to the government, possibly even more than he or she is paying today. Unless we adopt the Libertarian Party's position on taxes (reduce or eliminate nearly all taxes and the big government that goes with the higher tax revenues), there is going to be some federal government tax in this country in the future, and it is going to be awfully similar to what we have today.

Many campaign promises made during recent congressional and presidential elections have hinted that the IRS would no longer be necessary if a flat tax or national sales tax were implemented in place of today's income tax:

- ★ A *flat tax* is a tax on income where the tax is a certain percentage of income (unlike

today's multiple levels of taxation, which vary depending on how much taxable income is earned), with fewer deductions than today's taxation system or possibly no deductions at all. For example, everyone might pay 20% of their income in tax. Individuals in favor of the flat tax claim it would make the tax laws much simpler and fairer than they are at present.

- ★ A *national sales tax* would be just like today's state and local sales taxes, except that it would be set at a much higher rate (one proposal from Rep. John Linder (R-GA) is for a 30% sales tax), given that it's intended to replace the income tax.

Under either of these proposed tax systems, there would still need to be some federal agency (like the IRS) to enforce the tax laws, whether through an increased effort to audit small businesses and the self-employed (who may be more likely to fail to report income under a flat tax system) or retailers who fail to report sales (under a national sales tax). Either way, the IRS as we know it is not likely to disappear at any time in the near future.

## 2. So What Is the IRS?

While the IRS is not responsible for the recent tax increases or the complexity of the tax laws, it gets most of the blame and it is undoubtedly an easy target. The IRS is the largest agency in the United States Department of the Treasury. Its mission, at least according to the IRS, is to "provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." The IRS has the very difficult task of trying to uphold the federal tax laws by encouraging the highest degree of voluntary compliance with the tax laws and regulations.

Most Americans do not disagree with this mission and do not have a problem with the IRS attempting to collect the proper amount of tax

revenues due, at the least cost to the public, in both a fair and impartial manner. However, too often it seems that the IRS doesn't consider fairness, impartiality, and whether it is collecting the proper amount of tax. Instead, many IRS employees seem to want to collect as much tax as possible, in any way possible, regardless of the personal financial consequences and fairness to the taxpayer. Though this attitude is certainly not shared by every IRS employee, it is common enough that it creates a need for taxpayers to understand the tax laws, along with how the IRS is organized and operates in its attempt to administer the tax laws, so that they can stand up for their rights.

It should come as no surprise that the IRS is a hopelessly complex organization. It seems that not a year goes by without some new layer of bureaucracy being added to the already nightmarish bureaucratic system. Figure 1 is a brief and simplified illustration of the structure of the IRS.

Most of the layers of the bureaucracy shown in Figure 1 have no meaningful contact with taxpayers. Instead, the commissioner, deputy commissioners, and the National Office staff are primarily concerned with tax policy and management.

The IRS service centers are the initial contact point for most taxpayers, as these are the places where all tax returns get filed. After you file your tax return, most dealings you might have with the IRS will be at the local level (see the list of district offices in Appendix 2). As a result of the IRS reorganization (begun in 2001 and still being implemented!), you will likely come into contact with one of the four main operating divisions:

- ★ *Wage and Investment*: This division will handle more than 100 million taxpayers, including those who are employees and/or have home investment income.
- ★ *Small Business and Self-Employed*: This division will handle more than 45 million taxpayers who are self-employed or own small businesses (annual gross receipts less than \$5 million per year).

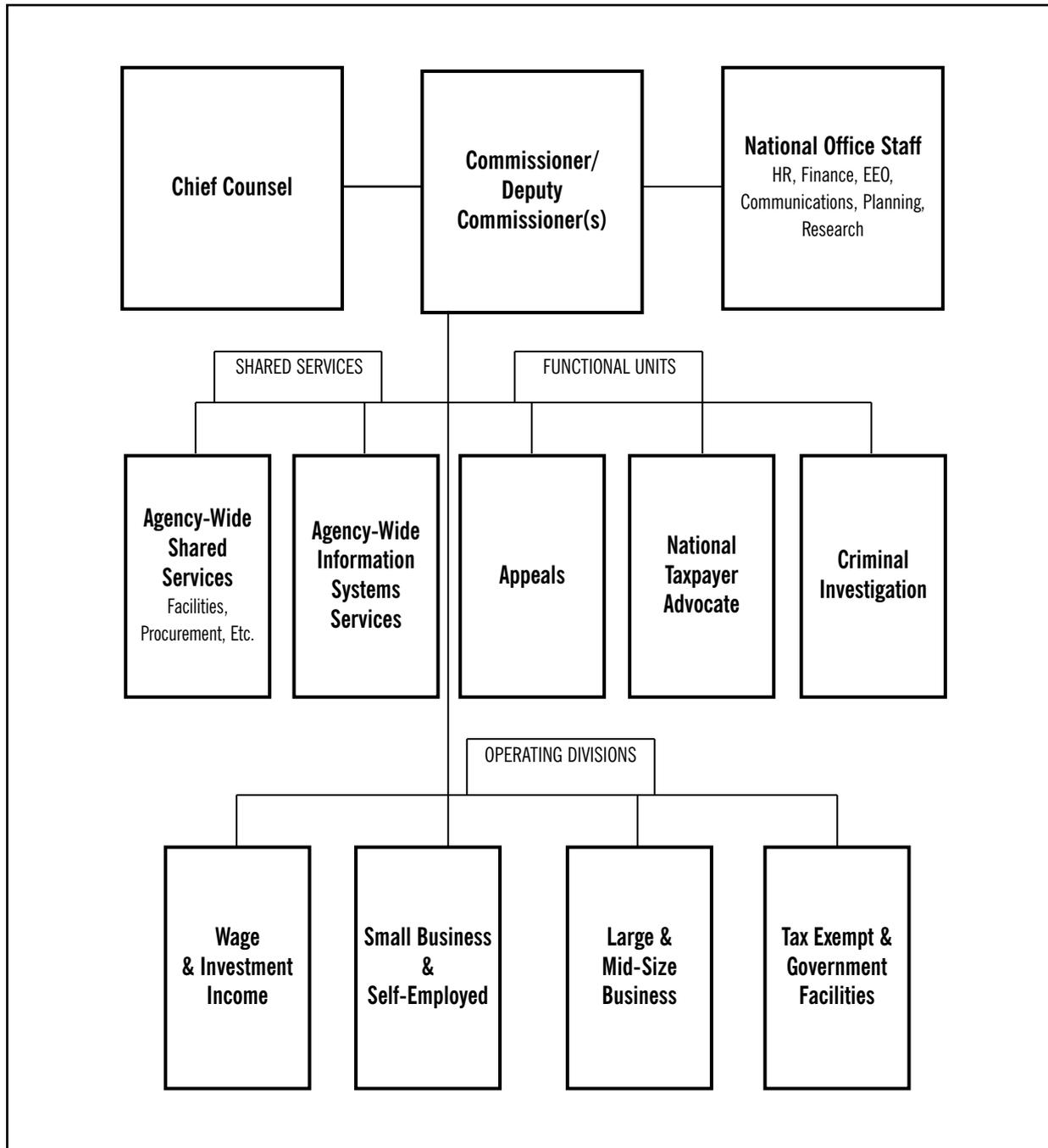
- ★ *Large and Mid-Size Businesses*: This division will handle businesses that gross more than \$5 million per year.
- ★ *Tax Exempt and Governmental Entities*: This division is responsible for handling employee benefit plans (such as 401(k) or other retirement plans), exempt organizations (such as charitable groups), and various governmental entities.

The IRS will continue to maintain its Appeals, Taxpayer Advocate, and Criminal Investigation Divisions. In addition, the examination (audits) and collection employees will be spread out among the four divisions so that they can develop specific expertise, depending on the type of taxpayer. Each of the various IRS divisions and functions will be discussed throughout this book.

It is difficult to believe how many offices and employees and how much money it takes to implement this country's tax policy. For the fiscal year 2010, the IRS employed nearly 106,000 people and had a total budget in excess of \$13 billion. By comparison, several well-known companies have a much smaller work force and annual operating budget than does the IRS. For example, the IRS employed about the same number of people in 2010 as did Dell Computers, Southwest Airlines, and NBC-TV combined.

There are so many different layers of management in the IRS that it appears there is no one left to do any work. As most companies that are in business to make a profit have discovered, multiple levels of management simply create an inefficient maze of confusion and chaos. The IRS proves the truth of this: it is as good as it gets when it comes to inefficiency. However, the IRS realizes it has these limitations, as in May of 2002 it received a passing grade of B- from the Federal Performance Project. Keeping the overall grade down were such negative factors as "decreased employee satisfaction, problems with computer systems, and lack of management flexibility."

FIGURE 1  
 ORGANIZATIONAL STRUCTURE OF THE IRS



Given the sheer size of the IRS, along with the size of its management, it is amazing that it manages to do a fairly decent job of collecting tax revenues. While there is no doubt that billions of dollars of income, from both legal and illegal sources, go untaxed and/or uncollected every year in this country, the IRS does collect over \$2.7 trillion every year. To get an idea of how much money \$2.7 trillion is, if you spent \$1,000 every second of every day, it would take approximately 85 years before all of the money was spent. Table 1 shows where the IRS gets its \$2.7 trillion from.

The numbers are staggering. And regardless of what any politician promises in the way of tax reform or tax relief, the numbers keep getting bigger. In general, as long as the numbers get bigger, so will the IRS. And as long as the IRS grows in size, US citizens will continue to have more tax problems. It is as simple as this.

### 3. How to Play with the IRS

Given the size of the IRS bureaucracy, you may feel intimidated or uncertain when dealing with its employees. But as a taxpayer, you should never feel this way. Despite the IRS's size and power, you have many opportunities to level the playing field and come out on top in the tax game.

#### 3.1 The rules

There are four basic rules to keep in mind to help you avoid any misunderstandings or unnecessary problems when dealing with the IRS.

- (a) *Strictly follow time deadlines to the day.* Many taxpayers get themselves in unnecessary trouble with the IRS because they don't do something when the IRS wants it done. While I'm not suggesting that you have no control over deadlines, missing an established deadline will certainly cause you more problems than it is worth.
- (b) *Anytime you communicate with the IRS, do it in writing.* Keep a copy of every communication for your records. If you must communicate orally, either in person or by

telephone, follow up the conversation with a letter documenting what was said and agreed to. You will see how important this rule is when you realize that one division of the IRS often has no clue as to what another division of the IRS is doing. Furthermore, there are often massive communication failures within the same IRS division, perhaps even by employees in the same office. If there is conflict sometime down the road between what you and the IRS believed was orally communicated, the IRS will almost always believe its own personnel (to your disadvantage). If you have a written document to back up your position, you can make a stronger case.

- (c) *Be specific.* When you must contact the IRS (whether in writing, in person, or by telephone), be specific about what you want to accomplish, what the facts are, and what the tax laws say regarding the issue. Many taxpayers create additional problems for themselves because they don't know what they want or what they are entitled to, or they are unclear on the facts or law. The IRS will use this uncertainty to your disadvantage.

As well, in many cases the biggest roadblock to finding a solution to the problem is finding the right person to deal with. The more specific you are, the more likely you are to find that person.

- (d) *Get the IRS to agree.* Most IRS employees are trained to question and disagree. If you make statements rather than ask questions, you are more likely to get the IRS to agree with you. For example, a statement like "You would agree that an expense is deductible if it was incurred in the ordinary and necessary course of my business" will have much better results for you than a question like "Is this expense deductible?"

If you follow these rules, you should be in a much better position to fight the IRS and win. This

**TABLE 1  
WHERE THE IRS GETS ITS MONEY**

Fiscal Year	How much the IRS collects from:				Total
	Individuals	Corporations	Employment	Other	
1999	1,002	216	599	101	1,918
2000	1,137	236	640	100	2,113
2001	1,178	187	682	98	2,145
2002	1,038	211	688	97	2,034
2003	987	194	696	93	1,970
2004	990	231	717	81	2,019
2005	1,108	307	771	83	2,269
2006	1,236	381	814	88	2,519
2007	1,366	396	850	80	2,692
2008	1,425	354	883	83	2,745
2009	1,190	225	858	70	2,343
2010	1,163	277	824	81	2,345

The amounts shown are in billions of dollars.  
Employment tax numbers include Social Security, Medicare, Unemployment, and retirement-related taxes.  
The "other" category includes excise, customs, estate, gift, and other miscellaneous taxes.

being said, there is still one more rule that must never be broken:

*Do not trust the IRS and its employees to do the right thing, and never rely on anything they say unless the statement is put in writing and signed.*

While many good people work for the IRS and try to live up to their word, many others do not. IRS employees often give incorrect tax advice or information, not because they are malicious, but because they do not fully understand the complex tax laws that they must interpret, administer, and enforce. When an IRS employee does provide

incorrect information, that employee will often reverse himself or herself to cover up the error. If you have not got the statement or information in writing, it will be your word (that you were misinformed) against the IRS employee's word. It is not hard to figure out who will win the war of words when the IRS is the judge.

### 3.2 Your rights

It is also important for you to realize that you do have rights during every contact you have with the IRS. These rights are set out in IRS Publications 1 and 3498 and include the following:

- ★ The IRS should explain to you what your rights are during any contact with the IRS. In reality, the IRS rarely does this, so it is up to you to know what your rights are during every phase of the tax game.
- ★ The IRS will always respect your right to privacy and the confidentiality of the information contained on any tax return. Given that there are severe penalties for violating the tax disclosure laws, the IRS is very good at observing your rights in this area.
- ★ You are always permitted to have professional representation (i.e., Certified Public Accountant or CPA, tax attorney, or other tax professional) during any contact with the IRS. The IRS is typically very good at allowing taxpayers to exercise their right to professional representation. The basic difference between a tax attorney and a CPA is the formal education they undergo and the availability of confidentiality. The CPA is trained in accounting, which will include some tax training, while the tax attorney has a law degree and usually some formal training or experience with tax issues. An attorney can give you more confidentiality (called the attorney-client privilege) than can a CPA, which means he or she cannot be forced to reveal details of your case. The Tax Reform Act of 1998 added a limited practitioner privilege for discussions between a tax practitioner and a taxpayer concerning tax advice. The difference between the two privileges is that the new tax practitioner privilege does not extend to criminal matters. It is a step in the right direction but does not go nearly as far as does the attorney-client privilege.
- ★ You have the right to be treated courteously and professionally. Unfortunately, the IRS often completely fails when it comes to this basic taxpayer right. As a taxpayer, you do not have to tolerate rudeness or unprofessional treatment from any IRS employee. While

you and the IRS may disagree about the facts and/or the law in your case, the IRS employee is aware that he or she must handle the disagreement in a professional and courteous manner. You have the right to demand (and receive) a new IRS employee should you ever be unhappy with your treatment.

- ★ You have the right to pay only the correct amount of tax due under the law. The IRS tries to observe this rule, although many audits are concluded with the taxpayer paying more in tax than the law actually requires.
- ★ You have the right to receive assistance from the Taxpayer Advocate Service when you reach a roadblock in normal IRS channels. This right is discussed in detail in Chapter 16.
- ★ You have the right to ask for an appeals office review of your case whenever you disagree with the IRS relating to the amount of your tax liability or certain IRS collection actions. You should always take advantage of this opportunity, as most IRS Appeals Officers are highly trained employees with enough authority to correct any lower-level IRS mistakes. The IRS Appeals functions are discussed in detail throughout this book.

### 3.3 Some useful publications

Throughout this book I will refer to several publications and research materials concerning the IRS and the tax laws in general. The following is a list of frequently cited materials, with information on where they can be located:

- (a) *Internal Revenue Code (IRC)*. This is the law under which the IRS and all taxpayers operate. It consists of Title 26 of the United States Code. The IRC can be found in many libraries and all law libraries. I will also refer to other sections of the United States Code throughout this book. For example, when I write about 5 USC §522, I am referring to Section 522 of Title 5 of

the United States Code (USC). The USC, like the IRC, can be found in many general libraries and all law libraries.

- (b) *Revenue Rulings (Rev. Rul.)*. This is the IRS interpretation of the IRC, which provides guidance to IRS employees and taxpayers about specific sections of the IRC. It can be found in most law libraries.
- (c) *IRS Regulations (Regs)*. This is the official policy on how the IRS will administer specific tax laws. The Regs can also be found in most law libraries.
- (d) *Internal Revenue Manual (IRM)*. This is the internal operating manual for the IRS. It does not have the full force of law and the IRS is not legally obligated to follow it. Not surprisingly, the IRS often chooses to ignore its own manual and rules, especially when doing so is to the taxpayers' disadvantage. You should not be discouraged by this and should always use the IRM if it is beneficial to do so. The IRM is available in most law libraries and can also be ordered directly from Tax Analysts, 6830 North Fairfax Drive, Arlington, VA 22213.
- (e) *Court decisions*. Throughout the book I will make brief mention of various court decisions. These decisions can be found in any law library and some public libraries.
- (f) *IRS publications*. The IRS publishes hundreds of different publications every year to assist you with questions you may have regarding all phases of the tax game. While many of these are highly specialized (covering such things as how to claim moving expenses and report gains from your mutual fund), many are general in nature and are quite valuable for nearly all taxpayers. Of the more general publications, I would recommend getting a copy of Publication 1 (*Your Rights as a Taxpayer*), Publication 17 (*Your Federal Income Tax for Individuals*), Publication 334 (*Tax Guide for Small Businesses*), and Publication 910 (*Guide to*

*Free Tax Services*). All IRS publications can be ordered directly from an IRS distribution center (see Appendix 1 for locations), and there is no cost for any of these.

I also refer to and explain four major tax reform bills that are now law: the Taxpayer Relief Act of 1997, the IRS Restructuring and Reform Act of 1998 (referred to throughout this book as the Tax Reform Act of 1998), the Economic Growth and Tax Relief Reconciliation Act of 2001, and the American Jobs Creation Act of 2004. Each of these new tax acts greatly strengthened the rights you have when dealing with the IRS. They should be used to your advantage whenever possible.

## Tax Points

- ⚠ Understanding the massive IRS bureaucracy and complex tax laws permits you to even the playing field with the IRS.
- ⚠ Always follow all IRS deadlines to the day.
- ⚠ Keep accurate records of any communications with the IRS or any of its employees.
- ⚠ Make it easy for the IRS to agree, rather than disagree, with you.
- ⚠ Understand the facts and law before you contact the IRS.
- ⚠ Never trust the IRS or any of its employees to do the right thing.
- ⚠ You have many rights that the IRS must recognize. The most important of these rights is the right to privacy and confidentiality with respect to your return information.
- ⚠ You have the right to be treated professionally and courteously every time you have contact with any IRS employee.