New Case Shows Strategic Considerations in "Cooperating" with IRS Audits

By Hale E. Sheppard*

Wolters Kluwer®

I. Introduction

At some point during most audits, taxpayers will ponder whether, or to what extent, they should "cooperate" with the Internal Revenue Service ("IRS"). They might also ask what, exactly, cooperation means in a particular situation. These are critical questions to which many taxpayers, and their advisors, lack clear answers. This type of unawareness of tax procedure can lead to bad decisions. This article describes duties associated with foreign accounts, standards for reducing related penalties, a new case in which taxpayers were stuck with higher sanctions because of their uncooperativeness, and various other contexts in which cooperation, or the lack thereof, has a significant effect on IRS disputes.[1]

II. Overview of FBAR Obligations

Readers first need some background on FinCEN Forms 114 ("FBARs") to appreciate the issues addressed in this article.

A. Mandatory Disclosures

Relevant law requires the filing of an FBAR in situations where (i) a U.S. person, (ii) had a direct financial interest in, had an indirect financial interest in, had signature authority over, or had certain other types of authority over (iii) one or more financial accounts (iv) located in a foreign country (v) whose aggregate value was more than $10,000 (vi) at any point during the relevant year.[2] Individuals have several obligations linked to holding an interest in a foreign financial account, aside from filing FBARs. These include checking the "yes" box on Schedule B (Interest and Ordinary Dividends) to Form 1040 (*U.S. Individual Income Tax Return*) to disclose the existence of the foreign account, identifying the specific foreign country in which the account is located, and declaring all passive income generated by the account, such as interest, dividends, and capital gains.[3] Moreover,

HALE E. SHEPPARD, Esq. (B.S., M.A., J.D., LL.M., LL.M.T.) is a Shareholder in the Tax Controversy Section of Chamberlain Hrdlicka.

taxpayers must execute their Forms 1040 in order for them to be valid. Many taxpayers are unaware that, by doing so, they are swearing under penalties of perjury that they have reviewed the entire Form 1040, including Schedule B containing the foreign-account questions, and everything is true, correct, and complete.[4]

B. Origins, Authority, and Penalties

Congress enacted the Bank Secrecy Act way back in 1970.[5] One purpose of the legislation was to require the filing of certain reports, like the FBAR, where doing so would be helpful to the U.S. government in carrying out criminal, tax, and regulatory investigations.[6] For many decades, the main problem was that few U.S. taxpayers filed FBARs, and they had little incentive to do so. Compliance was not rewarded, and violations generally went unpunished.[7] The government eventually took action to rectify the situation. Specifically, in 2003, the IRS gained authority to enforce the FBAR provisions.[8] It was empowered from that point forward to investigate potential violations, issue summonses, assess and collect penalties, issue administrative rulings, and take "any other action reasonably necessary."[9]

Congress increased the sanctions, too. Current law dictates that the IRS can impose a civil penalty on any person who fails to file an FBAR when required, period.[10] In the case of *non-willful* violations, the maximum penalty is $10,000.[11] The IRS asserts higher penalties where malevolent intent exists. In situations where a taxpayer *willfully* files a late, false, or incomplete FBAR, the IRS can mandate a penalty equal to $100,000 or 50 percent of the balance in the undisclosed account at the time of the violation, whichever amount is larger.[12]

If taxpayers do not voluntarily pay the penalties after the IRS assesses them, the Department of Justice ("DOJ") can start a collection action in federal court within two years.[13] This happens often.

C. Mitigation Guidelines

Cognizant of the potential for extreme FBAR penalties under the relevant law, the IRS took steps to moderate them in certain circumstances. It did so by introducing the so-called "Mitigation Guidelines," which apply to cases resolved after May 2015. The Mitigation Guidelines first appeared in an IRS Memorandum, and they were later incorporated into the Internal Revenue Manual.[14] The Mitigation Guidelines outline various levels of reduced penalties, for both willful and non-willful violations, depending on the situation.

The Mitigation Guidelines are not a given; the IRS emphasizes that they only apply where the following four conditions have been met. First, the taxpayer has no history of criminal tax or Bank Secrecy Act convictions during the preceding 10 years and no history of FBAR penalty assessments. Second, no money passing through any of the foreign accounts was from an illegal source or used to further a criminal purpose. Third, the taxpayer "cooperated" during the examination, which means, among other things, that the IRS was not obligated to issue a Summons to gather data, the taxpayer responded to reasonable requests for documents, meetings, and interviews, and the taxpayer eventually filed all required returns and FBARs. Finally, the IRS did not determine a fraud penalty against the taxpayer for failure to report income related to funds in a foreign account.[15]

III. Recent Case Centered on Mitigation Guidelines

The most recent case, focused on the Mitigation Guidelines, is *Mahyari and Malekzadeh*.[16] The basic facts in that judicial battle are as follows. The taxpayers, a married couple, were born and raised in Iran. They bought a residence there in the 1980s. They later moved to the United States, becoming U.S. citizens around 2006. After living in the United States for a few years, they decided to sell their residence back in Iran. They did so in 2011, first depositing the sales proceeds in an account in Iran. It appears that the taxpayers subsequently accessed those funds in two ways. They sent some of the money by wire transfer directly to the United States. They sent the remainder to an account in Canada, which they then used to purchase precious metals and have them shipped to their home in the United States. The taxpayers never filed FBARs disclosing the Iranian and Canadian accounts.

The court filings lacked detail, but it is evident that the IRS audited the taxpayers at some point and asserted FBAR penalties for the unreported Iranian and Canadian accounts in 2011, 2012, and 2013. The taxpayers did not pay the penalties, so the DOJ filed a collection lawsuit. The DOJ next filed a Motion with the District Court, asking it to hold that the FBAR violations, for all accounts and all years, were willful. The District Court largely agreed with the DOJ, but held that it was uncertain whether the violation regarding the Iranian account in 2011 was willful. The case proceeded to trial on that one narrow issue, with the jury ultimately deciding that the particular violation in question was non-willful. The District Court, therefore,

Wolters Kluwer

remanded the case to the IRS, asking it to recalculate the FBAR penalties, keeping in mind the jury's decision.

The IRS did so, and then the DOJ filed another Motion with the District Court, this time asking it to enter a final judgment based on the revised figures. The taxpayers opposed the Motion on two grounds. First, they maintained that the FBAR penalties were too high because the IRS should have calculated them using the Mitigation Guidelines. Second, they contended that the penalties were excessive because the IRS converted Iranian rials to U.S. dollars using an inappropriate conversion rate.

The District Court began by underscoring that the relevant statutes grant the IRS broad discretion in applying FBAR penalties and that they could only be set aside by a court in situations where taxpayers can demonstrate that the IRS acted arbitrarily, capriciously, or abusively. It further explained that an agency, like the IRS, only needs to "articulate a satisfactory explanation" and provide a "rational connection" between the facts and its actions. The District Court also emphasized that actions by the IRS are only improper if it relied on factors that Congress did not intend it to consider, completely failed to address a key factor, presented an explanation that is inconsistent with the evidence presented, or came to a conclusion that is so implausible that it cannot be attributed to a difference in view. Lastly, the District Court pointed out that any determination by the IRS is entitled to a legal presumption of correctness, and courts do not have the right to simply replace the IRS' judgment with their own. With that high standard laid out, the District Court turned to the specific matters in the case at hand.

The first issue was whether the taxpayers were entitled to favorable FBAR penalty treatment under the Mitigation Guidelines. The District Court repeated the four eligibility standards, noting that the taxpayers and DOJ were squabbling over just one: Whether the taxpayers had "cooperated" during the audit. The DOJ claimed that the taxpayers did not sufficiently cooperate because they failed to disclose all their foreign accounts on several occasions, they never filed late FBARs for one of the accounts, and they did not supply the IRS with copies of bank statements for the Iranian account. The District Court agreed with the DOJ for several reasons, holding that the IRS had a "rational, reasoned basis" for not applying the Mitigation Guidelines. For example, the taxpayers first told the Revenue Agent that they held no foreign accounts, then changed their story to say they only had an Iranian account, and, after multiple meetings, they finally admitted that they had unreported accounts in both Iran and Canada. Moreover, the FBARs that the taxpayers submitted to the Revenue Agent two years into the audit process omitted the account in Canada. The District Court also held that the failure to supply statements for the Iranian account should be held against the taxpayers, despite the unique circumstances. The records show that the taxpayers sent the Iranian bank an email requesting copies of the relevant statements, but they could not obtain them electronically because the bank had a policy of providing statements only to clients who personally appeared. The District Court addressed this conundrum by underscoring that the "cooperation" includes responding to all reasonable requests for documentation and explaining that the IRS was forced to reconstruct account balances to calculate the penalties. Anticipating possible criticisms, the District Court noted the following:

> Even if it were unreasonable for the IRS to require [the taxpayers] to make further efforts to obtain account statements from their Iranian bank, the IRS has stated two other independent reasons to justify that [the taxpayers] did not comply with the [Mitigation Guidelines]. Therefore, any assumed error [by the District Court] would be harmless.[17]

The second issue was about currency conservation, namely, whether the use by the IRS of the International Monetary Fund ("IMF") exchange rate was acceptable. The District Court recognized that the IRS used the IMF rate, instead of the normal Treasury Reporting Rates of Exchange, for three reasons. The IMF rate was closer to the actual exchange rate obtained by the taxpayers, the IMF rate benefited the taxpayers by reaching a lower penalty amount, and Treasury Reporting Rates of Exchange did not change or otherwise get updated during the relevant three years. The taxpayers argued that the IRS should have utilized the "black market exchange rate" because of the "unique economic environment" in Iran. The District Court declined the alternative method suggested by the taxpayers because the IRS has broad discretion in FBAR penalty matters, it supplied a "rational basis" and "reasonable justification" for using the IMF rate, its decision was not arbitrary or capricious, and the materials presented by the taxpayers, including a website and some scholarly articles, were unpersuasive.

For the reasons discussed above, the District Court granted the Motion filed by the DOJ, thereby obligating the taxpayers to pay the revised FBAR penalty amounts.

Wolters Kluwer

IV. Comments About Cooperation in Other Contexts

The lack of cooperation by the taxpayers in *Mahyari and Malekzadeh* resulted in higher FBAR penalties, but that is not the end of the matter. Indeed, savvy taxpayers and their advisors should be asking themselves several questions, including these: What does the concept of "cooperating" mean in different contexts? What advantages can taxpayers obtain by meeting this definition? These issues are examined below.

A. Stopping the IRS from Relying on Information Returns

The IRS generally is authorized to conduct audits, make determinations, and assess taxes, penalties, and interest.[18] In carrying out its job, the IRS relies on many tools, including information returns that payors must send to both the taxpayer receiving the payment and the IRS.

Every person engaged in a trade or business must file an information return, such as a Form 1099-MISC (*Miscellaneous Income*), for payments made to another person in the course of such trade or business that exceed a certain threshold in any year.[19] The IRS uses information returns in its automated-audit program, which is the IRS' primary enforcement tool in dealing with individual taxpayers. The IRS compares the data on Forms 1099 to the figures shown on Forms 1040 filed by taxpayers. When mismatches appear, the IRS manually screens the data and then sends the taxpayer a notice asking him or her to justify the inconsistency or pay the tax liability.[20]

The Internal Revenue Code has a provision designed to protect taxpayers from problems caused by inaccurate or malicious information returns filed by others, Code Sec. 6201. It states the following:

> In any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed ... by a third party *and the taxpayer has fully cooperated with the [IRS] (including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer as reasonably requested by the [IRS])*, the [IRS] shall have the burden of producing reasonable and probative information concerning such deficiency in addition to such information return.[21]

In short, if the taxpayer presents a "reasonable dispute" during a court proceeding about any income that he allegedly received based solely on an information return filed with the IRS, and if the taxpayer can show that he "fully cooperated" with the IRS during the audit process, then the responsibility shifts to the IRS to offer evidence to the court, aside from the information return, that the taxpayer received the income.

This concept has been addressed in various cases, the most famous of which is *Portillo*.[22] In that case, Navarro, a contractor, issued a Form 1099 for 1984 reporting the payments that he supposedly made to Portillo, a painting subcontractor who conducted his affairs primarily in cash. Portillo filed his Form 1040, reporting, among other things, the amount he believed that he had received from Navarro. The figures presented by Navarro and Portillo did not match. The IRS began an audit at some point and concluded that Portillo had omitted certain income on his Form 1040. Portillo denied this allegation.

At trial, Navarro stated that Portillo performed work for him in 1984. Navarro said that he computed the amount reported on Form 1099 from his records, which were later discarded. Navarro also testified that he paid Portillo both in cash and by check. The Tax Court found Navarro's testimony reliable and credible, and Portillo's contention that he received no additional cash payments from Navarro unpersuasive. Thus, the Tax Court upheld the Notice of Deficiency issued by the IRS.

Portillo sought review by the Fifth Circuit Court of Appeals. It stated that the IRS merely matched Form 1099 with Form 1040 and arbitrarily decided to attribute veracity to Navarro and falsity to Portillo. It also stated that, in this situation, the IRS had a duty to investigate Navarro's "bald" assertion of payment and determine if its position was supported by books, receipts, or other records. It found that the IRS' determination that Portillo had received unreported income was, in effect, "naked" because it lacked factual foundation.

Because the IRS failed to substantiate the supposed income by any other means, the Court of Appeals held that the presumption of correctness did *not* apply to the Notice of Deficiency.[23] Concluding that the Notice of Deficiency was arbitrary and erroneous, the Court of Appeals reversed the earlier judgment of the Tax Court regarding unreported income.

B. Shifting the Burden of Proof to the IRS

Generally, there is a presumption in federal tax disputes that determinations made by the IRS during an audit are correct.[24] There are exceptions to this principle, of course. Code Sec. 7491 provides that if a taxpayer introduces

"credible evidence" in a court proceeding with respect to any factual issue relevant to ascertaining certain tax liabilities, then the burden of proving such issue switches to the IRS.[25] Importantly, the preceding general rule only applies where (i) the taxpayer has complied with all applicable substantiation and record-keeping requirements, (ii) the taxpayer has "cooperated with reasonable requests by the [IRS] for witnesses, information, documents, meetings, and interviews," and (iii) taxpayers, other than individuals, must have a net worth below a certain threshold.[26]

The legislative history of Code Sec. 7491 illuminates the significance of "cooperation" in this context. One congressional report broadly defines the obligations of taxpayers. It indicates that they must cooperate with all reasonable requests by the IRS for meetings, interviews, witnesses, information, and documents. Additionally, they must provide reasonable assistance to the IRS in accessing items that are not within the control of the taxpayers, including items located in foreign countries. Taxpayers also must exhaust all administrative remedies available, among them addressing issues with the Appeals Office. Cooperation further involves taxpayers demonstrating the applicability of any privilege cited for not supplying requested materials to the IRS. Finally, taxpayers need to submit English translations of documents, if necessary.[27]

C. Recouping Fees from the IRS

Generally, Code Sec. 7430 provides that the "prevailing party" in any administrative proceeding before the IRS, or in any litigation brought by or against the government in connection with taxes, penalties, or interest, may be awarded reasonable costs.[28] Recoverable administrative costs can include legal fees, expenses for expert witnesses, and costs for studies, analyses, reports, tests, or projects necessary for the preparation of the taxpayer's case.[29] Litigation costs for which the taxpayer may seek reimbursement follow similar guidelines.[30]

The term "prevailing party" generally means the one that has "substantially prevailed" with respect to either the amount in controversy or the most significant issues presented and has a net worth that does not exceed the statutory thresholds.[31] Even if a taxpayer substantially prevails and meets the net worth requirement, he still cannot recover costs from the government unless other hurdles are overcome. For example, the taxpayer must have exhausted all administrative remedies available within the IRS.[32] To preserve eligibility for fee recoupment, the taxpayer also cannot "unreasonably protract" the proceedings.[33] Lastly, the taxpayer will not be deemed the "prevailing party" if the government establishes that his position was "substantially justified."[34] In other words, if the government manages to prove that the position it took during the battle was substantially justified, then the taxpayer is precluded from recovering costs. The regulations explain that the government's position is substantially justified only if it has a reasonable basis in both fact and law.[35] A significant factor in making this determination is whether the taxpayer presented all the relevant information under his control to the appropriate IRS personnel.[36] The regulations do not specifically use the term "cooperation" here, but requiring taxpayers to exhaust administrative remedies, not cause delays, and present all relevant information to the IRS is akin to cooperation.

The point of this article is to remind taxpayers that cooperation means different things in different contexts, varying degrees of cooperation exist, there are advantages and disadvantages to cooperating, and, most importantly, taxpayers should be aware of these issues and others before making important procedural decisions during an IRS dispute.

D. Acquiring Worker-Classification Relief

The IRS commonly audits companies and then concludes that certain workers, who were treated as independent contractors, should have been characterized as employees and subjected to all employment taxes and filing obligations. When this occurs, knowledgeable companies rely on so-called "Section 530."[37] The company that satisfies all the criteria necessary to warrant Section 530 relief obtains two major benefits. First, the IRS may not assess any back employment taxes, penalties, or interest charges against the company. Second, and perhaps more importantly, the IRS cannot obligate the company to reclassify the workers as employees going forward, regardless of the fact that applicable law supports reclassification. The company gets a free pass, if you will, for past *and* future behavior, if it can prove that Section 530 applies.[38]

Section 530 is a self-fulfilling prophecy in a sense. It provides that if a company treated a worker as an

Wolters Kluwer

independent contractor for certain tax periods, then the worker *shall* be deemed to be an independent contractor for such periods, provided that the company (i) filed federal tax and information returns as if the worker were an independent contractor, (ii) characterized *all* workers holding substantially similar positions the same way, and (iii) had a "reasonable basis" for its actions.[39] On the last point, if a company establishes a *prima facie* case that it was reasonable to treat the workers as independent contractors, and the company "fully cooperated" during the audit, then the burden of proof with respect to the classification issue shifts to the IRS at trial.[40]

V. Conclusion

Is this article suggesting that taxpayers allow the IRS to run roughshod over them during tax disputes? No. Is it recommending that taxpayers cooperate with the IRS to such a degree that it is detrimental to their position, timing, or strategy? Absolutely not. The point of this article is to remind taxpayers that cooperation means different things in different contexts, varying degrees of cooperation exist, there are advantages and disadvantages to cooperating, and, most importantly, taxpayers should be aware of these issues and others before making important procedural decisions during an IRS dispute.

ENDNOTES

* Hale specializes in tax audits, tax appeals, and tax litigation. You can reach Hale by phone at (404) 658-5441 or by email at *hale.sheppard@chamberlainlaw.com*.

1 This article builds upon an earlier one by the same author. *See* Hale E. Sheppard, *Clarifying Misconceptions about Extending Assessment Periods and "Cooperating" during IRS Audits*, 21, 4 J. TAX PRACT. PROCEDURE 41 (2019); republished in 98, 1 TAXES 37 (2020).

2 31 USC §5314; 31 CFR §1010.350(a).

3 Code Sec. 61(a); Reg. §1.61-1(a). In addition to these duties, taxpayers holding foreign financial accounts *after* 2011 generally must report them on Form 8938 (*Statement of Specified Foreign Financial Assets*). *See* Hale E. Sheppard, *Form 8938 and Foreign Financial Assets: A Comprehensive Analysis of the Reporting Rules after IRS Issues Final Regulations*, 41, 2 INT'L TAX J. 25 (2015).

4 Form 1040 (*U.S. Individual Income Tax Return*) for 2023, pg. 2.

5 Pub. L. No. 91-508, Title I and Title II (Oct. 26, 1970). This law is known as the Currency and Foreign Transactions Reporting Act.

6 Pub. L. No. 91-508, Title I and Title II (Oct. 26, 1970) at §202.

7 U.S. Treasury Department. A Report to Congress in Accordance with §361(b) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (Apr. 26, 2002), pgs. 9 and 10.

8 68 FR 26489 (May 16, 2003).

9 31 C.F.R. §103.56(g), 68 Fed. Reg. FR 26489 (May 16, 2003).

10 31 USC §5321(a)(5)(A).

11 31 USC §5321(a)(5)(B)(i). The IRS cannot assert this penalty if the FBAR violation was not only "non-willful," but also due to "reasonable cause." *See* 31 USC §5321(a)(5)(B)(ii).

12 31 USC §5321(a)(5)(C)(i).

13 31 USC §5314, 31 USC §5321(a)(5)(A), and 31 USC §5321(b)(2).

14 IRS Memorandum SBSE-04-0515-0025 (May 13, 2015); IRM 4.26.16 (Jun. 24, 2021); IRM 4.26.17 (Nov. 22, 2021).

15 IRM 4.26.16.6.6.1 (Nov. 06, 2015); IRM Exhibit 4.26.16-2 (Jun. 24, 2021).

16 *Mahyari and Malekzadeh*, U.S. District Court, Oregon, Case No. 3:20-cv-01887, Opinion and Order (Feb. 1, 2024); Andrew Valverde, *Iranian-American Couple's Non-Cooperation Sinks FBAR Mitigation*, 2024 TAX NOTES TODAY INT'L 24-1 (Feb. 5, 2024).

17 *Mahyari and Malekzadeh*, U.S. District Court, Oregon, Case No. 3:20-cv-01887, Opinion and Order (Feb. 1, 2024), pg. 9, footnote 2.

18 Code Sec. 6201(a).

19 Code Sec. 6041.

20 *See* IRM 5.18.1.5.11.14 (Apr. 6, 2016).

21 Code Sec. 6201(d) (emphasis added); *See also* Joint Committee on Taxation, Description of Amendment in the Nature of a Substitute to H.R. 2337, Taxpayer Bill of Rights 2, JCX-7-96, Mar. 20, 1996, pgs. 12 and 13; U.S. House of Representatives, Taxpayer Bill of Rights 2, Report 104-506, 104th Cong., 2d Session, Mar. 28, 1996, pg. 36.

22 *R. Portillo*, CA-5, 91-2 USTC ¶50,304, 932 F2d 1128 (1991).

23 *R. Portillo*, CA-5, 91-2 USTC ¶50,304, 932 F2d 1128, 1134 (1991).

24 Tax Court Rule 142(a)(1).

25 Code Sec. 7491(a)(1); *see also* Philip N. Jones, *The Burden of Proof: The Tax Court Responds to the Eighth Circuit's Directive*, 100 J. TAX'N 243 (Apr. 2004); Joni Larson, *Burden of Proof in the Tax Court after the IRS Restructuring and Reform Act of 1998 and Shea v. Commissioner*, 36 GONZAGA LAW REV. 49 (2000/2001); Adriana Wos-Mysliwiec, *The Internal Revenue Restructuring and Reform Act of 1998: Does It Really Shift the Burden of Proof to the IRS?* 14 ST. JOHN'S J. LEGAL COMMENTARY 301 (Fall 1999); David A. Baker and William R. Franzen, *20,000 Litigants and 2 Million Audits: The True Impact of Shifting the Burden of Proof*, 13 PROBATE AND PROPERTY 45 (Mar./Apr. 1999); Lisa M. Ivancic and Richard E Coppage, *Taxpayers Remain Burdened Despite Shifted Burden of Proof*, 62 PRACT. TAX STRATEGIES 284 (May 1999).

26 Code Sec. 7491(a)(2).

27 U.S. Senate, Internal Revenue Service Restructuring and Reform Act of 1998, Report 105-174, 105th Congress, 2nd Session, April 22, 1998, pgs. 45 and 46.

28 Code Sec. 7430(a).

29 Code Sec. 7430(c)(2).

30 Code Sec. 7430(c)(1).

31 Code Sec. 7430(c)(4)(A).

32 Code Sec. 7430(b)(1); CCA 200919037 (May 8, 2009).

33 Code Sec. 7430(b)(3).

34 Code Sec. 7430(c)(4)(B)(i).

35 Reg. §301.7430-5(c)(1).

36 Reg. §301.7430-5(c)(1); Reg. §301.7430-5(h) Ex. 1.

37 Public Law 95-600.

38 Section 530(a)(1).

39 Section 530(a)(1); Rev. Proc. 85-18.

40 Section 530(e)(4)(A); S. Rep. 104-281, 104th Cong., 2nd Sess., 26 (1996).

© Wolters Kluwer

This article is reprinted with the publisher's permission from JOURNAL OF TAX PRACTICE & PROCEDURE, a quarterly journal published by CCH Incorporated. Copying or distribution without the publisher's permission is prohibited. To subscribe to JOURNAL OF TAX PRACTICE & PROCEDURE or other journals, please call 1-800-344-3734. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.