

Tax Practice & Procedures

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IRS Practice and Procedures Committee Update

The IRS Practice and Procedures Committee held its semiannual meeting with executives of the Internal Revenue Service at the AICPA offices in Washington, DC, on May 18 and 19, 2009. Attendees from the IRS were Chris Wagner, commissioner of the Small Business/Self Employed Division (SB/SE); Steve Miller, commissioner of the Large and Mid-Size Business Division (LMSB), along with Paul DeNard, deputy commissioner; Doug O'Donnell, director of International Operations; Rick Byrd, commissioner of the Wage and Investment Division (W&I), along with Doreen Viglione; Sarah Hall Ingram, commissioner of the Tax Exempt/Government Entities Division (TE/GE), along with Joseph Grant, deputy commissioner; Diane Ryan, chief of appeals; Nina Olson, taxpayer advocate; Floyd Williams III, director of the Office of Legislative Affairs; and David Williams, director of Electronic Tax Administration.

Each of the IRS executives made a brief statement updating the committee on what is happening within their various divisions. This was followed by a dia-

logue with the committee members on a number of issues. Committee members presented issues based on experiences they and other AICPA members have had.

IRS Issues

The most common theme discussed across the various divisions of the IRS was the current economic climate in the United States. Collection problems are increasing along with bankruptcies. Offer in compromise requests and installment agreements are becoming more common. The IRS expressed concern over the increased defaults in installment agreements. The Service is trying to work with taxpayers in an effort to understand their difficult financial circumstances while making sure the government is collecting taxes due. The employment tax area has received increased focus, not only in collections but also with compliance examinations. The worker classification issue is alive and well.

High-income and high-wealth taxpayers are coming under additional scrutiny. Compliance examinations are on the increase, as are examinations of flowthrough entities. Taxpayers, especially

high-wealth individuals, are increasingly using flowthrough entities and multiple entities to siphon off income before it becomes a part of the individual's tax return. Specialty flowthrough examination groups have been set up and trained in the SB/SE and LMSB areas, with their primary focus on the misuse of these types of entities.

Abusive transactions continue to be of major concern. There has been an increase in offshore transactions as well as new abusive domestic schemes. The IRS has specially trained agents "surfing the web" looking for solicitations and descriptions of new and questionable transactions.

Globalization is an increasing challenge. More and more entities do business overseas and are setting up operations overseas. This leads to compliance issues related to whether the government is getting its proper share of tax. An issue the IRS is trying to plan for is the accounting problems that will be encountered when GAAP is replaced by IFRS. The Internal Revenue Code is based largely on GAAP, which will present differences after the switch to IFRS.

Committee Concerns

The committee took the opportunity to discuss a number of troubling areas, including audit reconsiderations, misuse and lack of consistency in the application of penalties and correspondence examinations, and overreaching information document requests (IDR). IDRs are supposed to be focused on individual exams, but it was noted that many agents are asking for more documents than appear to be required.

The Service finally received its budget in February 2009, which included new hiring authorizations. Because of the late date, the IRS divisions are cooperating with one another to hire and train new agents. They are finding that with the current state of the economy, applications from individuals with substantial private sector experience are on the increase. That could present savings in training and result in having the new agents in the field sooner than expected.

The IRS Practice and Procedures Committee is a tool for all members of the AICPA to use whenever they see a

systemic problem (or problems) with the IRS. All members are encouraged to make use of it.

From Lawrence Carlton, CPA, Bedford, MA

Interest-Free Period Under Sec. 6601(c)

Tax professionals are generally aware that a taxpayer must pay interest on any underpayment of tax. The IRS collects interest for the time the taxpayer has the use of the government's money, so interest generally accrues from the date the tax was to be paid until the taxpayer actually pays the tax. The underpayment interest rate charged to the taxpayer is equal to the federal short-term rate plus three percentage points (Sec. 6621(a)(2)). In the case of certain large corporate underpayments, a special "hot interest" rate equal to the federal short-term interest rate plus five percentage points applies (Sec. 6621(c)).

Although the federal short-term rate is currently low, underpayment interest can still accumulate to a significant dollar amount. Moreover, interest computations can be very complex, which can lead to errors in the amount of interest a taxpayer is charged. Therefore, tax professionals should review IRS interest computations to determine that the Service has used the correct interest rates, properly included all payments of tax, and charged interest for the correct period of time. As to making sure the IRS has charged interest for the correct period of time, the Service recently provided some guidance on when underpayment interest is suspended under Sec. 6601(c).

Suspension of Underpayment Interest Under Sec. 6601(c)

Sec. 6601(a) provides generally that if a taxpayer does not pay an amount of tax on or before the date prescribed for payment, interest shall be paid for the period from the due date to the date of payment. Sec. 6601(c) provides that

in the case of a deficiency as defined by section 6211, if a waiver of restrictions under section 6213(d) on the assessment

of the deficiency has been filed, and if notice and demand . . . for payment of such deficiency is not made within 30 days after the filing of such waiver, interest shall not be imposed on such deficiency for the period beginning immediately after such 30th day and ending with the date of notice and demand.

Interest is also not imposed during this period on any interest that may have previously accrued on the deficiency.

IRS Program Manager Technical Assistance

The IRS issued program manager technical assistance (PMTA 2009-003 (1/6/09)) in response to a question concerning the application of Sec. 6601(c) in the case of a taxpayer that closed a delinquent return filing investigation with the submission of a delinquent return, rather than the execution of a Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, or other consent to assessment. In the usual TDI (taxpayer delinquency inquiry), a taxpayer fails to file a return. Third-party information reports suggest that the taxpayer has received income and would owe a tax. Accordingly, the IRS sends an inquiry letter to the taxpayer stating that it has not received a federal income tax return and requesting the taxpayer to file the delinquent tax return.

If the taxpayer fails to respond to the inquiry letter, the IRS initiates an examination to determine the taxpayer's income tax liability. Following the procedures set forth in Regs. Sec. 301.6020-1, the IRS examiner prepares a tax return during the course of the examination (as authorized by Sec. 6020(b)) and asks the taxpayer to sign the prepared tax return. The examiner may offer a taxpayer a Form 870 or other form consenting to the assessment of the tax liability rather than being requested to sign the prepared tax return.

PMTA 2009-003 concluded that the interest-free period provided by Sec. 6601(c) does not apply when the taxpayer closes a delinquency investigation by submitting a return. In the PMTA, the IRS addressed a perception that an

unfair discrepancy exists between taxpayers that file returns and taxpayers that agree to execute a consent at the conclusion of the TDI. The perceived unfair discrepancy was that taxpayers agreeing to execute a Form 870 or other form consenting to the assessment of the tax liability at the conclusion of the TDI may benefit from the application of Sec. 6601(c) while a taxpayer signing a return could not benefit from the suspension period.

In PMTA 2009-003, the IRS disagreed with the idea that Sec. 6601(c) should apply at the conclusion of a TDI whether the taxpayer signed a tax return prepared by the Service or signed a consent to the assessment of tax. The PMTA noted that Sec. 6601(c) exists to encourage the Service to promptly process consents to assess tax and that when a taxpayer executes a Form 870 or other consent to assess a deficiency, the interest-free period provided by Sec. 6601(c) applies only to the period described in Sec. 6601(c). By statute, interest is not imposed if the notice and demand for payment of the deficiency agreed to in the consent have not been issued within 30 days after the execution of the consent.

PMTA 2009-003 also noted that a taxpayer's execution of a Form 870 is not the legal equivalent of filing a return. The PMTA discussed a number of differences between a tax return and a Form 870, including:

- A return has the effect of commencing the running of the periods of limitations and collection;
- It meets the requirement that the taxpayer file a written claim for refund if the taxpayer is entitled to a refund; and
- It allows the accrual period for the failure-to-file penalty to come to an end.

When a taxpayer executes a Form 870, the taxpayer agrees to the immediate assessment and collection of the agreed-upon tax liability. The taxpayer also waives its right to contest the deficiency in Tax Court. A taxpayer that executes a Form 870 does not surrender the right to contest the assessment altogether. The taxpayer may obtain judicial review in a federal district court or the claims court by way of a refund suit, but the taxpayer must first pay the amount of the

assessment, file a claim for refund, and institute the action within the statutory period.

Additional Considerations

When reviewing interest computations for clients, tax professionals should review the IRS interest computations to ensure the IRS has applied interest suspension rules under Sec. 6601(c) if applicable. As stated above, a taxpayer is relieved of the obligation to pay underpayment interest where:

- There is a deficiency;
- The taxpayer files a waiver of restrictions on assessment; and
- The IRS fails to issue a notice and demand within 30 days after the filing of the waiver.

The period during which no underpayment interest is paid starts immediately after the 30th day and ends on the date of the notice and demand.

The interest suspension rules under Sec. 6601(c) are not limited in application to delinquent return filing investigations. At the conclusion of most tax return examinations, if the Service has proposed adjustments, it has been the practice of revenue agents to seek a waiver. A waiver can be made by executing and filing Form 870 or it can be made on a Form 870-AD, Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment, but it is not effective until accepted by the IRS, thereby deferring any termination of interest under Sec. 6601(c). Similarly, a Form 870 conditioned on execution of a closing agreement is not effective until the closing agreement is executed.

Once an executed waiver is effective, if the Service fails to make notice and demand for payment of such deficiency within 30 days after the filing of such waiver, the interest suspension provision under Sec. 6601(c) applies. As an example, assume the IRS determines that a taxpayer has a deficiency in income tax for 2007 and files a waiver on June 1, 2008. The IRS issues a notice and demand to the taxpayer on December 1, 2008. Under Sec. 6621(c), the taxpayer is relieved from paying:

- Underpayment interest on the deficiency for the period July 2, 2008–December 1, 2008; and

- Compound interest for the period July 2, 2008–December 1, 2008, on the interest accrued as of July 2, 2008.

From John Keenan, J.D., and Vibhuti Patel, J.D., Deloitte Tax LLP, Washington, DC

This article does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.

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

In the second of a two-part piece, this item outlines the recommendations of Nina Olson, the national taxpayer advocate, for legislative reforms to the Code as presented in her annual report to Congress. Part I, in the July issue, recapped Olson's recommended changes within the IRS.

Legislative Recommendations

The main message of the national taxpayer advocate's legislative recommendations is "Simplify." Olson requested the repeal of the alternative minimum tax (77% of the additional income subject to the AMT stems from the disallowance of dependency deductions and state and local taxes) and the elimination or reduction of sunset provisions and phaseouts that hinder tax planning, including the misestimation of interim tax payment requirements. These simplifications could be offset with higher marginal tax rates.

She then recommended that Congress simplify existing portions of the Internal Revenue Code in which several disjointed tax treatment choices are available to individuals. For example, the numerous family status provisions could be simplified by consolidating them into two categories: (1) a refundable family credit to reflect the costs of maintaining a household and raising a family and (2) a refundable worker credit as an incentive for low-income individuals to work. The 11 education tax incentives could be simplified by uniformly defining common terms, income-level thresholds, phaseout ranges, and inflation

adjustments across provisions. The 16 retirement tax incentives could be streamlined by uniformly establishing eligibility rules, contribution limits, taxation of contributions and distributions, withdrawals, loan availability, and portability. The numerous pension plan provisions could be consolidated into a single retirement plan for each of three categories: individual taxpayers, plans offered by small businesses, and plans offered by large businesses. (Plans for government agencies would conform to either the second or third category, depending upon their size.)

In addition, Congress could simplify the treatment of cancellation of debt. Financially distressed individuals are often unaware that cancellation of debt income (CODI) can increase their tax liability. While exceptions exist, reporting under an exception is complex and requires filing Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), with the tax return (a form with which many tax preparers are unfamiliar). Hence, some taxpayers unnecessarily include canceled debt in gross income, and others who fail to include excepted income face unnecessary exams and assessments. Olson's main recommendation in this area is to change the law to provide that CODI is not includible in gross income unless the total amount of CODI attributable to the taxpayer from all sources exceeds a certain threshold for the tax year.

The problem in distinguishing between independent contractor and employee status also needs to be addressed. Olson recommends:

- Replacing Section 530 with a provision applicable to both employment and income taxes with corresponding industry guidance;
- Developing an electronic tool that employers could rely on to determine worker classification;
- Allowing both employers and employees to request classification redetermination; and
- Additional IRS outreach campaigns to increase awareness of the rules.

Two additional law changes are recommended: (1) allowing self-employed

10 Most Litigated Issues

1. Disputes over whether payments must be included in gross income, especially damage awards and foreign earned income
2. Appeals of collection due process, especially lien and levy actions
3. Contest of IRS summons of books and records
4. Trade or business expenses
5. Accuracy-related penalty
6. Civil damages for unauthorized collection actions
7. Failure-to-file penalty and estimated tax penalty
8. Relief from joint and several liability for spouses due to procedural issues, taxpayer knowledge, and, in declining numbers, jurisdictional issues
9. Frivolous issues penalty
10. Family status issues

Note: Ten tax issues most litigated in federal court, as identified by the National Taxpayer Advocate in her 2008 Annual Report to Congress.

health insurance premiums to be a deduction for AGI on Schedule C, which reduces self-employment taxes and is consistent with the treatment of insured wage-earning taxpayers, and (2) allowing the amount of charitable mileage deduction to be set by the IRS rather than by the Code, consistent with the setting of the standard mileage allotment for business expenses.

Olson recommends 11 common-sense penalty reforms as a starting point for simplifying the 130+ civil tax penalties, and she emphasizes a legislative need to temper Sec. 6707A, which requires that a penalty *must* be imposed where a taxpayer fails to make disclosures of listed transactions. This stiff penalty is particularly a problem in cases in which the taxpayer derives no tax savings from the transaction or is unaware the transaction is listed, or the transaction was initially not listed and the initial return was properly filed before the transaction was subsequently retroactively listed. Olson requests that Congress modify the tax law to allow the IRS to (partially) abate this \$100,000 (or more) penalty to be proportional to the amount of tax savings realized, lest the penalty, in itself, bankrupt some middle-class families. (In July 2009, Commissioner Douglas Shulman notified Congress that the IRS was suspending collection enforcement activities in cases where benefits from a listed transaction are less than \$100,000 for individuals or \$200,000 for other taxpayers in order to give Congress time to enact legislation modifying the penalty. However,

this suspension was scheduled to run only through September 30.)

Olson strongly recommends that Congress provide an exception to Rev. Rul. 2007-51, whereby the IRS may reduce refunds and credit carryback adjustments to satisfy unassessed tax liabilities. Allowing this ruling to remain intact allows collection prior to assessment, at least from corporations, which would appear to undermine the taxpayer's right under Sec. 6212 to challenge a proposed deficiency prior to assessment.

Olson also recommends several legislative proposals that would change the way the IRS interacts with taxpayers and their representatives. These proposals include:

- Enabling more flexible tax refund delivery options, including the use of stored value cards for taxpayers without bank accounts;
 - Forbidding pressure from the IRS on taxpayers to waive their levy rights as a condition of accepting a taxpayer's offer in compromise or installment agreement; and
 - Allowing the mailing of duplicate notices to credible alternate addresses in cases in which taxpayers have moved but have not yet notified the federal government or the U.S. postal service.
- She also recommends that Congress regulate unenrolled federal tax return preparers through registration, examination, certification, and enforcement programs.

The problems in our tax system for which the national taxpayer advocate recommends legislative action range from

severe and possibly constitutional in nature to common sense. Some additional recommendations, such as the termination of private debt collection practices, have already been announced and implemented as of this writing. In addition, Olson recommended several substantive changes within the IRS organization outlined in the last Tax Practice and Procedures column, on p. 483 of the July 2009 issue. The full text of the national taxpayer advocate's report is available at www.irs.gov/advocate/article/0,,id=202276,00.html.

From Valrie Chambers, Ph.D., CPA

Estimates and the *Cohan* Rule

When dealing with clients who have incomplete records, return preparers are frequently forced to use estimates whether they want to or not. A recent Fifth Circuit decision that a district court should consider estimates—using the *Cohan* rule as guidance—when taxpayer records do not strictly comply with the Sec. 41 research credit regulations serves as a reminder that practitioners also have a responsibility to clients to consider estimates while preparing many tax filings.

In *McFerrin*, No. 08-20377 (5th Cir. 6/9/09), the taxpayer owned several S corporations. McFerrin was a well-known and respected chemical engineer. For the 1999 tax year, McFerrin's companies did not claim an R&D tax credit but later filed amended returns that included the credit. The IRS issued a refund but later sued McFerrin for return of the refund on the grounds that McFerrin was not entitled to the credit and that it had issued the refund erroneously.

The IRS argued that even if McFerrin had incurred creditable expenses, he was not entitled to the credit because he had failed to substantiate his claim. The parties agreed that McFerrin had not strictly complied with the record-keeping requirements under Regs. Sec. 1.41-4 (despite producing nearly 70 boxes of records). The Fifth Circuit held that under the *Cohan* rule, "if a qualified expense occurred, . . . the court should estimate the expenses associated with those activities," despite the taxpayer's lack of substantiation.

The *Cohan* rule is based on a Second Circuit decision from 1930 in which George M. Cohan, a great entertainer but a lousy bookkeeper, claimed substantial travel and entertainment expenses but could not provide adequate records (*Cohan*, 39 F.2d 540 (2d Cir. 1930)). Today, Cohan would lose this battle because the Code has been amended by the addition of Sec. 274(d), which requires substantiation for travel, entertainment, business gifts, and expenses with respect to listed property. Luckily for Cohan, his case predated those rules, and the Second Circuit held that he should be permitted to use estimates to establish his entitlement to business expense deductions.

The rule allowing deduction of expenses is based on the principle that if the IRS asserts a deficiency but other evidence clearly indicates that some deduction should be allowed, the court can develop its own estimate. However, relying on the *Cohan* rule is anything but certain.

In many cases the courts have refused to apply the rule. For instance, in *Sam Kong Fashions, Inc.*, T.C. Memo. 2005-15, the Tax Court concluded that the taxpayer could not use general income estimates when it had failed to keep adequate records to document its expenses. The Tax Court reached a similar conclusion in *Stewart*, T.C. Memo. 2005-212. In addition, the Tax Court would not allow estimates when taxpayer documents were destroyed by a wind and hail storm but the taxpayer failed to make efforts to reconstruct the records (*Harlan*, T.C. Memo. 1995-309). While not impossible to meet, the taxpayer burden remains high in missing record cases.

Because taxpayers relying upon the *Cohan* rule frequently lose, this makes the use of estimates a very difficult decision for preparers. The Fifth Circuit said the district court should have used estimates, with no mention of whether the return preparer should have considered estimates. This leaves preparers uncertain about their authority to use estimates when the client's records do not strictly adhere to the regulation requirements.

There is some support in the regulations for taxpayers' use of estimates. For



instance, when records are missing or incomplete, Temp. Regs. Sec. 1.274-5T(c) (3) allows substantiation by other means, subject to IRS approval. Granted, this means the taxpayer is at the mercy of the Service, but a reasonable interpretation of the rules suggests that the Service should not be arbitrary in using its authority.

Tax preparers face sanctions for improperly using estimates, including the penalties under Sec. 6694 (understatement of taxpayer's liability by tax return preparer), Sec. 6695 (miscellaneous preparer penalties), Sec. 7407 (action to enjoin tax return preparers), and other sections. These penalties require the preparer to make a professional call as to when, if ever, estimates may be relied upon in an original return for reporting purposes and what, if any, added disclosures are required.

For instance, is a Form 8275, Disclosure Statement, required if a preparer uses estimates and cannot strictly comply with record-keeping requirements under Regs. Sec. 1.41-2? The Fifth Circuit has held that the taxpayer is entitled to at least partial research credits if the taxpayer can prove that it incurred creditable expenses. What should the preparer do on original filings? Can a credit be claimed or should it be left off totally if a taxpayer does not have all the records required by the regulations? When does an estimate of income or deduction give rise to the need to attach a Form 8275 disclosing the use of an estimate?

When common sense dictates that the taxpayer had some expense (or credit) but strict compliance with documentation standards may not be possible, practitioners must use their professional judgment in deciding whether to use estimates. For

further guidance, CPAs should refer to AICPA Statement on Standards for Tax Services (SSTS) No. 4, *Use of Estimates*.
From Joseph D. Brophy, MBA, CPA/ABV, CVA, CM&AA

Making the Most of Qualified Offers

In June 2009, with the issuance of Chief Counsel Notice CC-2009-018, the IRS chief counsel updated internal procedures relating to awarding payment of representation and litigation costs awards where a taxpayer is the prevailing party in any court proceeding that determines tax or penalties under Sec. 7430. One little-used option for resolving tax issues while in IRS Appeals is to submit a qualified offer under Sec. 7430(g). Besides making the taxpayer eligible for an award of costs, the submission of a qualified offer will often focus the IRS's attention on the taxpayer's case and perhaps lead to an acceptable resolution.

The taxpayer has an option to make a qualified offer to settle a case while the case is still in Appeals. If the taxpayer is held to be the prevailing party in a subsequent court proceeding and is held liable to pay an amount equal to or less than the qualified offer amount, the federal government must pay the taxpayer's reasonable litigation fees. Reimbursable costs include costs of representation incurred by the taxpayer after the date of the offer.

Due to the potential litigation costs the government could incur, the IRS has amended its procedures to evaluate qualified offers. The IRS Appeals officer must refer any qualified offers he or she receives to an IRS field counsel. The IRS counsel will then transmit a copy of the offer to the IRS Procedure and Administration Branch for review and approval. If the field counsel believes the IRS should accept the offer, he or she must prepare a memorandum setting forth the reasons for accepting the offer. The field counsel must prepare a formal written acceptance or rejection of the qualified offer.

By submitting a qualified offer under Sec. 7430(g), a taxpayer can make sure that an issue that he or she considers of high significance now has the attention of

competent legal authorities within the IRS. What may have been a throwaway issue to an IRS Appeals officer now garners the attention of an attorney. The submission of the qualified offer to Appeals should be considered at the point when negotiations have reached an end. It is an appropriate method of resolving a case when the practitioner determines that the client should have received a more favorable outcome.

Before submitting a qualified offer, the practitioner should consider referring an unresolved case to the Appeals manager or perhaps the manager's supervisor for resolution of issues. In practice areas where a practitioner is likely to deal with a manager on a repeat basis, the practitioner may wish to consider the potential for later retribution before referring the matter to the manager's supervisor. Referring the matter to the Appeals manager for review is the primary remedy for improper processes within Appeals.

The qualified offer must meet specified criteria governing the applicant and the application. The individual applicant must have a net worth of less than \$2 million (\$4 million for a joint return), and businesses are restricted to a net worth of \$7 million. The applicant must have exhausted his or her administrative remedies. The taxpayer must make the offer during the qualified offer period, which begins when the first letter of the proposed deficiency is sent and ends 30 days before the case is scheduled for trial. The taxpayer may make multiple offers; however, any new offer will supersede the prior offer.

The qualified offer must clearly state that it is being made for purposes of Sec. 7430(g). The amount of the offer must be one that would fully satisfy the tax liability. The taxpayer can express the offer as a dollar amount or as a percentage of the proposed adjustment. The specific requirements for making a qualified offer are in Regs. Sec. 301.7430-7.

While most contacts with Appeals satisfy the taxpayer's rights to an independent review, not all Appeals cases result in a satisfactory outcome. Appeals officers may rely on their instructions to "decline to settle some cases or issues . . . in order to achieve greater uniformity and enhance overall voluntary compliance with the

tax laws" (IRM Section 1.2.17.1.6), particularly in the area of penalty relief. Taxpayers may assert that settlement relief is available due to various tax theories, such as mitigation principles or that a payment is equivalent to a payment of a cash bond. If an Appeals officer inappropriately discounts a taxpayer's application of the law, the practitioner should consider the use of a qualified offer to facilitate settlement of the case.

The Appeals officers can be the tax professional's last recourse for justice for the taxpayer. Service Center correspondence auditors and underreported units are trained to issue the accuracy penalty but not to examine the unique situations that govern the reasonable cause exceptions relative to the individual taxpayer. Practitioners' use of the qualified offer may provide a balance to the current system, which too often does not consider the unique facts and law that apply to a taxpayer's circumstances.

From Kristine R. Wolbach, CPA, McDirmid, Mikkelsen & Secrest, P.S., Spokane, WA

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EditorNotes

John Miller is a faculty instructor at Metropolitan Community College in Omaha, NE. Joseph Brophy is president of Joseph D. Brophy, CPA, P.C., in Dallas, TX. Lawrence Carlton is director of taxes at Carlton & Duran, CPAs, PC, in Bedford, MA. Valrie Chambers is a professor of accounting at Texas A&M University in Corpus Christi, TX. John Keenan is a tax director and Vibhuti Patel is a senior manager with Deloitte Tax LLP in Washington, DC. Kristine Wolbach is a CPA with McDirmid, Mikkelsen & Secrest, P.S., in Spokane, WA. Mr. Miller and all the authors are members of the AICPA Tax Division's IRS Practice and Procedures Committee. For further information about this column, contact Mr. Miller at johnmillercpa@cox.net.