



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA 2 COUNSEL  
PHILADELPHIA, PA  
ATTN: JEFFREY VENZIE

FROM: Peter K. Reilly  
Special Counsel (Tax Practice & Procedure)  
Administrative Provisions & Judicial Practice

SUBJECT: Proposed Dover Project  
PREF-149037-01

This Chief Counsel Advice responds to your memorandum dated October 16, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Would the Internal Revenue Service (Service) be required to provide the taxpayer with a copy of Publication 1 before or at the initial interview with the taxpayer pursuant to the provisions of I.R.C. § 7521(b) with respect to cases developed under the proposed project?
2. If a taxpayer is a non-filer for a particular year would income information for that tax year shown on the Service's Information Reporting Program (IRP) data base constitute a reasonable indication that there is a likelihood of unreported income thereby permitting the use of Financial Status Audit Techniques under section 7602(e)?
3. Would the third-party contact procedures of section 7602(c) apply to the revenue officer and the revenue agent with respect to cases developed under the proposed project?
4. Would the revenue officer be required to inform the taxpayer that a revenue agent is involved in a case developed under the proposed project?

CONCLUSIONS

1. Cases developed under the proposed project involve the computation of the non-filer taxpayer's civil tax liability which results in the determination of that taxpayer's tax. Thus, the provisions of section 7521(b)(1) should be followed and Publication 1 should be provided to the taxpayer since Publication 1 satisfies the notice requirements of section 7521(b)(1).
2. The provisions of section 7602(e) do not apply to direct audit methods. The provisions of section 7602(e) do apply to indirect methods such the bank deposits method, the cash transaction method, the net worth method, the percentage of mark-up method, and the unit and volume method. IRP information indicating that the taxpayer has income in excess of \$100,000 for the tax year coupled with the taxpayer's failure to file a return to report this substantial amount of unreported income provides the Service with a reasonable indication that there is a likelihood of unreported income so that the Service can resort to the use of financial status or economic reality examination techniques.
3. Contacts made to assist in computing the non-filer taxpayer's civil tax liability are made with respect to the determination of the tax liability. Thus, the Service should comply with the provisions of section 7602(c) with respect to such contacts.
4. There is no provision under the Internal Revenue Code which would require the revenue officer to inform the taxpayer that the revenue agent is involved in a case developed under the proposed project.

## FACTS

Your request for advice pertains to a proposed project which would involve revenue officers working in conjunction with revenue agents to develop non-filer cases where there is unreported income in excess of \$100,000 for possible referral to the Criminal Investigation Division (CID). We understand the project is referred to as the Dover Project because it will be based on IRP information received in Dover, Delaware.

These cases are selected by a computer-generated matching program based on IRP information and the taxpayer's failure to file a return for the year at issue. If for a particular year, IRP information derived from W-2's and/or 1099's reflects income and the computer locates no corresponding return for that particular year, the case is created and assigned to Collection. Under the proposed project, cases reflecting IRP income in excess of \$100,000 will be selected for development and possible referral to CID if firm indications of fraud are detected.

Once selected, the revenue officer assigned to the case would first send a letter to the taxpayer advising that no return was located for that particular year and requesting an explanation from the taxpayer. In light of the potential fraud consideration, a return is not solicited by the revenue officer. The revenue officer will also begin to gather factual information with respect to the taxpayer's assets and income sources. The revenue officer will work in conjunction with a revenue

agent. The revenue agent will do a financial analysis audit based on the information gathered by the revenue officer to compute the taxpayer's civil tax liability. The result of this cooperation between the revenue officer and the revenue agent will be that the non-filer taxpayer's civil tax liability will be computed prior to referral to CID.

Given that the revenue agent's traditional function is to determine the proper amount of tax liability of a taxpayer, the revenue agent would be uniquely suited to provide assistance to the revenue officer to determine whether certain deductions or credits should be applied to the account. This procedure results in a more accurate estimation of the correct tax liability of that taxpayer. In addition, the revenue officer and the revenue agent would work together to make a determination as to whether firm indications of fraud are present and if so, make the appropriate referral to CID.

## LAW AND ANALYSIS

### Issue 1:

You wish to know whether the Service would be required to provide the taxpayer with a copy of Publication 1, Your Rights as a Taxpayer, before or at the initial interview with the taxpayer pursuant to the provisions of section 7521(b) with respect to cases developed under the proposed project. Section 7521(b)(1) provides that:

[a]n officer or employee of the Internal Revenue Service shall before or at an initial interview provide the taxpayer-

(A) in the case of an in-person interview with the taxpayer relating to the determination of any tax, an explanation of the audit process and the taxpayer's rights under such process . . . .<sup>1</sup>

By its express terms, section 7521(b) deals solely with procedures involving in-person interviews with a taxpayer. Reimer v. United States, 43 F.Supp. 2d 232, 237 (N.D. N.Y. 1999). Section 7521(b) does not pertain to contacts by way of written communications or telephone conversations. The Service satisfies the notice requirements of section 7521(b) by providing the taxpayer with Publication 1.

You have advised that the purpose of this conjunctive effort is to compute the non-filer taxpayer's civil tax liability. Section 7521(b)(1) applies to in-person interviews

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<sup>1</sup> Section 7521(b)(1)(B) provides that "in the case of an in-person interview with the taxpayer relating to the collection of any tax, an explanation of the collection process and the taxpayer's rights under such process." Thus, Collection employees are also subject to the provisions of section 7521(b)(1) when performing their traditional collection duties.

“relating to the determination of any tax.” Computing the non-filer taxpayer’s civil tax liability results in the determination of that taxpayer’s tax. Thus, the provisions of section 7521(b)(1) should be followed and Publication 1 should be provided to the taxpayer.

## Issue 2:

RRA ‘98 added new section 7602(e), titled “Limitation on Financial Status Audit Techniques.” Section 7602(e) provides that “the Secretary shall not use financial status or economic reality examination techniques to determine the existence of unreported income of any taxpayer unless the Secretary has a reasonable indication that there is a likelihood of unreported income.”

Section 7602(e) is not applicable to all audit methods. There are two distinct types of methods of proof in tax cases, direct or specific items methods and indirect methods (financial status or economic reality examination techniques).<sup>2</sup> The Service does not use specific items to support an inference of unreported income from unidentified sources. The use of direct methods simply does not implicate the provisions of section 7602(e). Thus, there is no prohibition requiring the Service to have a reasonable indication that there is a likelihood of unreported income before resorting to direct methods.

The provisions of section 7602(e) do apply to indirect methods such the bank deposits method, the cash transaction method, the net worth method, the percentage of mark-up method, and the unit and volume method.<sup>3</sup> When using an

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<sup>2</sup> In the direct or specific item methods, specific items are demonstrated as the source of unreported income. United States v. Hart, 70 F.3d 854, 860 n.8 (6<sup>th</sup> Cir. 1995); United States v. Black, 843 F.2d 1456 (D. C. Cir. 1988). With the specific item method of proof, the government uses “evidence of the receipt of specific items of reportable income that do not appear on his income tax return.” United States v. Marabelles, 724 F.2d 1374, 1377 n.1 (9<sup>th</sup> Cir. 1984). For example, the Service tracks funds from known sources to deposits made to a taxpayer’s bank accounts rather than analyzing bank deposits to identify unreported income from unknown sources. See United States v. Hart, 70 F.3d at 860 (tracing of unreported income from covert police fund is direct method); United States v. Black, 843 F.2d 1456 (monies traceable from dummy corporations to the taxpayer was evidence of specific items of income and not the use of the bank deposits or cash expenditures indirect method of proof). See also Pollak v. United States, 1998 U.S. Dist. LEXIS 16224 (N.D. Ill. 1998) (recognizing, in dicta, that directly tracing money transfers from an entity would not be a financial status or economic reality technique).

<sup>3</sup> Prior to enacting section 7602(e), the Chairman of the House Committee on Ways and Means requested the General Accounting Office to report on the frequency and results of the use of financial status audit techniques to identify unreported income due to concerns over the treatment of and burdens placed upon taxpayers. General

indirect method, a taxpayer's finances are reconstructed through circumstantial evidence. United States v. Hart, 70 F.3d at 860, n.8. For example, the government shows either through increases in net worth, increases in bank deposits, or the presence of cash expenditures, that the taxpayer's wealth grew during a tax year beyond what could be attributed to the taxpayer's reported income. United States v. Black, 843 F.2d at 1458. Indirect methods are used to support an inference of unreported income from unidentified sources.

Cases will be identified under the proposed project from information from the IRP data base. IRP information will indicate that there has been income in excess of \$100,000 for the tax year. Furthermore, the matching program indicates that the taxpayer has not filed a return to report this substantial amount of unreported income. This information clearly gives the Service a reasonable indication that there is a likelihood of unreported income so that the Service can resort to the use of financial status or economic reality examination techniques.

### Issue 3:

Section 7602(c), which was added by the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206, § 3417(a), imposes a notice requirement on the Service when contact will be made with third parties concerning the determination or collection of tax. Section 7602(c)(1) provides that:

[a]n officer or employee of the Internal Revenue Service may not contact any person other than the taxpayer with respect to the determination or collection of the tax liability of such taxpayer without providing reasonable notice in advance to the taxpayer that contacts with persons other than the taxpayer may be made.

Section 7602(c)(3) provides three statutory exceptions to this advance notice requirement. The requirement does not apply: (A) to any contact which the taxpayer has authorized; (B) if the Secretary determines for good cause shown that such notice would jeopardize collection of any tax or such notice may involve reprisal against any person; or, (C) to any contact made with respect to any pending criminal investigation. In addition, section 7602(c) does not apply to third-party contacts made in the course of a pending court proceeding. Prop. Treas. Reg. § 301.7602-2(f)(7). Thus, for example, the Tax Court has held that section 7602(c) does not apply to contacts made by counsel during trial preparation, where

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Accounting Office Report GAO/T-GGD-97-186 (September 26, 1997), Tax Administration, Taxpayer Rights and Burdens During Audits of Their Tax Returns, at 3 and 9 (GAO Report). The term "Financial Status Audit Techniques" is not defined in the Code; however, the GAO Report states that financial status or economic reality audit techniques consist of indirect methods of examination such as the bank deposits method, the cash transaction method, the net worth method, the percentage of mark-up method, and the unit and volume method. GAO Report at 9.

those contacts are not made with respect to examination or collection activities. Seawright v. Commissioner, 117 T.C. No. 24 (2001).

As we previously stated, the purpose of this conjunctive effort is to compute the non-filer taxpayer's civil tax liability. Section 7602(c)(1) applies to contacts made with respect to the determination of the tax liability of such taxpayer. Contacts made to assist in computing the non-filer taxpayer's civil tax liability are made with respect to the determination of the tax liability. Thus, the provisions of section 7602 should be followed unless one of the exceptions set out above applies.

Issue 4:

There is no provision under the Internal Revenue Code which would require the revenue officer to inform the taxpayer that the revenue agent is involved in a case developed under the proposed project.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

None.

Please call if you have any further questions.