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Tax Issues Facing Clients of Legal Services

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**SPECIAL FEATURE:
POVERTY IS
TAXING**



Tax Issues Facing Clients of Legal Services

By T. Keith Fogg, Professor of Law¹
Director of Federal Tax Clinic, Villanova Law School

Note from the Author: This article is dedicated to Mark Moreau. Mark started one of the first legal services tax clinics. He served as the director of the tax clinic at Southeast Louisiana Legal Services from 1999 until his retirement in 2013. In 2012 he was honored by the National Taxpayer Advocate for extraordinary service to the low income taxpayer community. In 2013 he became the first legal services attorney honored by the ABA Tax Section as a recipient of its Janet Spragens Pro Bono Award. Mark's career serves as an inspiration to all attorneys representing low income taxpayers, and he is a star in the tax clinic world that developed after the entry of legal services into its ranks. He passed away on February 25, 2014, much too soon. Please also see MIE's remembrance of Mark on page 53 of this Journal.

This article seeks to highlight tax issues facing clients of legal services. It will discuss several specific issues that routinely arise. The article will also discuss some of the challenges facing attorneys within legal services that take on a tax clinic and offer some advice on how to address those challenges. Before getting into the issues and the challenges, a little history on the confluence of tax and legal services might help to put the discussion into context.



History of Tax Clinics

Even though some debate about including tax clinics into the legal services model took place in the 1970s, the two were viewed as relatively incompatible because taxes were an issue for rich and middle class citizens and not the poor. If that were true in the 1970s, the Welfare to Work legislation passed in the mid-1990s dramatically changed the landscape as the Earned Income Tax Credit (EITC) became the second largest

social benefit program. The Child Tax Credit, also delivered through the tax system, is the fourth largest benefit program.

Shortly after Congress placed taxes and tax credits directly in the path of the clients of legal services, it also opened a door to inclusion of tax practice within legal services by adding Section 7526 to the Internal Revenue Code (IRC) in 1998. This section provides an annual grant of up to \$100,000 for organizations creating or maintaining a low income taxpayer clinic. Prior to 1998, tax clinics existed almost entirely as academic clinics. Of the sixteen low income taxpayer clinics in existence in 1998, thirteen were academic clinics and three were community clinics. Today, almost ten times as many clinics exist — almost half of which exist in legal services organizations.

With fifteen years of experience having tax clinics operating out of legal services organizations, reflections on this period permit reasonably well-founded observations. Many people reading this article probably come from an organization with such a clinic. Approximately half of the legal services organizations around the country have established a tax clinic with the aid of the grant administered by the Internal Revenue Service (IRS). Before talking about the client issues, I want to focus from the perspective of an outsider on the challenges faced by legal services organizations starting, and sometimes maintaining, tax clinics.

Tax Clinics within Legal Services Organizations

The grant funding for a tax clinic is capped at \$100,000, which generally allows one and no more than two members of an organization to focus on tax. The tax grant requires the organization to provide a dollar-to-dollar match including in-kind or pro bono hours. The attorneys in legal services tax clinics that I observe often arrive at the tax clinic with little or no tax background. Their supervisors within the organization often have little or no tax background. Unlike other

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segments of legal services that have well-developed backup centers, tax does not have a backup center such as the National Housing Law Project or the National Consumer Law Center.

As a consequence, I observe many attorneys handling tax issues within legal services organizations who do not have the opportunity to develop the knowledge and skills on tax issues in an ideal setting because of inadequate support within the system. The IRS, as the grant administrator, conducts an annual training program that provides a modest amount of information for a new practitioner. Some organizations have banded together to create support groups seeking to provide a network or practitioners to assist in learning and guidance. Still, the new tax clinic attorney in a legal services office faces many challenges getting up to speed on a wide variety of technical, legal, and procedural issues that exist in a tax practice. An organization with a new tax clinic attorney needs to work to find outside resources from the local tax bar or from existing LITCs to insure that an adequate safety net as well as training program exists for the new attorney. Otherwise, the new tax clinic attorney can become overwhelmed and frustrated.

While challenges exist with tax practice in legal services organizations, the benefits to the clients outweigh the challenges. Tax practices embedded in legal services organizations have the opportunity to see so many problems that a stand-alone tax clinic or an academic one would never see. Synergy exists with many, if not most or all, of the practice areas generally covered by legal services organizations. With an embedded tax clinic, it becomes easier to identify and address a range of client needs that might have gone unmet without it. The remainder of this article will seek to identify the practice areas in which tax can make a difference and explain how it can do so. Before moving into the synergistic areas, the first discussion will focus on the assistance such a clinic can provide to a low income individual by representing that individual in a direct controversy with the IRS over the tax benefits available under the Internal Revenue Code.

"Pure" Tax Issues

Clients seek the services of a tax clinic to assist them in fighting over tax benefits. For example, the Earned Income Tax Credit (EITC) can provide up to \$6,044 in annual benefits delivered directly to a

taxpayer in a lump sum shortly after the filing of the federal tax return. While obtaining the refund appears as easy as filing a return, the ease of receiving this lump sum makes the EITC a significant target for fraud and abuse. It also makes those eligible for the EITC targets for those who prey on the unwary. Congress mandates that the IRS pay special attention to the EITC. The audit rate for EITC returns can exceed the audit rate of taxpayer making many multiples of the average EITC taxpayer's annual income.

Because of the high audit rate and the high rate of adjustments to these returns, low income taxpayers often find themselves in need of assistance during the audit process, the Tax Court process, and the collection process. Studies have shown that represented taxpayers are much more likely to have their claimed EITC benefits sustained. Consequently, finding them representation can make or break a case. The audits of these returns occur by correspondence and many low income taxpayers simply do not respond adequately or timely to the correspondence audit request.

For those individuals who end up owing additional tax, representation during the collection process is also critical. The tax code and IRS administrative procedures permit taxpayers a number of choices in trying to deal with payment or relief from a liability. While opportunity exists for the taxpayer to reach some form of deal with the IRS, having a good representative is often the key to success in these interactions. Taxpayers are afraid of the IRS. Less-educated, elderly, and disabled taxpayers can be particularly fearful and reluctant to face the IRS on their own. This leads to taxpayers ignoring the IRS until that finally becomes impossible. In addition, the IRS collection process can be complex.

Legal Service Practice Areas with Links to Tax

Several discreet practice areas within legal services have important links with tax. Attorneys practicing in each of these areas can benefit from having an in-house tax clinic or a local tax clinic with which to work in order to best represent these clients. Each area will receive a brief discussion of the synergy between it and tax. No doubt other practice areas also have synergies with tax that merit discussion as well. The American Bar Association (ABA) publishes a book on tax practice developed and written by tax clinicians that covers the topics in several of the areas discussed. The ABA gives a complimentary copy of the book to each tax clinic. For those subjects where a chapter exists, reference will be made for those seeking further information.

Family Practice or Domestic Relations

Individuals fleeing from an abusive relationship frequently find themselves pulled back into tax issues that arose during the period of the relationship. The tax law imposes joint and several liability on those filing joint returns. Abused spouses, having little or no idea about the tax issues resulting from the joint returns they signed, find themselves with federal tax obligations that often reach tens of thousands of dollars. In order to start a new life, they need relief from these liabilities. While the Internal Revenue Code provides potential relief from the liabilities created on a joint return, the provisions require expert representation in order to achieve the maximum benefits available. The need for tax advice in this area exist not only in making the requisite application to the IRS for relief under section 6015 of the Internal Revenue Code but also in drafting divorce and other dissolution documents that can influence the IRS decision on the outcome. Close coordination at the earliest possible moment can hold off IRS collection, set up a successful innocent spouse application and insure protection of the identity and location of the abused spouse during the applications to the IRS and, if necessary, the Tax Court. Bob Nadler of Legal Services of Middle Tennessee and the Cumberlands was one of the attorneys on the lead case in this area opening up the statute of limitations for requesting relief that the IRS tried to shorten through regulation.

Other examples of family/tax intersection:

- (a) Clients who incurred a large tax debt following a divorce, due to improper treatment then withdrawal of retirement funds that were awarded to them. Both clients claimed to have received faulty advice from their divorce attorneys.
- (b) Client is divorced in January 2014. Her ex wants to file a joint 2013 return. Should she agree? What are the pros and cons? She claims her divorce attorney has no idea.
- (c) Client was ordered by the family court to file a joint tax return with her husband, even though she already filed a return using the married filing separate status and received her refund. What will be the tax consequences of the court order for her, and how can they be lessened?
- (d) Court order says the non-custodial parent is "entitled to claim the children on his tax return." He claims not only dependency exemptions for the children and the child tax credit, but EITC as well. Will the client get in trouble with the family court if she claims the EITC for herself?
- (d) Injured spouse situation where the clients refund is taken to pay the liability of a former spouse.
- (e) In family court cases, parents negotiate re the dependency exemption without

fully understanding the tax consequences for each parent. Now the Affordable Care Act adds additional consequences.

Consumer Law

Several issues link tax with consumer law. The primary issue today is probably identity theft with return preparation close behind. The National Consumer Law Center does significant work identifying tax issues impacting consumers and played a large role in convincing the IRS to stop assisting with the proliferation of refund anticipation loans, which are a scourge on low income taxpayers. Tax clinicians advocate individually and through the comment process to fix the tax problems caused by identity theft and to fix the broken IRS system for dealing with identity theft. Similarly, tax clinicians advocate on behalf of individuals impacted by fraudulent return preparers. This advocacy can include reporting the inappropriate preparer activity to the IRS or the state Attorney General's office. Sometimes, these preparers in an effort to obtain larger tax refunds, which generates bigger fees for themselves overstate the income of taxpayers because increased income can maximize the EITC at certain income points. The increased income reported on the federal tax return can negatively impact individuals in other benefit areas. Tax clinicians unwind the incorrect federal tax reporting in order to assist in appropriate benefit retrieval and to assist the individuals in dealing with the consequences of unpaid federal taxes.

Discharge of indebtedness is also a consumer issue impacting taxes when a home foreclosure or short sale, car loan or credit card loan is forgiven and a tax liability results. The individual receives a Form 1099 stating that they had X amount of income in the year of the foreclosure. While the general rule governing discharge of debt results in tax on the amount discharged, exceptions exist that can exclude this income. Issues of timing concerning this income also exist. Mortgage holders have little incentive to get the Form 1099 right but the Internal Revenue Code does provide for some penalties if it is inappropriately issued and does provide some protections to the individuals receiving these notices.

Other consumer issues: (a) misleading and scary letters from private OIC mills who troll the land records for tax liens; (b) schemes where the taxpayer gets a phone call supposedly from the IRS demanding credit card or bank information; and (c) the consumer's need for the refund in order to meet basic expenses — the IRS has the right to offset any refund to satisfy

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another federal tax liability, a state tax liability and a host of other approved debts and a knowledgeable/represented client can go to the IRS at the time of filing the refund claim in order to bypass the refund offset procedures due to hardship.

Bankruptcy

Individuals seeking bankruptcy relief frequently have federal tax problems. Discharging taxes in bankruptcy requires careful timing because of the way the discharge provisions link with the priority provision, which generally build upon the age of the tax debt. Knowledge of the tax system assists in working with the IRS to adjust accounts after bankruptcy. Knowledge of the IRS collection provisions, particularly its offer in compromise section, is required to properly evaluate the benefit of bankruptcy versus negotiation with the agency where tax debt serves as the main driver for bankruptcy. The existence of tax refunds can also produce assets for the estate available to other creditors. Coordination in the income as well as the debt areas of tax is therefore important in properly representing a client in bankruptcy or considering whether to file bankruptcy to obtain desired relief.

Elder Law

Tax issues cut across many concerns of the elderly. The claiming of an elderly family member as a dependent can allow another taxpayer to obtain tax and other benefits — particularly now that the Affordable Care Act looks to family size. Sometimes, it is the grandparents claiming grandchildren as dependents and fighting with the IRS where another individual seeks the tax benefits of claiming the children. Therefore, an understanding of the surprisingly complicated laws of dependency becomes important. It can also be important to understand how gambling income, even when coupled with equal or great gambling losses, can trigger taxation of social security benefits that would otherwise be untaxed. Explaining the true cost of gambling to individuals and family members may assist in dealing with addiction problems. Tax liens continue to attach to property after the death of a loved one. Tax clinicians can work to resolve lien issues to allow passage of property without this encumbrance. The care of elderly individuals often raises employment tax issues with respect to payment of the caregiver.

Disaster Relief

The Internal Revenue Code provides relief from deadlines following a disaster and also provides tax relief for certain losses. Taxation of benefits, or non-taxation, also becomes an important issue following disaster. While this is an area in which no tax clinic wants to become expert, sometimes knowledge of the tax relief provisions proves critical in the assistance of a client following the aftermath of a personal or large-scale disaster.

Disability

Several provisions of the Internal Revenue Code address a taxpayer's disability. These issues can range from exclusion of income received that is related to the disability, to the claiming of dependency exemptions of disabled adult children, to deductions and credits available for accommodations. The EITC may be claimed on disability retirement income paid before the minimum retirement age. Tax issues involving caregivers also exist in this practice area. Disability can extend the statute of limitations for claiming tax refunds through IRC 6511(h). Family members sometimes take over the finances after a long period of decline only to find that the individual has failed to file a tax return for many years losing the opportunity, without the special provision, to obtain substantial refunds from the IRS. Understanding the tax benefits available to individuals with disability can assist in providing the complete range of services available to them.

Immigration

Congress significantly links tax compliance to permanent status yet the path to tax compliance for many is very difficult. These individuals face not only the cultural barriers of a very different and complicated tax system but also employers who want to misclassify them and return preparers who want to rip them off. If new legislation passes, an even greater link between immigration and taxes appears on the horizon. This population is particularly vulnerable to unscrupulous preparers making a challenging area even more challenging.

Health Care; Affordable Care Act (ACA)

Congress has chosen to link many issues in the ACA to the tax code including determination of dependents which impacts size of household, tax credits to pay, tax penalties for going uninsured, and modified adjusted gross income. The heavy inclusion of tax concepts in what was previously a Medicaid world will

require much coordination between tax lawyers and those assisting with health benefits.

Housing

Tenants in litigation with their landlords sometimes settle. Sometimes, a 1099 is issued following a settlement. Housing attorneys need to advise their clients of the tax consequences of settlements. Depending on the legal claims, attorneys' fees may be paid. Those also have tax consequences for clients.

Employment

Worker classification has serious tax consequences.

Ancillary Benefits

Even though most legal services attorneys do not start with a tax background, they do have other practice backgrounds that inform their perspective. They can see issues academic clinicians do not see because of both their background and their client base. They bring richness to the practice not present before their arrival. This richness impacts not just representation of individual taxpayers but ideas on shaping agency decisions through comments and infiltration.

The IRS regularly publishes regulations fleshing out legislative provisions. Legal services attorneys have increasingly joined academics to comment on the agency's regulatory proposals and provide the agency with insight on the impact of its proposed positions on low income families. I recently participated in writing comments on the IRS proposed regulations regarding the innocent spouse provisions. Joining me in the process were two academic clinicians and two legal services attorneys. The legal services attorneys brought knowledge of broader issues that greatly improved the comments. Their presence in the tax world is making a difference in shaping the rules that govern low income taxpayers.

Legal services attorneys are beginning to infiltrate the IRS and the ABA Tax Section in a way that will provide meaningful outcomes for taxpayers. In recent years the IRS has hired at least five legal services lawyers as Local Taxpayer Advocates. This is an important job within the IRS that assists taxpayers experiencing hardship and provides additional advocacy opportunities. As this connection continues to grow, the culture of legal services will blend with that of the IRS to foster new ways within the agency of approaching taxpayer assistance. In addition, Bill Nelson, formerly of The Legal Aid Society of New York City,

became the director of the section within the Taxpayer Advocate Service that administers the grant funds and oversees the tax clinics.

Similarly, the ABA Tax Section has reached out in recent years to embrace legal services tax clinicians. Legal services attorneys now hold positions of leadership within the Tax Section where their backgrounds bring a new dimension to the most influential organizations outside government for shaping tax policy and procedure.

Going Forward

While challenges continue to exist, particularly in the areas of training and mentoring the often isolated legal services attorneys running tax clinics, tremendous benefits accrue to the clients and to the practice area because of the presence of legal services attorneys. The grant fund created in 1998 allowing the expansion of tax clinics has brought together a group of attorneys who enrich the tax profession and who create links between tax and other practice areas representing individuals in our society with the greatest needs. Current clinics assist individuals with tax controversies. Going forward we also need to find a way to assist with tax planning as the ACA and other provisions continue to merge tax with practice areas impacting low income individuals.

If you are interested in learning more about the LITC grant program, the work that clinics perform on behalf of low income taxpayers and the positive impact that clinics have in their communities, please look at the LITC Program Report (IRS Publication 5056) which can be found at www.irs.gov.

- 1 Keith Fogg is a Professor of Law at Villanova Law School where he directs the Federal Tax Clinic. He joined the faculty at Villanova after retiring from the Office of Chief Counsel, IRS. He served as the immediate past chair of the ABA Tax Section's Pro Bono and Tax Clinic Committee and will join the Tax Section's Council in the coming year as the first clinician to do so. His teaching and writing focuses on tax procedure and issues impacting low income taxpayers. He edits the book *Effectively Representing Your Client before the IRS* and co-authors a blog on tax procedure — Procedurallytaxing.com. Keith may be reached at fogg@law.villanova.edu.

Keith thanks two former legal services attorneys, Mike Campbell and Susan Morgenstern, one current one, Christine Speidel, and his colleague, Les Book, for their comments which have enriched this article.