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### Upcoming Free Events

#### Employment Tax Controversies

May 2                      RSVP: [conta.cc/2iWJRwv](http://conta.cc/2iWJRwv)  
Hackensack, NJ

#### Civil & Criminal Tax Penalties

June 6                     RSVP: [conta.cc/2iWEfSV](http://conta.cc/2iWEfSV)  
Hackensack, NJ

#### IRS Collection– Part I

July 11                    RSVP: [conta.cc/2iWLp9w](http://conta.cc/2iWLp9w)  
Hackensack, NJ

#### IRS Collection– Part II

August 1                 RSVP: [conta.cc/2iWEwFu](http://conta.cc/2iWEwFu)  
Hackensack, NJ

### REPRESENTING TAXPAYERS IN TAX CONTROVERSIES INVOLVING THE RECONSTRUCTION OF INCOME, EXPENSES & CREDITS

By Frank Agostino, Esq.  
Caren Zahn, EA,  
Michael Wallace, EA<sup>1</sup>

We are observing an increasing number of examinations and cases at the calendar calls of the United States Tax Court where either the taxpayer or the Internal Revenue Service (“IRS”) is making affirmative efforts to reconstruct a taxpayer’s income and expenses based on the absence of books and records. Similarly, taxpayer and the IRS are asking the IRS to reconstruct the income and expenses based on the unreliability of records. The goal of this article is to review the Internal Revenue Code’s record keeping requirements, as well as the methods recognized by the Courts to reconstruct income and expenses.

#### I. Record Keeping Requirements

Treasury Regulation § 1.6001-1 generally provides that the IRS may require any person, by notice served upon him, to make such returns, render such statements, or keep such specific records as will enable the district director to determine whether or not such person is liable for tax under subtitle A of the Code, including qualified State individual income taxes.<sup>2</sup> No specific form of books and records is required, except that books

*(Continued on page 2)*

and records must be maintained and submitted in the English language. Treas. Reg. § 1.0638A-3(b) (3) and § 1.0638A-3(f) (2).

**II. The Records Retention Period.**

Audited taxpayers generally ask: How long does a taxpayer keep records that support business income and expense deductions? Is it permissible to discard the records after the three year limitation on assessment (Section 6501) or perhaps the six year statute for fraud (Section 6531)? Or, should the records be maintained until after the 10 year collection period under Section 6502 has run? The IRS requires that records be retained “so long as the contents thereof may become material in the administration of any internal revenue law.”<sup>3</sup> In other words, best practice is to maintain records until the collection statute expires. International taxpayers maintaining books and records outside the United States must substantiate transactions as if such records were maintained within the United States<sup>4</sup> and follow the same retention requirement period.

**III. Income vs. Expense records**

**A. Income**

The types of documents that substantiate gross income include IRS wage and income transcripts, cash register receipts, purchases journals, bank deposit slips, cancelled checks, credit card receipts and Forms 1099-K or 1099-Misc. Testimony can sometimes establish gross income.

**B. Expenses**

Generally, the IRS requires more proof to substantiate expense items, including evidence such as petty cash slips, invoices, and cash receipts. Taxpayers need to provide

documentation for employment taxes paid and travel and entertainment expenses (such as mileage logs, gas and airline tickets). If any assets are purchased or disposed of, then sales invoices and closing statements should be maintained.

**C. Heightened Substantiation Requirements**

In general, if a taxpayer deducts travel, entertainment, gift, or transportation expenses, they must be able to prove (substantiate) certain elements of expense. They should keep adequate records to prove expenses or have sufficient evidence that will support their own oral or written statement. Taxpayers must generally prepare a written record for it to be considered adequate. This is because written evidence is more reliable than oral evidence alone. A computer generated record a taxpayer prepared may be considered adequate.<sup>5</sup>

IRC § 274 provides guidance for heightened substantiation of certain business and entertainment expenses. Specifically, IRC § 274 (d) outlines the substantiation categories for listed property under Section 280F, for example, passenger automobiles and property used for entertainment, recreation or amusement. The regulations state that no deduction will be allowed for listed property unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer’s own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the

preceding sentence shall not apply in the case of an expense that does not exceed an amount prescribed pursuant to such regulations. Highlighting the importance of recording the necessary information is *Garza v Commissioner*, T.C. Memo 2014-121. In that case, although the Tax Court agreed the taxpayer incurred travel expenses related to his employment, it determined that the calendar planner in which he maintained his odometer readings for vehicle expenses did not meet the heightened substantiation requirements of Section 274(d). The taxpayer only documented the odometer reading and did not incorporate the business purpose including the date, time or the amount miles for each trip.

### III. When can a Taxpayer Without Records Reconstruct Income?

Where a taxpayer's records are lost, inadequate or untrustworthy, the Court's have accepted various methods for determining the correct amount of income and expense. These methods involve the development of circumstantial proof, generally through the use of bank deposits, various income/expense ratios, or volume based analyses. These methods are especially useful to reconstruct a cash intensive business's income and expenses. Thus, practitioners who work with cash businesses particularly should be familiar with these methods. The methods reviewed in this article are: Source and Application of Funds, Bank Deposit and Cash Expenditure, Markup, and Unit and Volume.

#### A. Source and Application of Funds

This method is efficient for determining the actual amount of the understatement of income by analyzing the taxpayer's net cash flows and comparing that to all known expenses and all known receipts for the period

at issue. It is more easily used when the taxpayer has a statement of assets and liabilities readily available. Net increases and decreases in assets and liabilities are taken into account along with nondeductible expenditures and nontaxable receipts. Where a net positive cash flow is higher than the amount of taxable income reported on the taxpayer's return, the difference will be the upward adjustment to income.<sup>6</sup>

As an example, in the case of *Aref v Commissioner*,<sup>7</sup> one of the issues before the Tax Court was whether the taxpayer had unreported income from his international consulting business. In its initial analysis, applying the source and application of funds method, the IRS determined the taxpayer's unreported income totaled \$84,581 of which he conceded \$6,000. However, as the taxpayer pointed out, the IRS failed to include \$120,000 of loans received in the year in question. The Court ruled in favor of the taxpayer concluding there was no additional unreported income as the \$ 120,000 of loan income exceeded the amount initially determined by the IRS. In order to challenge source and application calculations, practitioners must know what the IRS considers sources of funds, and which sources are taxable. The IRM gives specific guidance on sources of funds:

Sources of funds are the various ways the taxpayer acquires money during the year. Decreases in assets and increases in liabilities generate funds. Funds also come from taxable and nontaxable sources of income. Unreported sources of income even though known, are not listed in this computation since the purpose is to determine the amount of any unreported income. Specific items of income are denoted separately. Exam-

ples of sources of funds include:

1. Decrease in [business] cash-on-hand, in bank account balances (including personal and business checking and savings accounts), and decreases in accounts receivable,
2. Increases in accounts payable,
3. Increases in loan principals and credit card balances,
4. Taxable and nontaxable income, and
5. Deductions which do not require funds such as depreciation, carry overs and carry-backs, and adjusted basis of assets sold.<sup>8</sup>

It is up to the practitioner, however, to make ensure the sources of funds used in computing allegedly unreported income are nontaxable.

**B. Bank Deposits and Cash Expenditures Method**

A second method used to reconstruct income is the Bank Deposits and Cash Expenditures Method. This method compares the total bank deposits plus cash expenses (not including nontaxable sources of income) to the total receipts shown on the return. Any excess of deposits plus cash payments over the amount of receipts shown on the return is additional income or inflated expenses. This method is useful if the taxpayer deposits all receipts into bank accounts AND the examiner can accurately determine non-business expenses. Because cash expense payments are often difficult to classify, the BD&CE method is usually not recommended for cash intensive businesses.<sup>9</sup>

Some IRS examiners presume that all deposits are taxable income, and require the tax professional to account for deposits from nontaxable sources. Thus, frequently, the tax

professional must ensure that all bank deposits are, in fact, includable in the taxpayer's income. With the ease of transferring funds via the internet, it can be difficult to trace the origin of deposited funds. For a basic example, if a taxpayer deposits funds into a savings account, then transfers that money into a checking account, it should not be counted twice. Another example can be found in *Austin v. Commissioner*.<sup>10</sup> In that case, the IRS used the bank deposit method to ascertain allegedly unreported income of the taxpayer. The taxpayer asserted that an escrow account had been established to purchase assets, and the deposits that passed through the escrow account were not his personal funds and therefore not includable in income. Through the stipulation process the IRS conceded that some of the deposits in the account analysis were not income.

**C. Markup Method**

The Markup Method or Mark-On is commonly used to reconstruct income in businesses that manufacture goods, or service business such as Laundromats, bars or pizzerias. It is effective when applied to businesses that have consistent inventory or whose purchases can be readily broken down in groups with the same percentage of markup.<sup>11</sup> The Markup Method produces a reconstruction of income based on percentages or ratios considered typical for the type of business under examination. It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markups to arrive at the taxpayer's gross receipts. For example, if the cost of goods is \$10.00 and the markup is 25%, the sales price should be  $\$10.00 + (\$10.00 * 25 / 100) = \$12.50$ . Inventory and purchase amounts may be used to determine the volume of goods produced, resulting in a relative easy calculation of net income under the unit and volume method

(see below).

An improperly reasoned markup analysis is also susceptible to challenge. The taxpayer in *Rataiczak v. Commissioner*<sup>12</sup> challenged the IRS determination on the grounds of (i) whether the IRS chose an acceptable markup percentage and (ii) whether the markup applied properly in determining the unreported income. The taxpayer owned an automobile service station that sold gas, auto parts, candy, refreshments and tobacco. A 25 percent markup was applied to the candy, refreshments and tobacco, while a 22.8 percent markup was applied to the auto service and repair arm of the business. (the fuel sales were not at issue). The application of the 22.8 percent markup was challenged on the basis that the IRS applied it to all auto parts purchased by the taxpayer, but failed to recognize the taxpayer did not receive payment for all the auto parts sold during the years in question or sell all the parts in inventory when the business closed. In other words, the IRS applied the markup to inventory that did not actually create income, resulting in an inflated amount of gross sales. The Court, based on testimony of the taxpayer that he had unpaid accounts receivable, theft losses, and unsold inventory during the periods at issue, held that the percentage markup was misapplied. The Court reduced the taxpayers gross profit, purchases, and allowed a theft loss, thereby reducing the taxpayers overall tax deficiency. Practitioners must not only review the amount of the markup, but ensure that it is applied only to goods that are actually sold at that marked up amount.

**D. Unit and Volume Method**

The Unit Method is similar to the mark up method if the number of units and the unit price is known, income can be reconstruction

by the Unit and Volume Method. In many instances, gross receipts may be determined or verified by applying the sales price to the volume of business done by the taxpayer. The number of units or volume of business done by the taxpayer might be determined from the taxpayer's books and records, which may also be adequate in determining cost of goods sold or expenses. In other cases, the determination of units or volume handled may come from third party sources.<sup>13</sup> For example, if a tile manufacturer's total sales per unit of a specific tile is \$750,000 (price/unit of \$1,500 X 500 units produced) and the manufacturer only reported \$650,000 of gross sales, the unreported income is \$100,000 (\$750,000 Sales per unit and volume method - \$650,000 reported gross sales). Unit and volume sales may be used in conjunction with the mark-up method. The mark-up method could be used to determine the per unit price (see example in the mark-up section above), and this method to determine total sales (i.e. unit price X units sold).

In *Key v. Commissioner*<sup>14</sup> the IRS used the Unit and Volume Method in an attempt to compute the taxpayers' unreported income for his marketing business, which marketed and sold a credit repair program. Using taxpayer's own businesses orientation guide and membership list, the IRS determined how many transactions (units) were brokered by the taxpayer and multiplied this number by the associated program cost as taken from the orientation guide. The IRS then added administrative fees to arrive at the amount of gross receipts. The Court determined the IRS's methodology was flawed by attributing 100 percent of the fees charged to income when in fact the orientation guide clearly stated taxpayer received only 80 percent of the fee. There was additional evidence that not all purchasers paid the full program cost; some paid no administrative fee, and some

paid nothing at all. In this case the IRS ultimately used an alternative method in order to arrive at the taxpayers' correct taxable income. Practitioners should ensure that the price per unit used by the IRS is the price received by the taxpayer. Similarly, practitioners should ensure that all units included in the computation were actually sold for that price.

Whatever the indirect method used by the IRS, practitioners must do their own diligence. Trust, but verify the income reconstruction analysis performed by the IRS and ensure that it is equitably done and results in the true and correct amount of tax.

#### IV. Expense Reconstruction

The Cohan Rule<sup>15</sup> provides relief to taxpayers who do not have adequate books and records by allowing them to claim a deduction for reasonably estimated expenses. This rule refers to the Second Circuit's decision in the 1930 case *Cohan v. Commissioner*, where the court determined that a taxpayer was allowed to estimate reasonable business expenses when no records were available. Based on this decision, taxpayers can base business related expense deductions on reasonable estimates. Treas. Reg. §1.162-17(d) (3) now provides similar guidance on substantiation of expenses. The regulation affirms that where records are incomplete or documentary proof is unavailable, it may be possible to establish the amount of the expenditures by approximations based upon reliable secondary sources of information and collateral evidence. For example, in the case of personal expenses the IRS may request a taxpayer fill out Form 4822, Statement of Annual Estimated Personal and Family Expenses.<sup>16</sup> The form allows the taxpayer to estimate personal, household, automobile, some deductible Schedule A ex-

penses and miscellaneous personal expenses paid by either cash or check. The estimates can be derived by using the IRS National Standards and Local Standards<sup>17</sup> established for food, clothing, utilities and out-of-pocket healthcare expenses. Business expenses can be estimated using appointment books to reconstruct dates and times of meetings, mileage logs, cancelled checks, client lists, and cell phone records. Expense deductions are a matter of when reconstructing expenses the tax professional must keep in mind that legislative grace and the taxpayer must prove they are entitled to all deductions estimated.

#### V. Statistical Record Reconstruction

Statistical data sites are another source taxpayers and the IRS can use to assist in record reconstruction. One example is BizStats,<sup>18</sup> a free service that provides industry standard business statistics for small businesses. For example, if a taxpayer is a construction contractor and you know the estimated gross sales, BizStats will provide you with the percentages and amounts of operating expenses in relation to sales. The IRS utilizes this tool in cash intensive audits to perform comparative and ratio analyses on businesses that may be underreporting cash. A second statistical tool, Bizminer, is a paid service that provides industry analysis and benchmarks for a variety of business lines and houses an IRS Resource Glossary that defines line items of the Form 1120 financial statement and the Schedule C for Sole Proprietors. A third statistical source used to reconstruct records is Sageworks, a paid service that provide loan portfolio, risk management and valuation applications.

While statistical data is a generally & reliable tool for income & expense of reconstruction, its use is accepted on a case by case basis

and can be challenged. In *Bauer v. Commissioner*,<sup>19</sup> the IRS used BizStats to estimate the taxpayers' allowable 2006 business expense deduction for contract labor related to his moving business. The taxpayer disagreed with the estimation from Bizstats, which categorizing the business under long distance freight trucking, and instead submitted an estimate from BizMiner, which categorized the business as household goods transportation. The Court ultimately held that the taxpayers' business was more in line with household goods transportation, and dovetailing that with the Cohan rule, allowed the taxpayer to deduct the contract labor expenses using the BizMiner estimates.

**VI. 1099-K Reconstruction**

Beginning in early 2012, under the housing Tax Assistance Act, merchant entities and third party settlement agencies are required to report on Form 1099K, payment card and third party network transactions. The Form 1099-K, Payment Card and Third Party Network Transactions, is an information return that reports the gross amount<sup>20</sup> of reportable transactions for the calendar year to the IRS.<sup>21</sup>

The books and records of a taxpayer should include the payments reported on the Form 1099-K. Taxpayers and tax professional should compare the Forms 1099-K with their records to ensure the accuracy of gross receipts reported on the return. The Internal Revenue Service extrapolates and compares the amount of income reported on the Forms 1099-K to the income reported on the return using a mark-on based on the percentage of cash sales to credit card sales that similarly situated businesses generated. For example, Forms 1099-K is issued to ABC Food Depot report \$300,000 of credit card sales on gross sales of \$750,000. According to the IRS,

similar businesses in the industry have between 20% and 30% of receipts from credit card sales. Consequently, the IRS may ask ABC to verify why its gross receipts are not between \$1,000,000 and \$1,500,000 by issuing either Letter 5035 or Letter 5039 "Income Reporting Verification Notice. If the IRS issues Letter 5039, the taxpayer has 30 days to submit Form 14420 "Verification of Reported Income." Failure to respond within the 30 day period could result in an IRS audit or an assessment notice. The Form 14420 will allow the taxpayer to prove and explain any discrepancies between the return line items and the amounts reported on the 1099-K.

**Conclusion**

Many tax professionals are uncomfortable preparing income tax returns for taxpayers who deal in cash, especially those who lack receipts to prove their income and expenses. They need not be. The teaching of the cases and Circular 230 is that the goal of all tax professionals is to assist the taxpayer calculate the "correct tax." Tax professionals representing taxpayers without adequate books and records should familiarize themselves with the rules, regulations and case law applicable to income reconstruction. If you or your client needs assistance with issues involving reconstruction of income or expense records, please contact Agostino & Associates with any questions.

UPCOMING UNITED STATES TAX  
COURT CALENDAR CALLS

**Footnotes:**

1. Frank Agostino is Principal of, and Caren Zahn and Michael Wallace are Enrolled Agents at Agostino and Associates, P.C.
  2. 26 CFR § 1.6001-1(d).
  3. 26 CFR § 1.6001-1(e).
  4. I.R.M., pt. 4.61.2.1 (May. 1, 2006).
  5. Publication 463
  6. I. R.M. 4.10.4.6.3 (09-11-2007)
  7. Aref v Commissioner, 97 T.C.M. (CCH) 1598 (T.C. 2009)
  8. I.R.M. 4.10.4.6.3.3 (08-09-2011)
  9. Cash Intensive Business Audit Techniques Guide- Chapter 5 – Examination Techniques
  10. Austin v. Commissioner, 2014 T.C. Memo 249 (T.C. 2014).
  11. I. R.M. 4.10.4.6.5 (08-09-2011)
  12. Rataiczak v. Commissioner, 78 T.C.M. 362, 1999 T.C. Memo 285 (T.C. 1999).
  13. I. R.M. 4.10.4.6.6 (08-09-2011)
  14. Key v. Commissioner, 2001 T.C. Memo 166 (T.C. 2001).
  15. Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930)
  16. See from 4822: <http://www.zillionforms.com/2005/F482.PDF>
  17. Collection Financial Standards: <https://www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards>
  18. BizStats: <http://www.bizstats.com>
  19. Bauer v. Commissioner, 2012 T.C. Memo 156 (T.C. 2012).
  20. The gross amount of a reportable payment does not include any adjustments for credits, cash equivalents, discount amounts, fees, refunded amounts or any other
  21. General FAQ's on Payment Card and Third Part Network Transactions: <https://www.irs.gov/uac/general-faqs-on-new-payment-card-reporting-requirements>
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**All Calendar Calls Are Held at:**

Jacob K. Javits Federal Building  
26 Federal Plaza  
Rooms 206, 208  
New York, NY 10278

March 6, 2017

March 20, 2017

April 3, 2017

April 17, 2017

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February 2017

## 6TH ANNUAL NEW JERSEY TAX CONTROVERSY FORUM

By Frank Agostino, Esq.  
Jairo G. Cano, Esq.<sup>1</sup>

On January 17, 2017, Agostino & Associates, P.C. together with the law firms of McCarter & English LLP and Cole Schotz organized the 6<sup>th</sup> Annual New Jersey Tax Update which took place at Seton Hall University School of Law. This article summarizes the highlights from the presentations made by the New Jersey Division of Taxation (“Division”) and identifies the Division’s priority areas for audit, collection and criminal investigation.

### 2017 Legislative Updates

For 2017, the New Jersey sales & use tax rate will decrease from 7.0% to 6.875%. The rate will be further reduced in 2018 to 6.625%. The new rate will not apply to boats for which the Sales Tax rate has been reduced to 3.5% with a cap of \$20,000.

This year will also see the expiration of the Urban Enterprise Zone tax rate for businesses located in Bridgeton, Camden, Newark, Plainfield and Trenton. Those businesses are now required to charge the full Sales Tax rate on taxable sales. The final EZ-50 UEZ tax return was due on January 20, 2017. These businesses are now required to file ST-50 on a quarterly basis. In addition, Form ST-51 is required on a monthly basis if a business collected more than \$30,000 in Sales Taxes in 2016 and if in 2017, the business collects more than \$500 in one month.

Partnerships must file Form NJ-1065 or NJ-CBT-1065 to report their 2016 taxes. The filing fee for these forms is \$150 for each partner that the partnership has with a maximum filing fee of \$250,000. The fee does not apply to partnerships that do not generate New Jersey source income, expense or loss. A partnership that has out-of-state partners and earns out-of-state income can prorate the filing fee. In addition, for 2016 taxes, those businesses that were approved for the New Jersey Business Employment Incentive Program grant can convert the grant into a tax credit for corporation business tax purposes.

All New Jersey businesses are required to give written notice to employees who may qualify for the Federal or New Jersey earned income tax credit. The statement that must be included is available on the New Jersey Division of Taxation’s website. The Notice must be distributed with the employees’ Form W-2s and must be filed no later than February 15, 2017. The obligation to notify employees applies to wage earners who received \$53,505 or less.

For 2017, the New Jersey estate tax exemption amount will increase from \$675,000 to \$2,000,000. Then, starting in January 1, 2018, the state will not impose an estate tax. The inheritance tax was not amended or repealed with this legislation. Therefore, individuals who wish to bequeath property in a manner that would be subject to the inheritance tax should reevaluate their estate plans to ensure that they plan for inheritance tax purposes.

**2017 Audit Priorities**

Patrick Foray, Supervising Auditor, New Jersey Division of Taxation identified two compliance risk areas that will receive high audit priority in 2017. First, the Division plans to increase Sales Tax audits of service businesses the Division believes have not complied with their Sales Tax filing and payment obligations. Second, the Division plans to increase audits of businesses that claimed the research and development credit on their Corporation Business Tax returns and those that claimed sales tax exemptions for property used for research and development.

During his presentation, Mr. Foray identified massage service, tattoo and body piercing as industries with a high percentage of noncompliance. When working with these industries, a practitioner should be aware of the Sales Tax obligations. For instance, anyone who provides massage, bodywork and somatic services is required to collect and pay over Sales Tax for those services unless the services were provided in connection with a doctor's prescription. When the services are provided in connection with a prescription, the services are not taxable. In the same way, a vendor does not need to collect Sales Taxes if the services are provided by a licensed health care professional, a licensed acupuncturist or a licensed cosmetic and beauty service provider. These distinctions can create confusion and compliance issues for service providers. Consequently, it is important for practitioners to educate their clients on best practices for maintaining records and properly documented non-taxable sales.

If a taxpayer determines it has not complied

with its Sales Tax filing and/or payment obligations, it is better to address the problem before the Division begins an audit. When taxpayers wait for an audit, they usually face larger liabilities. In addition, after an audit concludes, the Division often reexamines the same taxpayer for subsequent periods to determine if there are additional deficiencies. A pattern of continued noncompliance for the same taxes can support a referral of the taxpayer's case for criminal investigation. In fact, Mr. Foray stated that 10% of audit cases require consultation with a Fraud Technical Advisor and in many of those cases the civil fraud penalty is assessed.

Consequently, non-compliant taxpayers should consider resolving their cases with either a voluntary disclosure or a closing agreement. In order to submit the request for a voluntary disclosure, a taxpayer must provide:

1. A written proposal identifying the commencement date for the business activity, the taxpayer's registration status for New Jersey tax, the disclosure period, the type of tax, and whether any Sales Tax has been collected but not remitted; and
2. A completed VDA Fact Pattern Form.

If the taxpayer is admitted into the program, the Division may request copies of original tax returns. Furthermore, the Division will agree to waive late filing and late payment penalties. However, the Division will assess a 5% penalty in cases where Sales Taxes were collected but not remitted.

In addition, the Division will focus on

businesses that claimed the research and development credit and those that claimed a sales tax exemption for purchases connected with research and development activities. Taxpayers that perform qualified research activities in New Jersey may be eligible for the state's R&D credit. However, they must ensure that all requirements for claiming the credit are satisfied.

Similarly, purchases of tangible personal property for use or consumption directly and exclusively in research and development are exempt from Sales Tax. The purchaser must provide the vendor NJ Form ST-4 (Exempt Use Certificate). In order to be exempt from sales taxes, the property must be used in work that constitutes:

1. Basic research in a scientific or technical field of endeavor; or
2. The advancement of technology by experimentation in a scientific or technical field of endeavor; or
3. The Development of new products; or
4. The improvement of existing products; or
5. The development of new uses for existing products.

Research and development does not include ordinary testing, quality control, efficiency surveys, management studies, consumer surveys, advertising, or promotions. It also does not include research in connection with literary, historical, or other scholarly research conducted outside of the science and technology fields.

Against this background, practitioners who plan to claim the credit for clients on 2016 tax returns should ensure that all requirements for claiming the credit are met. In addition, they should review prior submissions where the credit was claimed to determine whether there are any compliance issues. Vendors not collecting sales tax for property sold for research and development should evaluate those sales to ensure that they collect the Form ST-4. Purchasers should similarly ensure that their purchases qualify for the R&D sales tax exemption before providing the Form ST-4. Finally, taxpayers who underwent Federal R&D credit audits should ensure that they complied with New Jersey's notice of Federal tax change requirements to ensure that this does not create additional exposure to future New Jersey audits on this issue.

**Collection – Bulk Sales**

Tom MacDonald, Chief of Compliance and Field Investigations North, highlighted the importance of compliance with the New Jersey bulk sale requirements. A purchaser, assignee or transferee of any business assets, other than in the ordinary course of business, must notify the Division at least 10 business days prior to the closing date so that the purchaser can establish an escrow account if the seller has a potential tax liability to the Division. The term business asset includes any tangible or intangible assets of the business.

The notification must come from the purchaser or the purchaser's representative. A communication from the seller or other third parties will not protect the purchaser from

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potential transferee liability for the seller's existing or potential tax liabilities. In order to file a proper notification, the purchaser must submit a completed Form C-9600 including:

1. Valid NJ tax ID numbers for the purchaser and seller;
2. A closing date that is at least 10 business days after the submission;
3. Proper mailing addresses for the parties and their attorneys;
4. A copy of the executed contract of sale, court order, or assignment agreement that clearly shows the sales price and the terms and conditions of the agreement.

The package must be signed by the purchaser or its attorney and submitted to:

Division of Taxation  
 Attn: Bulk Sale Section  
 P.O. Box 245  
 Trenton, NJ 08695-0245

or, by overnight mail, Fed-Ex or UPS to:

Division of Taxation  
 50 Barrack Street  
 Trenton, NJ 08695  
 Attn: Bulk Sale Section

When the package is received and reviewed by the Division, it will issue one of the following notices:

1. Escrow Letter, which states the amount that must be held at the time of the transfer;

2. Returns Required Letter, which informs the seller of any returns that must be filed before clearance is issued;
3. Clearance Letter, which states that the purchaser will not assume any liabilities and that no escrow is required;
4. Insufficient Notice Letter, which identifies information that is missing and that must be provided for the Division to make a determination; or
5. Bulk Sale Violation Notice, which informs the purchaser that it will assume the seller's liability for failure to comply with the bulk sale requirements.

If the Division fails to respond within 10 business days, the purchaser is deemed not liable for the seller's tax liabilities. On the other hand, if a late notice is sent, the purchaser will be liable for any outstanding taxes owed by the seller to the Division. This includes liability for any future assessments resulting from an audit of the seller. Given these draconian consequences, it is imperative that a purchaser understand and comply with its bulk sale obligations.

**Criminal Enforcement**

Charles Giblin, Special Agent in Charge, Office of Criminal Investigations ("OCI"), discussed OCI's successful prosecution of cases against cigarette and liquor smugglers who have been selling counterfeit goods with falsified state tax stamps. Mr. Giblin also highlighted the Office's efforts to identify and prosecute, those cases in addition to cases involving stolen identity refund fraud and mo-

FIRM NEWS

tor fuel tax violations.

**Conclusion**

The priorities highlighted by the Division's representatives highlight the importance of compliance. To this end, the Division wants to ensure that taxpayers correctly report their transactions to the Division. If your clients need assistance with matters involving the Division, please contact Agostino & Associates.

**Footnotes:**

1. Frank Agostino is Principal of, and Jairo G. Cano is an Attorney at Agostino and Associates, P.C.
2. <http://www.state.nj.us/treasury/taxation/pdf/eitcstatement.pdf>
3. <http://www.state.nj.us/treasury/taxation/pdf/eitcnotice.pdf>
4. For a comprehensive list of sales and services that are subject to the New Jersey Sales Tax see "New Jersey Sales Tax Guide," available at: <http://www.state.nj.us/treasury/taxation/pdf/pubs/sales/su4.pdf>
5. <http://www.state.nj.us/treasury/taxation/messagesvcs.shtml>
6. <http://www.state.nj.us/treasury/taxation/messagesvcs.shtml>
7. <http://www.state.nj.us/treasury/taxation/pdf/pubs/sales/su6.pdf>
8. <http://www.state.nj.us/treasury/taxation/pdf/pubs/sales/su6.pdf>
9. <http://www.state.nj.us/treasury/taxation/pdf/pubs/sales/su6.pdf>

On March 14, 2017, Agostino & Associates, P.C. will participate in a PLI seminar entitled "Nuts and Bolts of Tax Penalties 2017: A Primer on the Standards, Procedures and Defenses Relating to Civil and Criminal Tax Penalties." The seminar will be presented live in New York City, at various group cast locations nationwide, and also via live webcast. This one-day seminar is a unique opportunity to review the various tax penalties that can be imposed, the standards and transactions that can trigger penalties and sanctions, the procedures the Internal Revenue Service must follow to assess penalties, and the defenses that can be asserted. The seminar should be on the "must" list for law firm and accounting professionals who advise clients on structuring transactions and who represent clients in tax controversies; in-house tax professionals involved in tax planning, FIN 48 determinations and tax audits and appeals; and government agents and attorneys who want a primer on tax penalties and ethical standards. The event is chaired by Brian Skarlatos, Esq. of Kostelanetz & Fink, LLP, the accomplished faculty includes Frank Agostino, Esq., Roland Barral, Esq. (Skadden, Arps), Megan Brackney, Esq. (Kostelanetz & Fink), Marc Caine, Esq. (IRS Counsel), Ian Comisky, Esq. (Fox Rothschild LLP), William Conroy, Esq. (IRS Counsel), Lisa Flores (IRS Counsel), Linda Galler, Esq. (Professor, Maurice A. Dean School of Law, Hofstra University), Monica Koch, Esq. (IRS Counsel), Kathleen Pakenham, Esq. (Cooley LLP), and Diane Wollman, Esq. (Cleary Gottlieb). Also invited is Thomas Bishop (IRS CI, Assistant Special Agent in Charge, NYC). Please go to [http://www.pli.edu/re.aspx?pk=186490&t=KLT7\\_FCLTY](http://www.pli.edu/re.aspx?pk=186490&t=KLT7_FCLTY) for more details or to register.

On March 3, 2017, Frank Agostino and Jairo G. Cano will participate on two panels for the Federal Bar Association's Tax Law Conference in Wash

February 2017

## FIRM NEWS

two panels for the Federal Bar Association's Tax Law Conference in Washington DC. The panels will focus on Tax Court litigation and practical tips for resolving penalty issues.

For more information or to register, please visit: <http://www.fedbar.org/Education/Calendar-CLE-events/Tax-Law-Conference.aspx>.

### AGOSTINO & ASSOCIATES IS HIRING!

Agostino & Associates a nine-attorney Bergen County New Jersey Tax Controversy firm looking for an EA to assist with post-filing tax controversies, tax litigation, the seminar series and our monthly newsletter. Nonattorney applicants will be expected to attend our monthly training courses and sit for the United States Tax Court Admission Examination for non-attorneys given in November 2018. Interested candidates should send a cover letter, resume and writing sample to Frank Agostino @ FAgostino@AgostinoLaw.com

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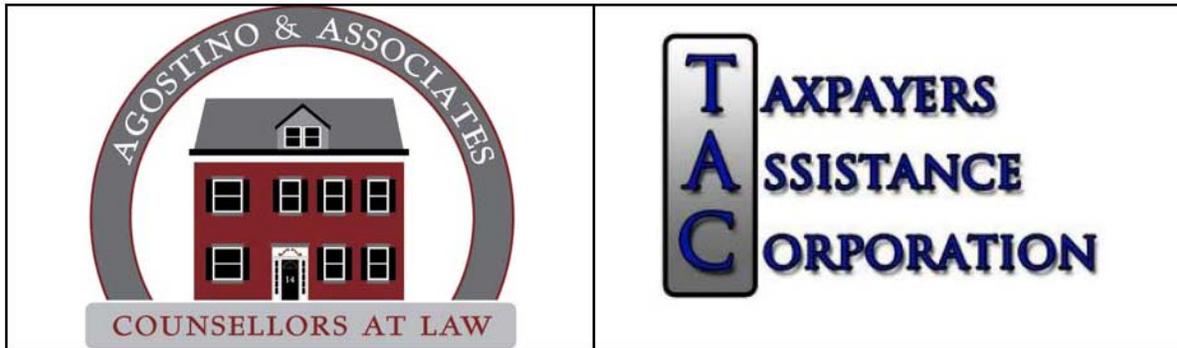
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# JOIN OUR U.S. TAX COURT ONLINE FORUM

The group is intended to provide a forum for those taking the Agostino & Associates 2017/2018 seminar series and the 2018 US Tax Court Exam. It also provides a forum for the Taxpayer Assistance Corporation volunteers to discuss our pro bono outreach.

To join please email Frank Agostino at [fagostino@agostinolaw.com](mailto:fagostino@agostinolaw.com) with your name and email address.

# AGOSTINO & ASSOCIATES

## 2017-2018 TAX CONTROVERSY SEMINAR SERIES PREPARATION FOR THE EA & US TAX COURT EXAMS

**THREE FREE NY & NJ CLE, CPE, and EA CE CREDITS PER CLASS**  
This series is free. However, A&A asks that each attendee volunteer for 3 hours of pro bono service per class.

**WHERE:** Bergen Community College  
Ciarco Learning Center  
355 Main Street  
Room 102/103  
Hackensack, NJ 07601

**WHEN:** First Tuesday of the Month  
6:00 PM – 9:00 PM



### 2017 COURSES:

[Employment Tax Controversies including Worker Classification & Trust Fund Penalties](#)  
May 2, 2017

[Civil & Criminal Tax Penalties](#)  
June 6, 2017

[IRS Collection- Part I](#)  
July 11, 2017

[IRS Collection- Part II](#)  
August 1, 2017

[Representing Cash Businesses- Markon & Other Indirect Methods of Income Reconstruction](#)  
September 5, 2017

[Representing a Taxpayer Before the IRS Office of Appeals](#)  
October 3, 2017

[Valuation and the Role of Expert Witnesses in Tax Controversies](#)  
November 7, 2017

[The Tax Consequences of the Choice of Entity Decision](#)  
December 12, 2017

If you have any questions, please contact Joann Kozlowski at (201) 488-5400 ext. 100, or [jkozlowski@agostinolaw.com](mailto:jkozlowski@agostinolaw.com)