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STATE BAR OF CALIFORNIA
TAXATION SECTION
TAX PROCEDURE AND LITIGATION COMMITTEE

2014 WASHINGTON D.C. DELEGATION

THE MODIFICATION AND COMPROMISE OF RESTITUTION ORDERS IN CRIMINAL TAX CASES

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May 5, 2014

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EXECUTIVE SUMMARY[2]

Federal district courts may sentence a defendant to pay restitution upon conviction of certain criminal tax offenses. Afederal district court is required to order a defendant to pay restitution in all Title 18 cases to compensate victims for actual loss. *See* 18 U.S.C. § 3663A. In criminal cases under Title 26, the Court may order restitution if agreed to by the parties, as a condition of probation or as a condition of supervised release. *See* 18 U.S.C. §§ 3663(a)(3), 3563(b)(2), and 3583(d). A restitution order is a final judgment that cannot be modified.

In 2010, Congress added section 6401(a)(4) to the Internal Revenue Code, which requires the Internal Revenue Service (IRS) to assess and collect the amount of restitution under an order pursuant to 18 U.S.C. §3556 for failure to pay any tax imposed under Title 26 in the same manner as if such amount were a tax. Sometimes, the IRS may be identified as the victim, and the district court therefore orders the defendant to pay a tax-related loss to the IRS. This new code section allows the IRS to use its administrative collection tools to collect the amount of the restitution order issued by the federal district court.

Congress made some additional changes with respect to restitution orders in 2010. First, Congress placed restrictions on the ability to challenge an IRS assessment of a restitution order issued by a federal district court. Section 6201(a)(4)(C). Second, a restitution-based assessment is not subject to deficiency procedures. Section 6213(b)(5). Third, Congress granted the IRS authority to make a restitution-based assessment at any time. Section 6501(c)(11).

There are significant procedural issues faced by a taxpayer who owes both criminal restitution and a civil tax liability. This paper proposes some workable solutions so that the interests of both the government and the taxpayer are better served.

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DISCUSSION

I. HYPOTHETICAL EXAMPLE

This paper will draw from the following example: Assume that Johnson Flood is a prominent high-tech entrepreneur in California's Silicon Valley. After leaving a corporation he co-founded, Flood formed a new company that created software for the Department of Homeland Security ("DHS"). A former bookkeeper who worked for Flood's company informs the government that Flood has engaged in a scheme to defraud the governmentthrough the use of asham invoicing scheme. The informant also contacts the IRS and says that Flood has failed to report substantial amounts of income that was deposited into an account in the name of his late mother, over which he has sole signatory authority. As a result of a grand jury investigation by the U.S. Attorney's Office, Flood is indicted on one count of conspiracy to defraud the United States under 18 U.S.C. §371, three counts of making false claims to the United States under 18 U.S.C. §287, and three counts of executing a false tax return under 26 U.S.C. §7206(1) for 2008, 2009, and 2010.

Flood eventually pleads guilty to one count of making a false claim and one count of tax perjury. The stipulated loss due to the false claims is $850,000. The Government and Flood stipulate that the unreported gross receipts for the three years in the indictment are $1.6 million. The tax loss is $448,000 (28 percent of the unreported gross receipts).

As part of the plea deal, Flood agrees to pay restitution of $850,000 for the false claims loss and $448,000 for the tax loss. He also agrees to cooperate with the IRS to determine his correct tax liability and to be liable for a fraud penalty. The Court sentences Flood to 24 months incarceration on both counts, to run concurrently, followed by three years supervised release.

To enable the IRS to collect the amount of the restitution owed to the government, the IRS assesses the $448,000 restitution amount as if it were a tax under 26 U.S.C. § 6201(a)(4). As a result of false claims conviction, Flood's ability to do business with the Government ends. He liquidates his brokerage accounts and pays $700,000 towards restitution for the false claims loss and

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$100,000 toward restitution for the tax loss. While Flood is incarcerated, the IRS conducts an audit of his tax returns for 2008, 2009 and 2010. As a result of the audit, the IRS determines adjustments of $1,600,000 in unreported gross receipts, plus $710,000 in previously unclaimed deductions for net adjustments of $890,000 and a tax of $290,000. The IRS also imposes the civil fraud penalty. Flood does not petition the Tax Court and the IRS assesses tax of $290,000, plus a fraud penalty and interest.

When Flood is released from incarceration, he is able to find employment as a computer programmer. His income is sufficient to pay his living expenses, including a $4,800 a month mortgage. The Department of Justice is responsible for collection of the unpaid restitution order for both false claims and tax losses. Given Flood's current financial condition, he enters into a stipulation with the U.S. Attorney's Office that he will pay $250 a month toward the restitution amount, to be applied one-half to the tax loss and one-half to the false claims loss.

The IRS, however, determines that Flood's living expenses are above the national average and his housing expenses are above the amounts allowable. The IRS demands that Flood pay $2,800 a month. When he refuses, the IRS levies on his wages to collect the restitution. Since the restitution order is a judgment that may not be modified except under limited circumstances,[3] the IRS continues collection action, even though Flood does not have the financial resources to pay in full the tax assessed (let alone the tax restitution amount).

Although Flood would be a suitable candidate for an offer in compromise, the IRS is prohibited from compromising the restitution amount. Since the Department of Justice has jurisdiction over the case, the IRS cannot compromise the tax liability it assessed. Flood is in a catch-22.

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[3]A restitution order may be modified only in limited circumstances. *See e.g.,*Fed. R. Crim. Proc. 35(allowing the district court to correct a sentence within 14 days for "arithmetical, technical, or other clear error"); 18 U.S.C. §3742 (on remand after appeal); 18 U.S.C.§3664(d)(5) (allowing the victim to seek increased restitution); 18 U.S.C. §3664(k) (adjusting payment schedule due to a change in defendant's financial condition that affects his ability to pay); 18 U.S.C.§3572 (allowing the district court to adjust a payment schedule); 18 U.S.C.§3613a (modification or revocation of probation or supervised release or resentencing where a defendant defaults in paying restitution); upon resentencing.

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This paper proposes a workable solution to Flood's problem. Under the proposed legislative amendments, after Flood's conviction became final, the IRS would have sole jurisdiction to collect the restitution. Thus, Flood would not have to deal with two agencies in negotiating collection. Since collection would be handled by one agency, the Department of Justice could devote its resources to other matters. Because the IRS determined that the actual tax liability was less than the amount ordered as restitution, the district court could modify the sentence so that restitution did not exceed the tax loss. Finally, if the IRS determined that Flood could not pay off the full amount of restitution, the IRS could accept an offer in compromise. Thus, the IRS would not have to waste resources on attempting to collect taxes that were uncollectible.

II. CURRENT LAW

A. Title 31 Restitution Orders

A federal district court, when sentencing a defendant convicted of certain criminal offenses, may order that the defendant make restitution to any victim of such offense. 18 U.S.C. § 3556 provides:

> 18 U.S.C. 3556. Order of restitution
>
> The court, in imposing a sentence on a defendant who has been found guilty of an offense shall order restitution in accordance with section 3663A, and may order restitution in accordance with section 3663. The procedures under section 3664 shall apply to all orders of restitution under this section.

In determining whether to order restitution, the federal district court considers: (1) the amount of the loss sustained by each victim as a result of the offense; and (2) the financial resources of the defendant, the financial needs and earning ability of the defendant and the defendant's dependents, and such other factors as the court deems appropriate. 18 U.S.C. § 3663(a)(1)(B)(i).

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The federal district court also may order restitution in any criminal case to the extent agreed to by the parties in a plea agreement. 18 U.S.C. § 3663(a)(3).

18 U.S.C. § 3612(c) vests the Attorney General with responsibility for collecting unpaid restitution and fines. *See e.g*., *United States v. Fisher*, 2013 U.S. Dist. LEXIS 165473 (E.D. Mich. Nov. 21, 2013) ("This authority is broad: the government may use any of the 'practices and procedures for the enforcement of a civil judgment under Federal law or State law.")

B. Firearms Excise Tax Improvement Act of 2010

In some criminal tax cases, the Internal Revenue Service may be identified as the victim, and therefore, the federal district court may order the defendant to pay restitution directly to the IRS for a tax-related loss. CC-2011-18 (8/26/2011). However, prior to 2010, neither Title 18 nor Title 26 provided the Service with the power to administratively collect on a restitution order because restitution is not a tax. *Id*.

In 2010, Congress expanded the IRS collection authority to ensure collection of unpaid restitution when it enacted the Firearms Excise Tax Improvement Act of 2010[4] ("FETIA"). Section 3 of FETIA amended section 6201(a) by adding section 6201(a)(4), which provides the IRS the authority to assess and collect the amount of restitution under an order pursuant to 35 U.S.C. § 3556 in the same manner as if such amount were a tax.[5] In short, the IRS may summarily assess certain orders of criminal restitution once the appeal period has expired. Section 6201(a)(4) provides, in relevant part:

§ 6201. Assessment authority.

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[4]P.L. No. 111-237, §3.

[5]The legislative history to section 6201(a)(4) provides little, if any, guidance as to why Congress believed that the criminal restitution payable to the IRS should be assessed as if it were a civil tax.

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(a) Authority of Secretary. The Secretary is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title, or accruing under any former internal revenue law, which have not been duly paid by stamp at the time and in the manner provided by law. Such authority shall extend to and include the following:

(4) Certain orders of criminal restitution

(A) In general -- The Secretary shall assess and collect the amount of restitution under an order pursuant to section 3556 of title 18, United States Code, for failure to pay any tax imposed under this title in the same manner as if such amount were such tax.

(B) Time of assessment -- An assessment of an amount of restitution under an order described in subparagraph (A) shall not be made before all appeals of such order are concluded and the right to make all such appeals has expired.

(C) Restriction on challenge of assessment -- The amount of such restitution may not be challenged by the person against whom assessed on the basis of the existence or amount of the underlying tax liability in any proceeding authorized under this title (including in any suit or proceeding in court permitted under section 7422).

"Whether a criminal restitution order can be assessed as a tax under section 6201(a)(4) depends on whether the restitution order is traceable to a tax imposed by Title 26. Restitution ordered for a criminal violation of IRC 7201 (attempt to evade or defeat tax), IRC 7202 (willful failure to collect or pay over tax), IRC 7203 (willful failure to file return), IRC 7206(1) (fraud and false statements), as well as several other criminal tax violations under the Internal Revenue Code and Title 18 may meet the requirements necessary to be assessed as a tax." *See* IRS Memorandum For Technical Services Operations, February 5, 2014, SBSE Control # SBSE-04-0214-0013.

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Congress made two additional changes to the Internal Revenue Code in enacting FETIA. First, Congress added section 6213(b)(5), which provides that the restrictions applicable to deficiencies do not apply to assessments under section 6201(a)(4). In other words, a defendant has no right to file a petition in U.S. Tax Court to challenge the IRS' assessment of the amount of the restitution. Section 6213(b)(5) provides, in relevant part:

> § 6213. Restrictions applicable to deficiencies; petition to Tax Court.
>
> (b) Exceptions to restrictions on assessment.
>
> (5)Certain orders of criminal restitution. If the taxpayer is notified that an assessment has been or will be made pursuant to section 6201(a)(4)—
>
> (A) such notice shall not be considered as a notice of deficiency for the purposes of subsection (a) (prohibiting assessment and collection until notice of the deficiency has been mailed), section 6212(c)(1) (restricting further deficiency letters), or section 6512(a) (prohibiting credits or refunds after petition to the Tax Court), and
>
> (B) subsection (a) shall not apply with respect to the amount of such assessment.

Second, Congress added new section 6501(c)(11), which provides that the general three-year limitation on assessment of taxes does not apply with respect to certain orders of restitution under section 6201(a)(4). In other words, the IRS may assess the amount of the restitution at any time.Section 6501(c)(11) provides, in relevant part:

> § 6501. Limitations on assessment and collection.
>
> (a) General rule. Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if

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> the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period. * * *
>
> * * *
>
> (c) Exceptions.
>
> * * *
>
> (11) Certain orders of criminal restitution. In the case of any amount described in section 6201(a)(4), such amount may be assessed, or a proceeding in court for the collection of such amount may be begun without assessment, at any time.

C. IRS Chief Counsel Notices

After Congress enacted FETIA, IRS Office of Chief Counsel issued Chief Counsel Notice 2011-018 providing guidance with respect to the IRS' authority under section 6201(a)(4) to assess and collection the amount of criminal restitution ordered for failure to pay any tax under Title 26. The Service's guidance including the following with respect to the applicability of section 6201(a)(4) to specific restitution orders and the assessment of the amount of criminal restitution ordered:

- The IRS can assess restitution ordered against a criminal defendant "even if the restitution relates to the unpaid income or employment tax liabilities of the corresponding business entity or employer." CC-2011-018 (8/26/2011), I:Q&A-4.

- If itis determined by a subsequent exam that the amount of restitution ordered is excessive, the IRS should contact the Tax Division or the appropriate U. S. Attorney's Office to request modification of the restitution order and that the taxpayer could also seek modification of the order. After the order is modified, the IRS could then abate part of the restitution assessment.*Id*., II:Q&A-10.

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- The IRS can enter into an installment agreement with the taxpayer regarding a restitution-based assessment so long as it provides for the full payment of the assessment or allows sufficient time for collection of the full amount of the restitution-based assessment after completion of the installment agreement. *Id.*, II Q&A-17.

- The Service cannot, however, accept an offer-in-compromise regarding the amount of the restitution ordered or the restitution-based assessment. *Id.*,at Q&A-18.

In 2013, the IRS Chief Counselissued Chief Counsel Notice 2013-012, which clarified the guidance previously issued regarding the treatment of restitution-based assessments.

First, the Notice provided that even if a taxpayer can reduce his or her civil tax liability by taking advantage of a carry back of a net operating loss, the taxpayer nevertheless must still full pay the amount of the restitution-based assessment. The Notice states, in part:

> For example, a taxpayer is ordered to pay $100,000 in restitution for the tax period ending December 2010 and the Service subsequently examines the taxpayer for the same tax period. Pursuant to the examination, the Service determines a civil tax liability of $150,000. The taxpayer timely requests that a NOL deduction from the tax period ending December 2011 be carried back to the tax period ending December 2010, which would reduce his tax liability by $100,000. If the Service allows the NOL carryback, the taxpayer's civil tax liability would be reduced to $50,000, and any penalties would be based upon the amount of the remaining civil tax liability. The Service may allow the NOL carryback, even though it would reduce the tax liability below the restitution-based assessment of $100,000, because the civil tax liability is separate and independent from the restitution-based assessment. <u>The Service is required to collect $100,000 from the taxpayer for tax period ending December 2010 to satisfy the restitution-based assessment</u> because the Service must "assess *and collect* the amount" ordered as restitution, regardless of whether the civil tax liability is determined to be less. Section 6201(a)(4)(A)

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> (emphasis added). Because the Service cannot collect twice for the same tax period, the first $50,000 collected to satisfy the restitution-based assessment of $100,000 must also be applied to the civil tax liability of $50,000. *See United States v. Tucker*, 217 F.3d 960 (8th Cir. 2000); *United States v. Helmsley*, 941 F.2d 71, 102 (2d Cir. 1991).

*See*CC-2013-012 (7/31/2013), fn 3 (emphasis added).

Secondly, Notice 2013-012 clarified the Service's position with respect to whether the Service could abate any portion of the assessment if the amount of the criminal restitution ordered and the subsequent restitution-based assessment is determined to be excessive by a subsequent examination. The Notice states, in part:

> The treatment of a restitution-based assessment as separate and distinct from an actual determination of tax liability for the same tax period requires clarification and revision of Question and Answer 10 in Chief Counsel Notice CC-2011-018, The Assessment and Collection of Criminal Restitution. The answer to question 10 in that document addressed the situation where restitution ordered "is excessive" compared to the amount of tax liability determined by civil examination for the same tax periods. By using the term "excessive," Question 10 erroneously assumed that the amount of restitution is directly related to, comparable with, or an aspect of tax liability as determined by the Service's examination. *On the other hand, Question and Answer 10 properly concluded that the Service may only abate a restitution-based assessment to bring it in line with an amended restitution order from the sentencing cour*t.Regardless of whether the civil examination for the same tax period covered by the restitution order results in deficiency determination greater or lesser than the amount of restitution, *the Service shall assess and collect the full amount of restitution ordered.*
>
> It should be clarified that a federal district court may only modify a restitution order in the limited circumstances listed in 18 U.S.C. § 3664(o)(1); therefore, a taxpayer's opportunities to seek modification of his or her restitution order are more limited than implied by Question and Answer 10. *The Service should not contact*

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the Justice Department's Tax Division or U.S. Attorney's Office to request a modification of the restitution order based on the results of the civil exam.

See CC-2013-012 (emphasis added).

D. Recent Case Law Involving Restitution Orders and the IRS

In*Isley v. Commissioner*, 141 T.C No 11 (2013),the Tax Court held IRS Appeals lacked authority to accept a taxpayer's offer in compromise because the IRS had referred his tax case to the Department of Justice for prosecution.

There, Ronald Isley was a founding member of the popular Isley Brothers singing group. In 2006, Mr. Isley was convicted of five counts of tax evasion and one count of willful failure to file and sentenced to three years imprisonment. As part of the sentence in his criminal case, the district court issued a judgment and probation commitment order (JPC order) requiring, in part, that Isley file and pay taxes owed for the years of the conviction and pay all taxes when due, and, if necessary, sell assets to satisfy his tax obligations. *Id*. at 12-13. While in prison, Mr. Isley timely filed Forms 12153, Request for a Collection Due process or Equivalent Hearing. As part of the CDP hearing, Mr. Isley submitted a Form 656, Offer in Compromise. The IRS Appeals rejected his offer in compromise on the ground that it lacked authority to compromise his tax liabilities, and the case proceeded to court.

The Tax Court held that IRS Appeals lacked authority to accept Isley's offer in compromise because it sought to compromise liabilities for conviction years, which had been referred to the Department of Justice for prosecution. *Id*. at 27. However, IRS Appeals could at least negotiate the terms of a potential offer in compromise, but could not unilaterally approve it. *Id*. The Tax Court reasoned, in part:

> Moreover, it makes perfect sense from a policy standpoint that DOJ's primacy in compromising tax liabilities that have been referred to the Attorney General for prosecution should continue until the terms of the court's

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> judgment (or of any settlement authorized by the Attorney General or his delegate) have been satisfied.

Id. at 30. According to the Tax Court, any compromise by the IRS of Isley's tax liabilities would have violated the express terms of the JPC order, which required that Isley make full payment of the taxes owed for the years of conviction. *Id*.Isley's only recourse was limited to asking the district court and/or the Attorney General or his delegate to modify the full payment requirement contained in the JPC order. *Id*. at 32.[6]

In *United States v. Fisher*, 2013 U.S. Dist. LEXIS 165473 (E.D. Mich. Nov. 21, 2013), the defendant Edward Fisher was convicted of conspiracy to defraud the United States and was ordered to pay criminal restitution to the IRS of $10,000,000. Fisher had repaid approximately $6,012.44 of the obligation, and under his current financial circumstances, agreed to pay the IRS $100 a month. The government applied for and received writes of garnishment for funds in Fisher's retirement accounts. Fisher moved to quash or modify the garnishments arguing, in part, that the garnishments violated his restitution agreement with the IRS.

The court ruled that 18 U.S.C. § 3612(c) vests the Attorney General with the responsibility for collecting unpaid restitution and fines. This authority is broad and there is no exception for retirement accounts. The court rejected Fisher's argument that the garnishments violate his payment agreement with the IRS because a payment schedule does not serve as a bar to further collection efforts.

Fisher stands for the proposition that a repayment plan with the IRS does not bar further collection efforts by the Department of Justice, including garnishment of retirement accounts.

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[6] *Isley* did not involve a restitution order but a judgment and probation commitment order (JPC order), and so the order could be modified, unlike a restitution order.

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III. REASONS FOR SUGGESTED CHANGES

The enactment of section 6201(a)(4) creates a number of procedural issues for a taxpayer who owes both criminal restitution and a civil tax liability, as outlined below.

- There is no coordinated procedure with respect to entering into a repayment plan with respect to criminal restitution and a civil tax liability. Criminal restitution and a civil tax liability are separate and distinct. Separate payment plans must be entered into with the Department of Justice and the IRS.

- Both the IRS and the Department of Justice can take enforced collection action at the same time. This means that a taxpayer could be forced to default on one payment plan with one agency due to enforced collection action by the other agency.

- The IRS lacks authority to accept an offer-in-compromise regarding the amount of the restitution order or the restitution-based assessment. This was illustrated by the *Isley* case.This means that a taxpayer can never compromise the amount of restitution, even where the IRS determines that he will never be able to pay in full the amount assessed. The restitution order, once it becomes final, cannot be modified.

- While a taxpayer has Collection Due Process rights under sections 6320 and 6330, when the Service attempts to collect a restitution-based assessment, the IRS cannot enter into any installment agreement or offer-in-compromise that would result in the taxpayer paying less than the ordered restitution amount.

- Although the IRS can enter into an installment agreement with the taxpayer regarding a restitution-based assessment, the Department of Justice can nevertheless take collection action against the taxpayer to satisfy the restitution order. This scenario was illustrated in the *Fisher* case.

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- The IRS lacks the authority to abate any portion of the assessment, even if the IRS determines that the restitution-based assessment is excessive by a subsequent examination. The taxpayer must still full pay the amount of the restitution-based assessment, even if the amount is excessive.

IV. PROPOSED LEGISLATIVE CHANGES

To address these issues, this paperposes that legislation be enacted to amend 26 USC §6401(a)(4) by adding the following provisions:

- The IRS has sole authority to collect the restitution amount, after assessment of the restitution amount under section 6401(a)(4). This could be accomplished, for example, by an inter-agency delegation of authority to the IRS, and the advantage of this proposal is that it does not require a change to the statute.

- The crux of the problem may lie with Title 18 because restitution orders may be modified only in limited situations. A proposed solution would be to modify the relevant statute(s) in Title 18 to allow more liberal modifications of the restitution order in tax cases. This way, if there is a determination by the IRS or a court (including the Tax Court) that the underpayment of tax for the years covered by the restitution order is less than the amount of restitution, upon motion by the Government or the defendant, the district court may modify the restitution order upon motion by the Government or the defendant, if the IRS or a court (including the Tax Court) determines that the underpayment of tax for the years covered by the restitution order is less than the amount of restitution; and

- The IRS can compromise the restitution amount that was assessed as a tax under section 6401(a)(4), subject to approval by

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the federal district court that ordered restitution. Again, this would require a legislative fix.

V. CONCLUSION

This paper has attempted to provide a framework for discussion purposes with respect to restitution orders in criminal tax cases. The current state of the law creates uncertainty with respect to these matters, and taxpayers need specific and constructive guidance in this area.