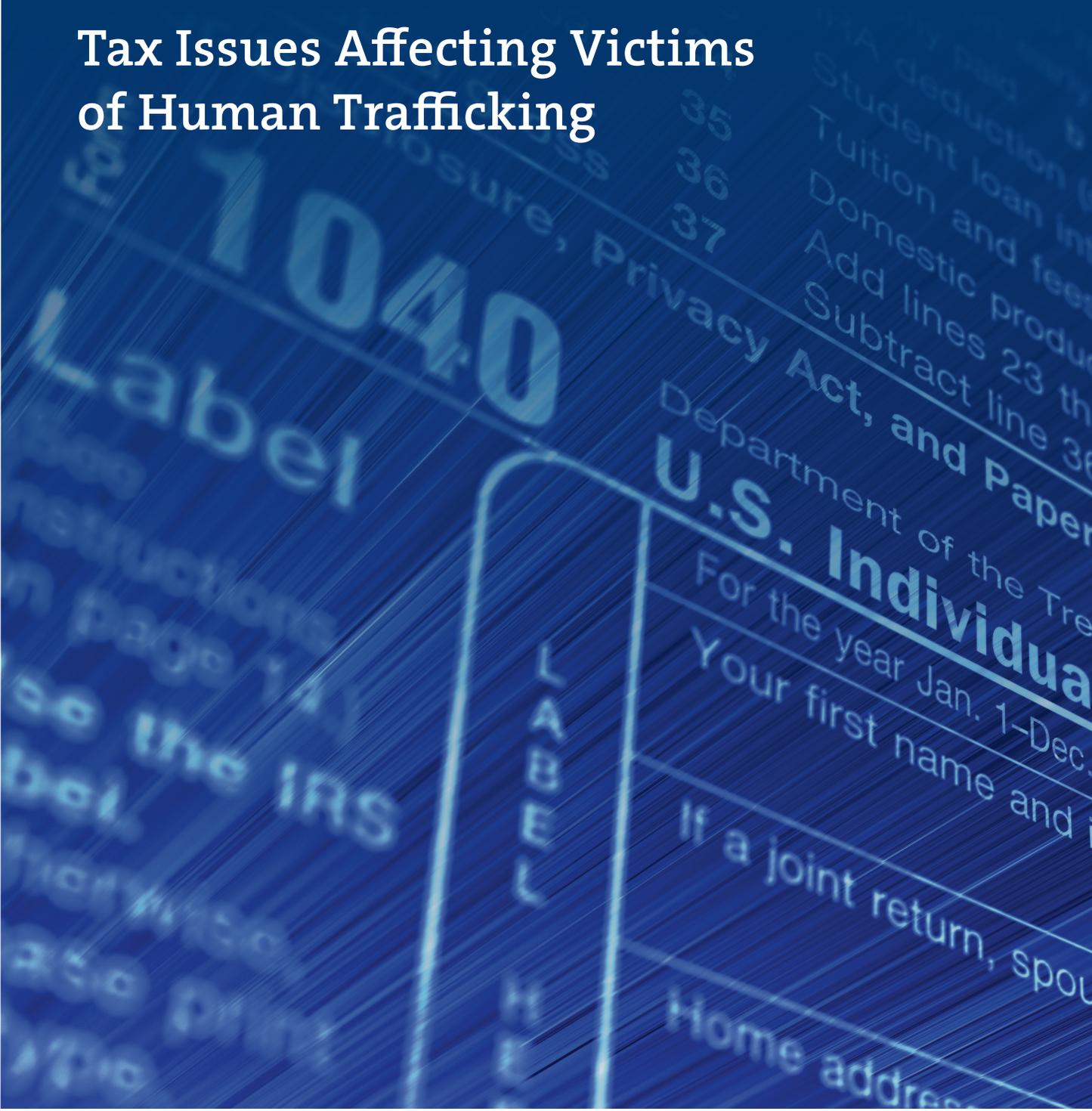


AN ADVOCATE'S GUIDE TO

Tax Issues Affecting Victims of Human Trafficking



ROPES & GRAY



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Note: This guide provides background information only. It is not tax advice. If you or your client are facing a tax issue, please consult a tax attorney.

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A SURVIVOR'S STORY

Rebekah grew up in a modest, middle-class home in Texas. The baby of six children, Rebekah was placed in a group home at the age of 16 after stealing and experimenting with drugs. Feeling abandoned and rejected by her family, she ran away from the facility and did her best to survive on the streets. She quickly turned to drug use to numb the pain and theft to meet her basic needs. She searched for family any place she could find it. At the age of 17, Rebekah found solace in the “loving” clutches of a trafficker, who groomed her for months using promises of care and concern before manipulating her into engaging in prostitution for his benefit.

Rebekah was forced to earn money for her trafficker through daily acts of prostitution, sometimes for more than 12 hours at a time. Her trafficker punished even the smallest indiscretions with extreme brutality. If she flinched, she was beaten even harder, with the worst abuse saved for her attempts to protect herself from his blows. Rebekah's trafficker also controlled every aspect of her life, from what she ate, how she dressed and how she cleaned herself to how and when she interacted with customers.

Eventually, her trafficker began demanding that she allow him to put the deeds for homes and cars he had purchased in her name so that he could evade the attention of law enforcement. A master manipulator, Rebekah's trafficker was able to calculate exactly what he needed to do in order to get her to obey him. He also made her open bank accounts using false names and social security numbers so he would not be connected to the accounts used to house his illegal funds. If the accounts became overdrawn or the checks written against them bounced, it was her trafficker who decided whether or not the account would be brought current. Most times he chose not to, and a new account was opened in its place. He also refused to let her file tax returns for the money she was depositing into the accounts. Completely isolated from the world and conditioned to obey her trafficker's demands, she felt there was no way to survive other than to comply.

In 2006, Rebekah was federally indicted for the financial crimes she was forced to commit by her trafficker. Brainwashed by him not to cooperate with law enforcement, she did not disclose her trafficker's involvement in the crime to anyone. Although her trafficker paid for an attorney for her, she refused to let him interview her, as her trafficker had instructed. As a result, she had only a single contact with the attorney during the time she was incarcerated awaiting trial. Eventually, she



pleaded guilty to conspiracy to commit tax evasion and was sentenced to 13 months in federal prison.

Rebekah's trafficker maintained his control over her throughout the duration of her prison sentence. Once she was released from prison, her trafficker forced her and his other victims to file back tax returns. He manipulated them into doing so by telling them that this would prevent the federal authorities from coming after them again, but in reality, he was just forcing them to fraudulently claim all of his income, none of which Rebekah actually kept. Out of fear for her life, Rebekah filed the back tax returns as demanded. The amounts on the returns were based off every penny that ran through a bank account with her name on it from 2001-2009. Rebekah now owes the IRS more than a quarter-million dollars. This fraudulent behavior on the part of her trafficker was not limited to Rebekah. At present, two of the trafficker's other victims also owe substantial amounts of money to the IRS.

Rebekah is now in Currently Not Collectible status with the IRS after her trafficker paid a law firm in Las Vegas to file her taxes and help with a solution. Rather than submitting an Offer in Compromise on her behalf based on the fact that her liability arose due to the trafficker's criminal and fraudulent conduct, the firm took the simpler route of requesting Currently Not Collectible status, effectively requiring Rebekah to "wait out" the ten-year collection statute until the liability becomes uncollectible. Needless to say, she was unaware of the availability of free assistance from low-income taxpayer clinics at the time.



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It was not until the trafficker turned himself in to serve his own 24-month sentence that Rebekah finally found the courage to escape. Finally away from her trafficker after 10 long years of abuse and exploitation, she struggled with debilitating shame and blame. However, with the help of other trafficking survivors, Rebekah slowly began to understand what had been done to her and started the process of healing. Although she now shares her story with agencies and nonprofits throughout the country, her criminal convictions coupled with the debt her trafficker ran up in her name have made it difficult to move on with her life. Finding a place to live, filling out job applications, and even volunteering to coach her 4-year-old's soccer team have all become difficult, if not impossible tasks. While she has recently submitted a Presidential Pardon with the help of a law school clinic in Maryland, this remedy is both insufficient and improbable. Moreover, her tax liability remains outstanding, and requesting an Offer in Compromise is no longer prudent due to the fact that it would extend the statute of limitations for the IRS to collect the liability.

Rebekah's experience is not an anomaly. Although few people associate human trafficking and tax fraud, human trafficking victims often experience both at the hands of their traffickers. A review of case law, trial transcripts and sentencing documents reveals that traffickers often use their power over victims to commit tax fraud. Traffickers fail to pay employer-side taxes, steal their victims' identities, file false tax returns in victims' names and seize fraudulent tax refunds. Victims find themselves fending off IRS investigations months, sometimes years, after escaping their traffickers.

Attorneys and advocates will likely encounter more and more trafficking survivors facing tax controversies in the coming years. This guide for advocates is divided into two sections. The first addresses the civil tax consequences victims might face because of trafficking, and the second deals with the tax consequences of money a victim might receive at the close of a civil or criminal trafficking case.

PART ONE: MITIGATION OF TAX PROBLEMS CAUSED BY A TRAFFICKER'S ABUSE

A trafficker's tax fraud—whether in a sex or labor trafficking case—can directly lead to tax controversies for the victim. For example, in *Ndukwe v. Ndukwe*,¹ a civil case filed in federal court in New Jersey, the victim alleged that her family forced her to travel to the United States using fraudulent travel documents. When

¹ Complaint, *Ndukwe v. Ndukwe*, No. 2:09-cv-06443 (District Court of New Jersey, County of Newark, December 22, 2009).



she arrived in the United States, the victim alleged that her sister forced her into involuntary servitude, taking control of her paychecks and threatening to expose the victim's unlawful status. The defendant also required her sister, the victim, to report herself as a single taxpayer with zero deductions. At the end of each year, the defendant allegedly demanded that the victim turn over all W-2s for the filing of annual federal and state income tax returns. The defendant filed the tax returns, keeping the tax refund checks. The defendant allegedly misused the victim's identity, creating enormous problems for the victim after her escape when she tried to file and report her own income tax returns to the IRS. This case ended after the judge granted the plaintiff's motion for voluntary dismissal with prejudice.²

Trafficking survivors can struggle with the tax consequences resulting from the underlying victimization. It is crucial for trafficking advocates to be aware of potential civil tax issues victims might confront. Moreover, it is essential to know when and how to refer a victim to a tax specialist. The discussion below provides information on both of these topics: what a trafficking advocate should know and how a trafficking advocate can seek tax-specific help. Happily, positive outcomes in human trafficking cases with tax consequences are possible:

A social service organization . . . referred a survivor of human trafficking to a [Low-Income Taxpayer Clinic] (LITC) for assistance with a tax controversy. The IRS was sending notices for the 2014 tax year stating that nearly \$4,000, in income and self-employment taxes for underreported wages, was owed. The trafficker had reported to the IRS that wages were received, which triggered the IRS liability calculation. The LITC called the IRS and explained that the taxpayer had been trafficked as a domestic worker during 2014 and had endured physical and emotional abuse, working more than 100 hours per week. Subsequently, based on the relevant facts, the IRS adjusted the tax liability calculation, which resulted in a refund.³

² *Ndukwe v. Ndukwe*, No. 2:09-cv-06443 (D. New Jersey).

³ U.S. DEPARTMENT OF TREASURY: INTERNAL REVENUE SERVICE, *Low-income taxpayer clinics represented 19,479 taxpayers dealing with an IRS tax controversy; See the latest program report and LITC contact list* (March 27, 2018), <https://www.irs.gov/newsroom/low-income-taxpayer-clinics-represented-19479-taxpayers-dealing-with-an-irs-tax-controversy-see-the-latest-program-report-and-litc-contact-list>.



TAX CASES FOR HUMAN TRAFFICKING ADVOCATES

By John B. Snyder, III⁴

Tax is the bogeyman of the legal world. Most attorneys instinctively shut down when they see the word “tax,” causing them to brush tax issues aside. Thus, despite the importance of taxes in the lives of nearly every American, the American bar suffers a yawning void of knowledge when it comes to tax. This is as true in the public interest and human trafficking (HT) bar as anywhere else.

Fortunately for HT advocates and clients, nothing is as complex as they fear. Most tax issues trafficking survivors will encounter are straightforward enough to screen for and understand, at least to the extent necessary to get a client referred to a competent tax specialist. Further, unlike in some fields, help in the tax world is freely available.

This primer is designed to help HT advocates identify tax issues their clients may face and to assist them and their clients in seeking more effective tax assistance. Part I provides a very brief overview of some common misconceptions and critical information that both advocates and clients should know. Part II gives a very general overview of the tax controversy system. This discussion is extremely broad, and attorneys are urged to refer clients to competent tax representatives for a more thorough discussion of these issues. Part III briefly addresses some tax controversy issues that are especially likely to manifest in human trafficking cases. Part IV explains the resources available for free assistance with tax problems. Finally, Part V provides a list of questions that a human trafficking attorney may want to broach with a client to identify tax problems before referring the client to a specialist.

I. Six Things Human Trafficking Lawyers and Clients Should Know about Dealing with Tax Problems

1. The IRS is not out to “get” the taxpayer.

The IRS's mission is to enforce the tax laws fully and fairly, including ensuring that taxpayers pay no more than the correct amount of tax due. See I.R.C. § 7803(a) (listing various taxpayer rights). Its goal is *not* to collect as much money as possible, and, contrary to what many taxpayers fear, it is

⁴ John B. Snyder, III, Director, University of Baltimore Low-Income Taxpayer Clinic; J.D., 2000, Duke University School of Law, *cum laude*; B.A., 1997, University of New Mexico, *summa cum laude*.



emphatically *not* a tool other government agencies use to harass their opponents. A tax dispute is a tax dispute; no more, no less.

If a taxpayer or, even better, a taxpayer's representative, makes a nonfrivolous argument that a taxpayer is entitled to relief, the vast majority of IRS employees will evaluate it fully and fairly, within the parameters of the relevant regulations or law. The Service will work with a taxpayer, especially a taxpayer represented by a tax specialist. This is doubly true for the rare emotionally and factually compelling situation such as a human trafficking case.

Similarly, the IRS (and the courts that handle tax cases) is not bound by other bodies' determinations. The Service will not deny a human trafficking client tax relief simply because the client's application for vacatur or other relief was denied.

2. There are many chances for relief.

As summarized very briefly in the sections below, the tax controversy world consists of multiple stages. At each stage, some remedies cease to be available while new ones open up. Some tax issues may be more difficult to challenge than others. However, taxpayers are rarely "out of luck" entirely.

3. Tax cases move slowly.

The IRS is overworked and understaffed, and some tax cases are complex. Thus, tax disputes take a long time to resolve. If a taxpayer files a fairly simple return on April 15, 2018, the IRS might begin auditing in June, complete the audit in July and issue a Notice of Deficiency in August. If the taxpayer petitions the U.S. Tax Court in response to the Notice, the parties will often spend several months attempting to settle the case, and trial may not be set for a year or more. Similarly, if a representative submits an offer in compromise on a taxpayer's liability, it may take as long as six months for the IRS to begin evaluating the offer. Fortunately, while interest continues to accrue on outstanding liabilities while a dispute is pending, other IRS actions, notably attempts to collect, are normally tolled.

4. Help is important and easy to get.

As discussed in the section on "Getting Assistance," tax help is both free and freely available in most areas. The Low-Income Taxpayer Clinic program is large, robust, experienced and highly organized. Moreover, unlike the "poverty bar" in some other areas of law, it is highly appreciated by the courts and by



its ostensible adversary. Dealing with a pro se taxpayer is difficult, exhausting and often ineffective for both the taxpayer and the IRS, and all participants in the controversy system value the knowledge and efficiency that LITCs bring to the system. For human trafficking advocates, this is likely a profound but welcome difference.

5. Having a tax lawyer does not solve the problem.

Many taxpayers have built up so much fear of the IRS and the tax system—and numbers, period—that they suffer a kind of mental paralysis when faced with them. When a tax dispute begins, a sensible taxpayer obtains a representative, free or otherwise. However, that is only the first step to resolving a tax problem. A representative can't simply call the IRS and “make a deal” to end a tax dispute. The IRS and courts will not grant relief without evidence. Failure to provide supporting evidence, not failure to make reasonable arguments, is almost certainly the most common reason the IRS refuses to accept requests for collection relief.

Thus, when referring a human trafficking client to a tax specialist, advocates should ensure that the client understands the importance of working with the tax specialist and providing information when requested.

6. Tax information is kept very, very confidential.

As discussed in the section on the controversy system, the Service holds tax returns and return information confidential. Filing a past-due tax return will not “put a client on the government's radar”; it simply alerts the IRS that the client filed late. The act might have tax consequences, but except in wildly unusual situations beyond the scope of this document, it will not start an investigation into the client by other government agencies or by third parties.

Thus, there is almost never anything to gain from ignoring tax problems. Instead, clients should be encouraged to take steps to resolve them.

II. About the Tax Controversy System

Tax controversy is the area of tax law that deals with disputes between taxpayers and the taxing authority. Practitioners often divide tax controversy into administrative practice, in which taxpayers' representatives deal directly with the Internal Revenue Service (“IRS” or “the Service”), and tax litigation, in which



There is almost never anything to gain from ignoring tax problems. Instead, clients should be encouraged to take steps to resolve them.

representatives argue taxpayers' cases in court.

When learning about tax controversy for the first time, however, it is more useful to divide it into two stages. In the first, disputes as to liability, taxpayers can dispute whether they are substantively liable for a tax. Here, the dispute revolves around whether the taxpayer's tax return actually reflects reality. In the second type of case, disputes as to collectability, taxpayers have usually exhausted their opportunities to argue whether they owe the tax at issue. Instead, disputes as to collectability involve arguments about whether the taxpayer can or should pay the tax owed.

The rest of this section discusses the two types of disputes.

A. *Liability Disputes in General*

The tax controversy process begins with the filing of a tax return. The Service holds returns and information derived from returns strictly confidential. I.R.C. § 6103(a). Except in very unusual situations, the Service may not disclose their content, *even to other state or federal agencies*, and it may not disclose them to third parties without taxpayer consent. *See id.* at (e), (h)(4), (k) (listing some of the more important of the many exceptions to the rule of confidentiality). The Service takes the prohibitions of Section 6103 very seriously. Thus, a human trafficking client need not be concerned that an outstanding tax liability, without more, will bar the client from relief, for example, from a prior conviction. (Of course, seeking some forms of relief, such as clemency, might require the client to disclose an outstanding liability on her own.)

If the return shows a tax liability (already paid or unpaid), the Service normally assesses the liability shown on the return upon filing. I.R.C. § 6201(a)(1); *see also*



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id. at (e); § 6204 (providing for further assessments). **Assessment** is simply the recording of a liability on the books of the Service. *See* I.R.C. § 6203. Assessment is a purely mechanical process when the return involved reflects the correct tax liability or when any problems with the return are due solely to mathematical errors. *See* I.R.C. § 6201(a)(1).

Assuming a taxpayer files a proper return, the Service has three years from the date the return was filed to assess a liability for the tax period covered by that return. I.R.C. § 6501(a, b). Practically, this gives the IRS three years to audit most returns because it has only three years to assess additional tax based on those returns. There are several important exceptions to the basic assessment statute of limitations. Two exceptions are relatively likely to come up in human trafficking cases. First, if a taxpayer was required to file a tax return for a period but did not file one at all, the IRS has an unlimited time to assess. *Id.* at (c)(3). Second, the Service also has an unlimited time to assess if the taxpayer filed a return fraudulently, with the intent to deceive. *Id.* at (c)(1). Assessment is critically important because the Service cannot collect a tax liability without an assessment.

If the Service detects a problem with a filed return or if the return is randomly chosen, the return is subject to **examination**, better known in the non-tax world as “audit.”



In an audit, the Service scrutinizes questionable issues on the return and considers whether the taxpayer should owe more tax than reported on the return. Despite the fearsome connotations of “audit” in American culture, if an examination is handled “in the field,” by a *person* at the local IRS office rather than through form letters, audit is an extremely effective forum for explaining a taxpayer’s situation. Ultimately, the examining agent either agrees or disagrees with the taxpayer’s position. The agent memorializes the Service’s conclusions in a “30-day letter,” also called a “**Revenue Agent’s Report**.” This is usually the first clear statement the IRS makes of its position in a tax controversy. Note that in cases handled entirely by mail, “correspondence audits,” the IRS usually does not send a 30-day letter.

The 30-day letter is so called because a taxpayer has thirty days from its date of issuance to request review of the examining agent’s determinations by the IRS Office of **Appeals**, a quasi-independent division of the IRS that reviews other divisions’ conclusions and specializes in resolving cases.

If the taxpayer chooses not to (or can’t, due to lack of a 30-day letter) go to Appeals or if Appeals upholds the results of the examination, the Service usually issues a **Notice of Deficiency**, also called a “90-day letter.” See I.R.C. §§ 6211-6213. This is one of the most important documents in the controversy process, as it allows the taxpayer to petition the U.S. Tax Court to redetermine the deficiency involved. The taxpayer has only ninety days to file the petition, and no extensions are possible. Taxpayers who can afford to pay their liabilities in full might take an alternative path: pay, file an administrative refund claim, and, if that fails, sue for a refund in U.S. District Court. See I.R.C. § 6511, 7422.

As this discussion indicates, the kind of relief a representative can seek varies greatly depending on what stage of the process a controversy has reached. For this reason, it’s critically important that human trafficking advocates make sure that clients with potential tax problems retain copies of whatever documents the clients receive from the IRS. Reviewing those documents will be a tax specialist’s first step in determining what can be done to solve the client’s tax problems.

B. Collection Relief in General

Many human trafficking clients won’t reach human trafficking advocates, let alone tax specialists, until after the liability phase of the process ends. Instead, they will come to attorneys with existing, outstanding tax issues. In most of these cases, the IRS will have already determined and assessed a tax liability against the taxpayer. That is, the



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liability will have been recorded on the IRS's books, and the IRS will be trying collect it. To spot a collection issue, look for phrases in IRS notices and letters like "you have an outstanding balance," "notice of federal tax lien" or "levy."

The fact that a case is in collection matters for three reasons. First and most importantly, once a liability has been assessed, the IRS usually starts trying to collect from the taxpayer instead of merely asking the taxpayer for information. The IRS is a powerful, though sometimes quiescent, creditor. The assessment itself, without any information being publicly recorded, creates a lien in the IRS's favor on "all property and rights to property" of the taxpayer. I.R.C. § 6321. (The Service often files notice of the lien, anyway, to preserve its position against other creditors.) This enables the Service to levy on many kinds of property. Tax levies are similar to garnishments, except that the IRS need not obtain a court order before it undertakes the levy. Notice to the taxpayer and the opportunity for an administrative conference are all that are required. *See* I.R.C. § 6330.

Second, a taxpayer's available remedies change when a case reaches the collection phase. Most notably, it is very difficult to dispute the substantive basis of a tax liability once a case reaches collection. Instead of arguing that the IRS misunderstood what happened in a past tax year and should not have treated the taxpayer's situation the way it did, a representative must usually argue that even though the liability exists, there is some *present* reason that the taxpayer should not have to pay it. Further, collection disputes can rarely be litigated even if a taxpayer comes to the representative promptly.

Third, the IRS has only 10 years from the date of assessment to collect a tax liability. I.R.C. § 6502(a)(1). Sometimes, there will be more than one assessment for the same tax period, resulting in a series of staggered collection statute expiration dates. If those ten years are close to elapsing, it may be better for a taxpayer to "wait out" the statute rather than seeking collection relief, even if she otherwise appears qualified for it. This is because the statute is tolled during any period during which the taxpayer is seeking an installment agreement or an offer in compromise. Because the IRS routinely takes six months or more to process requests for collection relief, this can result in large extensions of the time on the statute if the request for relief fails.

There are three major forms of collection relief.

- **Currently Not Collectable ("CNC")** status is an administrative remedy created by Treasury Regulations and IRS procedures. As the name implies, when a tax year



is placed in CNC status, the liability continues to exist and accrue interest, but the Service no longer attempts to collect it. The IRS reviews tax periods placed in CNC status every year, and if a taxpayer's income substantially increases (usually expressed as "if she wins the lottery or something"), the year will be taken out of CNC, and collection will resume.

- **Installment agreements** permit a taxpayer to pay an outstanding balance over a period of time. I.R.C. § 6159. The Service has recently begun placing taxpayers who call in with collection issues into installment agreements with little input from the taxpayers, even though taxpayers regularly default on such installment agreements. Depending on the amount of the taxpayer's liability and how much the taxpayer is willing to pay per month, requests for installment agreements may be very involved or extremely simple to submit. Submitting an offer suspends any IRS collection action and the collection statute of limitations during the period the request for an agreement is pending.
- The Service may also accept an **offer in compromise ("OIC")** for a tax liability. I.R.C. § 7122. Such an offer satisfies a taxpayer's outstanding liability for less than the full amount due. Some offers involve considerable sums, while other taxpayers qualify to make offers of \$50, \$10 or a dollar. Determining how much to offer requires reviewing various IRS forms. In order to make an OIC, a taxpayer must have filed all required tax returns; if the taxpayer has not, the Service will reject the offer.

As with installment agreements, a request for an offer in compromise suspends IRS collection action and the collection statute of limitations while it is pending. OICs take a long time to process; the IRS's Centralized OIC Units usually takes between three and eight months to begin reviewing an OIC once it is received. However, once an offer examiner actually starts reviewing the OIC, the examiner usually requests additional information, such as up-to-date bank statements. The tax representative will need to submit the additional information within a very short time, such as two to three weeks.

To obtain any of these forms of relief, a taxpayer must usually submit some version of IRS Form 433, Collection Information Statement. This form lists all of a taxpayer's household's monthly income and expenses, as well as any assets the taxpayer holds. A taxpayer must also submit numerous supporting documents with a Form 433. This is usually a time-consuming process that requires regular contact between the taxpayer and the tax representative. Notably for human trafficking



clients, the IRS will *not* share this information with other agencies or outside entities; it is protected from disclosure by Section 6103.

III. Special Considerations in Human Trafficking Cases

Human trafficking clients are likely to present a few specialized issues in tax cases.

First, a human trafficking client may not have filed tax returns at all for some years. If a taxpayer has unfiled returns for a year in which she earned income above the filing threshold, she should be counseled to file accurate returns for those years. This is true even if the income came from an illegal source; so long as the income is accurately reported, no *tax* crime has normally been committed. In some cases, it may be advisable for a client to claim the Fifth Amendment privilege against self-incrimination to avoid stating the source of income on a return.⁵

Second, a client may have filed incorrect returns in the past, perhaps to avoid reporting income related to the trafficking experience. If the facts of the case (or a prior determination in a criminal case) suggest that the returns were filed with the intent to deceive, the Service may assert a fraud penalty against the taxpayer.

⁵ This raises issues related to criminal representation and defense outside the scope of this discussion.



Notably, the Service has an unlimited statute of limitations to make assessments based on a fraudulent return.

Often, a tax practitioner will begin repairing such a situation by filing correct, amended returns for the years at issue. Filing an amended return does not “undo” fraud on an original return. *See Badarocco v. Commissioner*, 464 U.S. 386 (1984). However, disclosing that the original returns were wrong shows the taxpayer’s good faith and may prevent the Service from asserting a fraud penalty.

Third, a human trafficking client may have filed erroneous returns at the behest of a third party, normally a trafficker. Even though the returns are wrong, challenging the substance of the tax liability will be difficult. A taxpayer is presumed to have reviewed any returns she signs, and she, not the preparer or a third party, is held responsible for any errors.⁶ While it is possible to argue that the client signed under duress, duress is as hard to prove in tax as in any other area of law—the definition is the same as that used in family and criminal law.

However, clients are not out of luck in such a situation. The Service recognizes the harshness of the legal rule and provides administrative opportunities for relief. First, if the third party prepared the return and had a refund claimed on the return diverted into his own bank account, the taxpayer can seek Return Preparer Fraud relief. This usually requires evidence that the refund itself was stolen and, in many cases, requires that the taxpayer have referred the fraud to police for investigation. Even more useful is seeking an “effective tax administration” offer in compromise. For example, the Service has determined, as a matter of internal policy, that a taxpayer should not have to pay a liability that arose due to the crime or fraud of a third party. *See* I.R.M. § 5.8.11.2.2.1.⁷ Accordingly, a taxpayer who was coerced into filing returns to benefit a trafficker, such as returns that claimed the trafficker’s income as hers, should submit such an offer. Instead of arguing, as most taxpayers seeking OICs do, that she cannot afford to pay the liability, she instead argues that the liability is the consequence of the trafficker’s criminal scheme, not her own intention. Effectively, this provides a “back route” to argue the inequity of the trafficking victim’s situation to the IRS.

⁶ A taxpayer who filed a joint return with the third party during the year at issue may be able to avoid the joint liability by obtaining innocent spouse relief. *See* I.R.C. § 6015. However, this applies only to taxpayers who filed a joint return with a spouse.

⁷ This is a citation to the Internal Revenue Manual, which instructs IRS employees, including offer examiners, on what standards to apply and how to evaluate submissions.



Finally, human trafficking clients are more likely than most taxpayers to have a combination of civil and criminal tax issues. While criminal tax prosecutions are very rare compared to civil tax examinations, they do happen, most often in situations involving illegal income or potential conspiracy charges. Of course, these are exactly the situations human trafficking clients are likely to face in disproportionate numbers. An overview of how to handle criminal tax matters lies beyond the scope of this discussion, which focuses on *civil* tax matters. However, when handling a civil tax matter, it is important to keep in mind the *res judicata* effect of any prior criminal proceedings. This matters most if a prior criminal case included a finding that the client's tax returns were fraudulent. Such a finding will normally prevent the taxpayer from challenging a civil fraud penalty in a subsequent civil case, since the United States will have already proved fraud to the higher standard of "beyond a reasonable doubt." While it is still possible to demonstrate good faith and to otherwise act to mitigate potential civil fraud determinations, as discussed above, practitioners should be aware that a prior criminal finding of fraud will affect subsequent discussions of a parallel civil matter with the IRS.

IV. Getting Tax Assistance

The tax controversy world has one of the most robust and effective systems of *pro bono* representation in the entire U.S. legal system. Finding free tax assistance for a human trafficking client should be relatively straightforward.⁸

The programs below are generally funded in part by grants from the Taxpayer Advocate Service (TAS), an independent office within the IRS that educates taxpayers about their rights and responsibilities, makes administrative recommendations to protect taxpayer rights to the IRS and legislative ones to Congress, and provides direct assistance in some administrative controversies. TAS also handles a limited number of cases itself. A client may be referred to TAS when there is an active dispute with the IRS and the IRS is not following its own stated procedures or when the standard modes of relief discussed above aren't available. However, due to TAS's limited staffing and the fact that its employees are normally not attorneys, it is usually more effective to take advantage of the resources listed below.

⁸ All the services discussed in this section are normally free, except that some Low-Income Taxpayer Clinics may charge de minimis fees in some cases. Many LITCs, however, are entirely free of charge.



Clients facing tax controversies can be directed to Low-Income Taxpayer Clinics, many of which are affiliated with law schools or independent legal aid organizations. A current list of LITCs may be found in IRS Publication 4134, available at <https://www.irs.gov/pub/irs-pdf/p4134.pdf>

If a client *only* needs tax returns prepared, the client can be directed to a Volunteer Income Tax Assistance (VITA) site. As the name implies, VITA sites prepare tax returns for low-income taxpayers. Some VITA sites operate only seasonally, and others prepare only current-year returns; contact your local sites for details. The Taxpayer Advocate Service and, normally, local poverty assistance clearinghouses maintain contact information for VITA sites.

If a client needs the type of assistance discussed in the rest of this document, though, the client should be directed to a Low-Income Taxpayer Clinic. Under Section 7526 of the Internal Revenue Code, the IRS, through TAS, funds clinics to advise and represent taxpayers in federal tax controversies. The overwhelming majority of tax clinics receive such a grant and are recognized as LITCs; most are affiliated with law schools or with independent legal aid organizations. A majority of an LITC's clients must have projected annual incomes within 250% of the national poverty level and outstanding tax liabilities of no more than \$50,000 per tax year, exclusive of interest. However, many LITCs will make exceptions to these rules in particular cases; law school clinics are particularly likely to accept human trafficking cases, with their involved facts and pedagogical value. A current list of LITCs can be found in IRS Publication 4134, available at <https://www.irs.gov/pub/irs-pdf/p4134.pdf>.

V. What to Ask a Human Trafficking Client About Taxes

This list of questions can be used to gather information that a tax specialist will



An Advocate's Guide to Tax Issues Affecting Victims of Human Trafficking

find useful in handling the tax phase of a human trafficking case. Many clients may not be able to furnish this information in an initial interview, but simply getting the client to begin thinking about these issues will make a subsequent discussion with a tax specialist much more effective.

Note the many questions about current finances, assets and expenses. These questions are designed to develop a foundation for crafting a persuasive offer in compromise or other request for collection relief.

- Do you owe any taxes to the IRS (or a state)?
- Do you know how much you owe?
- Did you file tax returns for the years for which you owe?
- Were those tax returns accurate—did they reflect the amount of income you actually had?
- Did a trafficker or another person force or convince you to file returns?
- Did you sign the returns before they were filed? Did you see the returns?
- Is the IRS (or a state) trying to collect from you now?
- If you are already paying the IRS each month, how much are you paying? If you are not already paying, how much do you think you could afford to pay each month?
- What is your overall financial situation like?
- Are you working or receiving other income now? If so, how much?
- What recurring expenses (rent, utility bills, judgments against you, etc.) are you paying?
- Do you have any bank accounts? How much is in your bank accounts?
- Do you own a house or rent? If you own, how much equity do you have in the house?
- Do you own a car? If so, how much equity do you have in the car?
- Do you have any other assets (usually, this is life insurance or a retirement account of some kind)?



- Can you provide documents that show your income and expenses? If so, how quickly can you gather the documents? If not, would you be willing to sign an affidavit explaining your income and expenses?
- Do you have any medical problems? Do any of those prevent you from working?
- Have you ever been defrauded by anyone, including a trafficker?
- Have you been convicted of any crimes? Are any of them related to taxes? Were there any terms about taxes in any plea agreements?

PART TWO: POTENTIAL TAX CONSEQUENCES OF MONETARY AWARDS IN TRAFFICKING CASES

A victim of trafficking might be forced into the orbit of the tax system not because of the trafficking itself—as was discussed in Section One—but rather because of the money he or she receives as restitution or damages following a criminal or civil trafficking case. The Trafficking Victims Protection Act affords victims mandatory restitution, including back wages and other out-of-pocket expenses.⁹ 18 U.S.C. § 1593. The amount of the restitution is required to be “the full amount of the victim’s losses, as determined by the court,” including the client’s actual losses, such as medical, physical, emotional and economic costs, *and* an additional amount equal to the greater of the value of the victim’s services to the trafficker or minimum wages and overtime wages under the FLSA. *Id.* at 1593(b)(1).

Of course, trafficking victims who successfully bring a civil suit against their trafficker will receive money as the result of either a settlement or a judgment. It is paramount that advocates understand the tax implications of criminal restitution and civil damages, so that the money that was intended as a remedy is not reduced unnecessarily by overpayment of tax.

⁹ 18 U.S.C. § 3663 is the general criminal restitution statute, which sets forth factors a court should consider in determining whether or not to order restitution in a criminal case, while § 3663A provides for mandatory restitution in certain types of criminal cases, depending on the facts relating to the nature of the offense and the nature of the injury caused to any victims of the crime. By contrast to these statutes, the only predicate condition to restitution under the TVPA is that an offense under the TVPA has been committed. 18 USC § 1593



HUMAN TRAFFICKING SETTLEMENTS AND JUDGMENTS— TAX CONSIDERATIONS

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Tax treatment of payments received by trafficking victims as restitution or civil damages must be taken into consideration by practitioners to protect clients. Ignoring the tax consequences of these payments can cause harm to clients long after resolution of the underlying criminal or civil case. Although the rules governing mandatory restitution payments are generally clear—the payments are not taxable to the human trafficking client (see Part I below)—the law governing civil judgments and settlements is less favorable and less clear (see Part II below). Very generally, civil judgments or settlement money paid for “physical injury” or “physical sickness” are not taxable. Most other types of damages, including damages for labor law violations, are taxable, and may also be subject to employment taxes. Civil judgments and settlement amounts must be allocated among the taxable and non-taxable claims alleged in the victim’s lawsuit or established at trial. The allocation determines which amounts may appropriately be treated and reported to the IRS as taxable income and which damages may be properly excluded from the human trafficking client’s income.

Parts I and II, respectively, discuss the tax treatment of payments received by human trafficking clients as mandatory restitution under the TVPA and as damages received from a civil judgment or settlement agreement. Part III provides model settlement agreement language for resolving civil matters. In general, trafficking victims benefit from settlement agreement language that clearly addresses the tax issues discussed below, along with a short file memorandum making allocation recommendations in their individual cases. This guides the client (or return preparer) in preparing tax returns, and may help the client respond to IRS inquiries about the tax reporting of settlement amounts.

I. The TVPA and Mandatory Restitution

Criminal restitution resulting from a TVPA offense is nontaxable. In Notice 2012-12, 2012-6 I.R.B. 365 (Jan. 19, 2012), the IRS held that “[m]andatory restitution payments awarded under 18 U.S.C. §1593 are excluded from [a trafficking victim’s] gross income for federal income tax purposes.” As a result, any amount a victim receives from a TVPA mandatory restitution order is not required to be reported to the IRS as income and is tax-free to the recipient. Although the Notice makes clear



that the entire mandatory restitution award is nontaxable, it leaves unanswered whether the IRS would afford similar nontaxable treatment to other variations of criminal restitution, such as restitution awarded when the judge or prosecutor references the general restitution statute instead of the trafficking-specific statute. Another open question is the tax status of restitution where the defendant was charged with trafficking crimes but pled guilty to a non-TVPA offense. Depending on the specific facts and circumstances of the case, it may be reasonable in some cases for a victim to take the position that the criminal restitution award is nontaxable.

II. Civil Settlement or Judgment Awards

Unlike criminal restitution, damages received by a trafficking victim pursuant to a settlement agreement or judgment (both referred to as “settlements” in the following) may be taxable. Whether a settlement payment is reportable and/or taxable depends on the specific facts relating to the settlement and the nature of the claims that were settled. For example:

a. Settlements that compensate for “physical injuries or physical sickness” are not treated as income and are therefore tax-free. Section 104(a)(2) of the Internal Revenue Code specifically excludes from gross income “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.” Settlement agreements should specify that these amounts will not be reported on Form 1099, Form W-2 or otherwise by the defendant.¹⁰

1. If an action originates in physical injuries or illness, “all damages flowing therefrom are received on account of the physical injury or physical sickness under Section 104(a)(2),” including documented economic losses that are a direct result of the physical injury or sickness. Chief Counsel Advisory 201045023.¹¹

2. But damages for a psychological or emotional harm that manifests in physical injury are nontaxable only if the damages are awarded

¹⁰ Note, however, that if a defendant pays a settlement directly to a lawyer, the defendant might be required to report that payment on a Form 1099 issued to the lawyer.

¹¹ While Chief Counsel Advisories and other internal IRS guidance are not precedential, they provide guidance on how the IRS has approached similar issues in the past.



“on account of” the physical manifestation, and not the underlying psychological or emotional harm. *Sanford v. C.I.R.*, T.C. Memo 2008-158.

b. Civil settlements that compensate for wages the victims should have been paid are treated as wage income and are therefore subject to tax. These include settlements of FLSA or similar state law claims. The defendant should report these amounts to the victim and the IRS on Form W-2. Although employment tax is due on these amounts, counsel should try to negotiate as a condition of the settlement agreement that the defendant pay any employment tax owed.

c. Civil settlements that compensate for other types of claims may also be treated as income, though not necessarily wages, and the defendant may be required to report these amounts to the victim and the IRS on Form 1099-MISC as “other income.” The victim may have to pay income tax on these amounts. An example of this is FLSA liquidated damages.¹²

When deciding how to characterize a settlement amount, the Tax Court has held that the “reason or intent” of the payment is dispositive. When damages are paid under a settlement agreement, the Tax Court first looks for an express statement in the agreement of the reason for the damages payment. *Domeny v. Commissioner*, T.C. Memo 2010-9. If the agreement is ambiguous, courts then look to the intent of the payor, which involves an analysis of “all the facts and circumstances”¹³ of the agreement, including the manner in which the payment is structured. The IRS also looks to whether the settlement amounts were allocated reasonably among the various claims brought in the complaint. Accordingly, settlement agreements should specify the portion of the settlement that compensates a victim for each of the categories of physical injuries or sickness, wages and other non-wage income, and should allocate the settlement among the client’s various claims in a reasonable fashion.

Because the determination of whether damages may be excluded from gross income is highly fact specific, we advise attorneys representing victims in human trafficking claims to provide extensive documentation during a trial or settlement negotiations and to put that documentation into the client’s file. Whenever possible, this documentation should show all colorable claims of physical injuries and

¹² *United States v. Sabhnani*, 599 F. 3d 215 (2d Cir. 2010) (stating “[t]he question here is whether Section 216(b)’s provision for liquidated damages counts as part of the ‘value of the victim’s labor as guaranteed under the minimum wage and overtime guarantees of the Fair Labor Standards Act.’ We think it does.”).

¹³ *Domeny*, at 4.



sickness and any further claims (including mental injuries or sickness, lost wages, and medical bills) that are a direct result of the physical injuries or sickness. The documentation should also include any basis for concluding the initial physical injury or sickness led to the subsequent claims.

The following chart summarizes the basic categories of damages based on tax treatment and reporting:

Claim to Which Amount Is Allocated	IRS Reporting, if Any	Taxes Paid, if Any
Claim on Account of Physical Injury or Illness	None.	None. A Client may exclude the amount awarded from her income so that she does not pay tax on it.
FLSA Claim for Unpaid Wages (including portion of TVPA claims calculated based on FLSA minimum wages)	A Client should report the amount awarded as wages on their tax return.	A Client should pay income tax on the amount awarded. In addition, employment taxes are due on the amount (including both the employee and employer portions, payment of which can be negotiated by the parties).
FLSA Claim for Liquidated Damages (including portion of TVPA claims calculated based on FLSA claim for liquidated damages)	A Client should report the amount awarded as "other income" (not wages). A defendant should report the amount on Form 1099-MISC.	A Client should pay income tax on the amount awarded.



III. Settlement Agreements

We recommend consulting with tax counsel prior to negotiating the terms of a settlement agreement. Allocation of the settlement amount among the various claims and agreement as to reporting of those claims can be important to defendants as well as to trafficking victims. Tax consequences should be treated as a substantive portion of the terms of the settlement agreement.

Settlement agreement language should allocate the settlement payment to the client's various types of claims, and should specify whether the amount allocable to each type of claim will be reported to the IRS on Form W-2 (wage income), Form 1099-MISC (other taxable income) or not at all (amounts paid on account of physical injuries or sickness). The parties should agree to report each amount consistent with the provisions of the settlement agreement for all federal, state and local tax purposes.

Clients who receive mandatory restitution payments or settlement payments have been vindicated, in part, for the trafficking offenses they have suffered. Careful documentation of the allocation of such payments among taxable and nontaxable categories, and agreement on allocation and reporting matters in the settlement agreement, can help a client address tax reporting obligations.

CONCLUSION

Trafficking can have long-term and harmful repercussions. Even the best advocate can leave a client facing significant risk by failing to address all potential issues. Armed with the knowledge that trafficking victims might face serious tax problems, advocates should seek out expert assistance. The goal should always be to prevent trafficking survivors from experiencing further hardship. Resources—including Low-Income Taxpayer Clinics and *pro bono* tax attorneys—are available to assist.

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