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Issues Associated with IRS Audits

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What is it?

There are numerous issues associated with Internal Revenue Service (IRS) audits. You should know your chances of being audited, the different types of audits, strategies for handling audits, your rights with respect to an audit, and how to appeal audit decisions.

Your chances of an IRS audit

In recent years, the IRS has audited (on average) 1-2 percent of individual income tax returns. The audit rates can vary from year to year, however, owing to several factors, including changes in the IRS's staffing. To some extent, audit focus has begun to shift.

In the past, the IRS particularly scrutinized itemized deductions. The trend at the IRS in recent years has been to focus more on ensuring that taxpayers report all taxable income. As a result of this trend, taxpayers who are self-employed, receive much of their income in tips, or run cash-intensive businesses face a greater likelihood of audits. The IRS now pays more attention, moreover, to doctors, lawyers, and accountants (who often run their own businesses and do their own bookkeeping). Several other factors can lead the IRS to single out your return for an audit. Possible red flags include the following:

- A return that is missing required schedules
- A return that is missing a required alternative minimum tax form
- A return signed by a preparer associated with problems in the past
- A claim for refund of at least \$200,000
- A return reporting income of at least \$150,000

Furthermore, it is clear that certain IRS districts are more active than others in conducting audits. If you live in Las Vegas, Los Angeles, Atlanta, Boise, San Francisco, Anchorage, or Cheyenne, you run a greater risk of being audited.

Finally, if your itemized deductions in several major categories--medical and dental expenses, taxes, charitable contributions, interest, and miscellaneous--are greater than average, you have an increased risk of being audited.

Note that you are least likely to have your return audited if you don't itemize deductions and all or most of your income is subject to withholding.

Types of audits

There are three basic types of audits: correspondence audits, office audits, and field audits. In a correspondence audit, you mail your records to the IRS. In an office audit, you bring in your records to the IRS for examination. In a field audit, the examination takes place at your office or your representative's office. The IRS decides the time and type of audit, with the requirement that the arrangement be reasonable under the circumstances.

What tips should you bear in mind when dealing with the IRS?

There are a number of tips you should keep in mind when dealing with the IRS. In particular, you should know your rights regarding IRS audits.

Know your rights

With the exception of criminal investigations, you have the right to an explanation of the audit process and your basic rights at or before the time of your initial in-person meeting with the agent. Your other rights during the audit process include the following:

- The right to representation by an attorney, a CPA, or an enrolled agent
- The right, with advance notice, to tape-record meetings with the IRS agent
- The right to claim additional deductions you didn't originally claim on your return
- The right under most circumstances to only one inspection of your records per tax year
- The right to request an opinion from the IRS's National Office on specific technical issues that arise

Keep good records

You should keep records of all income (including nontaxable income, gifts, and savings) in the event that the IRS tries to assess tax based on a perceived discrepancy between your income and your lifestyle. Likewise, you should keep detailed records regarding expenses and deductions.

Limit direct contact with IRS personnel

Keep direct contact with IRS personnel to a minimum. The less contact you have, the less opportunity a revenue officer will have to raise unexpected questions. Also, limited direct contact keeps the audit focused on the specified issues.

Tip: If you have specific questions or are having difficulty understanding the audit process, consider consulting a tax professional before contacting the IRS examiner. This way, you may be able to avoid the possibility of opening up new issues for audit.

Avoid particular mistakes in your dealings with the IRS

The following are mistakes you should avoid in dealing with the IRS:

- Communicating with the wrong IRS Service center
- Making gratuitous, hostile remarks to an IRS agent
- Coming to an audit without records
- Projecting a negative attitude toward the IRS
- Not filing a tax return
- Falling for tax-evasion schemes
- Not using the peel-off label the IRS sends you
- Omitting your Social Security number on documents and correspondence

You should note a few matters concerning some of these mistakes. First, failing to bring records to an audit

makes you come across as unprofessional and not responsible. Second, not filing a tax return leaves you in a position in which the IRS has unlimited time to go after you for your return. If you file a return, the statute of limitations starts to run. Third, participation in a tax-evasion scheme leaves you vulnerable to substantial interest and penalty charges. Fourth, failing to use the peel-off address label with your return takes you out of routine processing mode and may increase your likelihood of an audit.

What are some practical strategies for handling IRS audits?

Consider doing the following in connection with an audit of your return:

- Before your initial interview with the IRS agent, meet with your representative to discuss strategies and expected audit results.
- Volunteer little or no information to the IRS agent. Simply have your representative respond to the agent's questions.
- Keep detailed records of the materials you submit to the agent, the questions asked by the agent, and the times of these activities.
- Know when it is time to conclude the audit and move the case to the next level. Avoid wasting time by submitting additional information after the agent has made a decision.
- Avoid agreeing to extend the statute of limitations unless you expect a favorable audit report. Extending the statute of limitations gives the IRS agent more time to examine your return and possibly discover more potential problems.
- Settle the audit at the lowest level possible. This way, you save expense and avoid the likelihood of other issues being raised.
- Be thoroughly prepared. Agents don't waste time conducting an in-depth audit if they see early on that a taxpayer's records clearly substantiate the items claimed on the return.

Be clear on disallowed deductions

Understand why an IRS agent proposed to disallow an item on a return, to increase an income item, or to make other adjustments. Never accept an agent's word on what constitutes law. Agents aren't experts on all aspects of the tax law. Seek another opinion on the law from an attorney or other tax professional.

Your rights concerning repetitive audits

IRS policy bars repetitive examinations involving the same issue. If an agent wants a second look at the books, demand a letter from the IRS District Director before complying.

If you filed an individual return and respond to an initial contact letter stating that an audit of the same issue(s) in either of two preceding years resulted in a no-change or small tax change, you may be able to end this audit at an early stage. The examiner will ask you for information that will help locate your account. The examiner will then determine whether the current issue relates clearly enough to a prior year no-change or small tax change to warrant a similar determination. If the examiner reaches this conclusion, the audit is ended, pending group manager approval. If both of the prior years were examined for the issue in question and one year resulted in a substantive adjustment, the examiner will continue the current year audit as a regular audit. The group manager will indicate approval of the examiner decision to continue the audit.

Negotiations

Although you can't bargain officially with an IRS agent, unofficial negotiation happens all the time. You can bargain over an entire item (such as medical expense deductions, charitable deductions, or interest expense deductions) only, unless the law permits the item to be divided up.

Example(s): Sue disagrees with the agent over the deductibility of a single \$500 charitable contribution. She and the agent can't expect to settle for \$250. Rather, they need to agree that the entire \$500 is either deductible or not.

Be careful about signing the examiner's report

When you sign the examiner's report, you are agreeing that you owe the specified tax. You can't appeal the report within the IRS and can't file a petition in the Tax Court. If the audit is completed and the agent proposes to disallow items to which you feel entitled, don't sign the report.

Tip: If you are uncertain about whether to sign, consider consulting a tax professional before deciding.

Waiving the statute of limitations

An IRS auditor may ask you to waive the statute of limitations to allow more time to examine the case. If you refuse to sign the waiver, the examiner will generally disallow all the items he or she wanted to audit and issue a Notice of Deficiency. This Notice of Deficiency requires you to file a petition with the Tax Court within 90 days to avoid having to pay the tax until the Court considers the merits of the case.

Tip: It may be to your advantage not to sign the waiver if there are items on the return that you would rather the agent not probe into during an audit. In the Tax Court, you will still have to substantiate your treatment of the items in question, but you generally won't face the kind of probing that can open up other items.

Tip: You also have the option of asking for a restricted waiver, which extends the limitations period for only a particular item on the return.

Unagreed issues

Unagreed issues take a long time because they go through an internal IRS review process. There is often considerable delay before an agent's report, including unagreed items, is issued. If the IRS appeals officer feels that an issue may not have been treated properly, the case may be returned to the agent, causing further delays.

If you need an immediate audit report before completion of the review process, you can request it from the agent or the group manager at the completion of the audit.

How do you appeal an audit's findings within the IRS or in court?

You can appeal the findings of an audit through the IRS appeals office. If you can't resolve the matter there, you can take it to court.

IRS appeals office level

- Filing a protest --The protest-filing procedure depends on the amount of money at issue.
 1. You must file a formal written protest if the disputed amount is over \$10,000
 2. You may file a brief written statement if the disputed amount is between \$2,500 and \$10,000
 3. You may make an oral request if the disputed amount is \$2,500 or less

Tip: You and your representative should organize the facts and review all possible legal arguments before preparing a written protest. Statements in a written protest are an admission by you and can be used against you in the appeal.

- Appeal strategies -- Keep in mind the following as you pursue your appeal:
 1. Don't furnish any additional facts or legal theory during the initial conference with the Appeals Officer. Wait until the government's position has been stated.
 2. Be conscious of etiquette. Be on time, treat the Appeals Officer in a professional manner, furnish additional information promised in a timely manner, and create a positive impression.
 3. Be prepared for settlement discussions. You and your representative should compute a settlement bracket (i.e., a low offer and a high offer) in advance of any appeals conference. This way, you'll be able to recognize and accept a good settlement offer immediately. Settling at this level may be easier than investing the time and effort of trying the case in court.

Obtaining a copy of the audit file

Before filing an appeal, you will want to obtain copies of the case workpapers compiled by the Revenue Agent who handled the audit. Ask for the file after the audit is completed.

To obtain a copy, submit a written request under the Freedom of Information Act with the Disclosure Officer in the IRS district. It takes approximately six weeks to receive the file. There may be a copying charge. The workpapers show what information the agent used to determine adjustments to the tax bill. They will also show what relevant information the agent didn't make a permanent part of the file.

Appealing in court

You have two options for taking the IRS to court:

- You pay the amount assessed, file a request for a refund, and the IRS rejects the request
- The IRS issues a Statutory Notice of Deficiency (90 day letter)

In the former scenario, you go to either U.S. District Court or the U.S. Claims Court. In the latter scenario, you file a petition in the United States Tax Court, except that there are no appeals for cases handled under small case procedures.

Technical Note: In order to get to court at any stage, you can request a Notice of Deficiency or file for a refund and request an immediate rejection. You must file the petition with the Tax Court within 90 days from the date of the Notice of Deficiency.

Tip: If you have a net worth of \$2 million or less and prevail in Tax Court against the United States, you may be awarded litigation costs.

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