



The Life Cycle of an IRS Audit

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and Diana C. Española



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Reservoir Place
1601 Trapelo Road, Suite 205
Waltham, MA 02451
781-622-5930

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Careful advance preparation can help reduce the scope of a tax audit or examination and can lead to a more favorable disposition. While, of course, a thorough understanding of the underlying facts and applicable law is a must, facility with the IRS procedures is critical to preserving a taxpayer's rights. This article is a summary of some of the more important IRS procedural rules and guidelines governing civil¹ IRS examinations and audits, including: how returns are selected for examination; a brief description of the types of civil examinations; an explanation of the tools available to IRS examining agents and revenue agents; dispositions in IRS audits or examinations and, if necessary, where to seek relief from an unfavorable result in an examination or audit.

Selecting Tax Returns for Examination

At the outset, it is helpful to understand how tax returns are selected for examination. The IRS selects returns for examinations in several ways - some based upon objective criteria coded into a carefully protected computer program and others based upon old fashioned detective work.

The main computer program that the Service uses to identify returns for examination is the Discriminate Function System. The Discriminate Function (DIF) score is the product of a mathematical formula for identifying and selecting returns² for examination. The program scores tax returns using a formula based on historic information obtained from specific examination programs. A high DIF score indicates a high potential for adjustment. The Service periodically conducts compliance studies to update and reformulate its basis for audit selection formulas. Different types of taxpayers and returns are subject to different DIF formulas. While the specifics of the program are not public, certain items appear to cause a return to be selected for examination, such as participation in a tax shelter, large charitable contributions, home office deductions, large travel and entertainment expense or large automobile expense. Returns selected under the DIF program are then manually screened so that attachments to the return and other data that a computer cannot detect can be properly considered.

The Service also relies on information provided by third parties, such

as banks, brokers and employers. Much of this information is required to be reported by payers of certain types of income on Forms W-2 or 1099. Referrals may also be made by other examining agents. For example, the return of a party related to another taxpayer being audited, such as the partners of a partnership being audited may also be selected for audit. The Service also may investigate tips regarding potential noncompliance, and select those returns for audit as a result.

Examinations may also be triggered a variety of other ways, such as, by mathematical errors or missing information. Also, a claim for refund can trigger an examination.

Types of IRS Examinations

IRS civil examinations can take a variety of forms, depending upon the type of taxpayer, the complexity of the tax return and the initially determined scope of the exam. The simplest examinations conducted by the IRS are Campus Examinations. Campus Examinations are correspondence exams addressing simple problems like substantiation that can be resolved easily by correspon-

¹ Criminal tax investigations are governed by very different rules. If the Service is conducting a criminal investigation, or you have reason to suspect that an agent is considering a referral to the Criminal Investigation Division, you should contact competent criminal tax counsel immediately.

² All Forms 1040 for individuals, Forms 1120 for C corporations with assets under \$10 million or no balance sheet, Forms 1120S for S Corporations with assets under \$10 million and all Forms 1065 for partnerships are scored under the DIF system.

dence and/or telephone. Area Office Examinations may be conducted for slightly more complicated issues such as small business returns and more complex non-business returns. Area Office Examinations may be conducted by correspondence, office interview or even by a field examination, depending on type and complexity of the return. In all cases, the taxpayer is asked to provide supporting documentation of questionable items. Business returns will always be examined in an office or field interview rather than a correspondence examination.

As a practical matter, examiners at the correspondence and office levels are much less invasive. The examining agents are required to process many cases and often have little time to completely familiarize themselves with the return. Indeed, the examiner may not have reviewed the taxpayer's file and return until after the taxpayer has replied to all correspondence regarding the examination, and often not until the day of the interview. The scope of office examinations is generally limited to items on a checklist of issues contained in the Internal Revenue Manual. The examiners have little discretion and basically, are charged with verifying income and deductions based upon records provided. A taxpayer's inability to produce adequate records may lead not only to disallowance of the disputed items for the year at issue, but also to audits of other years' returns.

Field Examinations involve more complex issues. The examining agent will be a revenue agent, as opposed to an office auditor. He or

she will be better trained and will have had more experience. A Field Examination consists of examination of a taxpayer's books and records at the taxpayer's place of business or where the books, records or source documents are maintained. The agent will review the taxpayer's entire return and all documentation related to that return. The agent may be assisted by a technical specialist such as an "engineer agent" if the return presents a special issue such as valuation. Unlike, office auditors, revenue agents spend considerable time preparing for the examination. Prior to the examination, the revenue agent will review any prior examination reports from the same taxpayer. This may lead to scrutiny of recurring issues or inclusion of other years' returns in the examination. Of course, the revenue agent will also look at the return for unusual or questionable items.

Taxpayer Rights during an Audit

Taxpayers are guaranteed certain important rights during audits and examinations. Among these rights is the right to be provided certain information describing the examination process and other rights at the commencement of the examination. Examinations must be conducted at a reasonable time and place and taxpayers have the right to bring representation to any interview. Taxpayers have the right to record any interviews with the agent. Taxpayers also have the right not to be interviewed, except through the summons process, and must be notified of any summons to a third party and of their right to quash any such sum-

mons. Importantly, taxpayers have the right to have their tax information kept confidential.

Under new law, the IRS has the burden of proof in any court proceeding with respect to a factual issue ... if the taxpayer introduces credible evidence relevant to the determination of the taxpayer's tax liability.

Burden of Proof

Under prior law, there was a rebuttable presumption that IRS's determination of tax liability is correct, and therefore (with some exceptions such as fraud), the burden of proof was on the taxpayer to show that the IRS's determination was wrong. Under new law, the IRS has the burden of proof in any court proceeding with respect to a factual issue related to income, estate, gift, and generation-skipping transfer taxes if the taxpayer introduces credible evidence relevant to the determination of the taxpayer's tax liability. To be eligible, the taxpayer must prove that he or she complied with required statutory and regulatory substantiation and recordkeeping requirements; cooperated with reasonable IRS requests for meetings, interviews, witnesses, documents, and information; and (if not an individual) met certain net worth limitations. Cooperation generally involves: providing

reasonable assistance to the IRS in accessing witnesses, information, and documents not within the taxpayer's control; exhausting administrative remedies, including IRS appeal rights; and establishing the applicability of a privilege. Cooperation does not require that the taxpayer agree to an extension of the limitations period. The IRS continues to have the burden of proving fraud, irrespective of the new law.

Interacting with the Agent

When possible, the taxpayer's representative, not the taxpayer, should interact with the agent. Indeed, in most cases, the meetings should take place at the representative's office, not the taxpayer's place of business. Direct contact between the agent and the taxpayer (or taxpayer's employees) should be minimized. Agents are trained in interviewing techniques designed to elicit information. They will ask open ended questions, and will listen carefully to the responses. Taxpayers who meet with an agent should be careful to answer only the question asked.

Care should be taken to create a complete record of all information provided to the examining agent.

Absent having been served an administrative summons, a taxpayer has the right to refuse to be interviewed. Although, historically examining agents have been reluctant to press for taxpayer interviews,

examining agents have become more aggressive in seeking taxpayer interviews and using summonses to compel them. If interviewed pursuant to a summons or otherwise, the taxpayer has a right to counsel and may assert appropriate privileges.

Care should be taken to create a complete record of all information provided to the examining agent. Maintain a detailed record of all documents and records provided to the examining agent. Maintain a record of any oral communication with the agent whether in person or by telephone. Confirm any material oral agreements in writing.

How Agents Gather Information

During the examination, the agent may request various types of documentation to verify items of income and expense on the return, including records, such as receipts, invoices, books, and worksheets. Revenue agents may also review prior or subsequent tax returns or the returns of related taxpayers.

Generally, agents have broad powers to compel production of relevant information. Nevertheless, certain types of information may be subject to privilege or otherwise not subject to compelled production. Once provided, the privilege is likely to have been waived. For example, an agent may ask to see invoices to substantiate a deduction claimed for professional services, such as accounting or legal fees. The descriptions of the services provided could contain information leading to another adjustment. If the descriptions of

the services may be privileged, the taxpayer may be able to withhold the actual invoices in favor of some other proof of payment, or may be able to provide redacted invoices.

There has been much discussion about whether tax work papers can be so compelled. Tax work papers prepared in connection with the preparation of the tax return can be reviewed. However, audit accrual work papers, which may reflect opinions and estimates related to questionable items on the return, present a more complex question. Agents are cautioned in the Internal Revenue Manual to exercise restraint in this area, but the Service is becoming more aggressive, particularly where listed transactions are involved.

Keep in mind that the taxpayer's books and records may contain confidential information of another taxpayer, such as IP or the terms of a contract. The taxpayer may be under a contractual obligation to keep this information confidential. If the agent can not be convinced to accept redacted documents, the taxpayer may want to decline to produce the document unless an administrative summons is issued compelling its disclosure.

An agent will typically request documents and other information by issuing an Information Document Request (Form 4564). Initial requests at the beginning of an examination are typically fairly broad with subsequent requests focusing on specific issues. Keep careful track of IDR requests and items produced. Always maintain a duplicate copy of any documents that are provided

and include a transmittal letter with any response describing the documents produced.

If a taxpayer fails to produce requested items, the Service can summons a taxpayer or third party for books, records or testimony. Agents are directed to make an attempt to obtain information informally before issuing a summons. Agents are instructed to consider issuing a summons when a taxpayer fails to make requested records available within a reasonable period of time; where the records submitted are known or suspected to be incomplete and the examining agent believes that additional records containing relevant and material matter may be in the possession of the taxpayer or a third party; and when the examining agent is in doubt as to the availability of pertinent records and wishes to obtain oral testimony as to what records may exist and their location.

When an administrative summons is issued, the summoned person must personally appear at the time and place specified with any requested items. The summoned person has the right to counsel, the right to assert the attorney-client privilege, and the right to raise the self-incrimination privilege under the 5th Amendment. The IRS can issue administrative summonses to third parties believed to hold relevant information. Notice of summons issued to a third party must be given to the taxpayer within 3 days of the date on which service is made to the third party and no less than 23 days before the summons return date. This is to allow the taxpayer sufficient time to file a petition to quash.

If a summoned party ignores the summons or otherwise fails to fully comply, the Service may bring legal proceedings to enforce the summons in federal district court. A court will generally enforce a summons if there is a legitimate purpose for the examination; the information demanded may be relevant to that purpose; the information is not already in the possession of the Service; the information or document is not privileged and the Service has complied with the applicable administrative requirements of the Code and regulations.

Dealing with a Potential Criminal Referral

If an agent has a “firm indication of fraud” he or she is required to suspend the civil examination without disclosing the reason to the taxpayer. IRS regulations prohibit an agent from developing a criminal case against a taxpayer under the guise of a civil investigation. Then the agent must refer the case to the Criminal Investigation Division. The agent may be aware of potential fraud before he has enough evidence to suspend the exam and turn over the case. Take care to look for clues in the agent’s actions and behavior as to whether the nature of the case will shift to a criminal investigation. Among the tell-tale signs that a civil case may be heading toward a criminal referral is the sudden cessation of communication with you by the agent; the agent asks the client “state of mind” questions — usually starting with words like “why” and “didn’t you know?”; or the agent issues summons for otherwise closed tax periods, or summonses are issued for periods other than those con-

tained in the original examination notice. Most importantly, look for the appearance of a “special agent”. A special agent is a federal law enforcement officer. He or she is required to identify himself as such and to give a Miranda-type warning. A special agent may arrive with the revenue agent or alone. Note that a special agent may make an unannounced visit to the taxpayer. The sole purpose of any such meeting is to catch the taxpayer off guard and without counsel, so that the client can incriminate himself. Because it is human nature to try to explain things, a taxpayer should be advised never to speak to a special agent without counsel present.

Take care to look for clues in the agent’s actions and behavior as to whether the nature of the case will shift to a criminal investigation.

If an examination becomes a criminal investigation, or if you think that the examining agent is heading in that direction, consider the following: terminating all direct contact between the taxpayer and the IRS; obtaining taxpayer records from third parties and holding them; advising the taxpayer to refrain from witness tampering and document creation or alteration. Cooperation with the revenue agent will not save the day. If there is evidence of criminal conduct and that evidence is enough to obtain a conviction, there will be a referral, irrespective of how a taxpayer cooperates.

Dispositons of Audits -- “Agreed” or “Unagreed”

Audits may be concluded with an “agreed case” or an “unagreed case”. Of course, if the taxpayer presents sufficient documentation for the items at issue, the examining agent may accept the return as it was filed. If the taxpayer and the examining agent reach an agreement on adjustments, the taxpayer and examining agent complete a form describing the adjustments to the return and agreeing that any additional tax may be assessed. Where the taxpayer and the examining agent cannot reach an agreement, the examining agent’s next step will depend upon whether there is sufficient time remaining on the statute of limitations on assessment³ (generally six months). If there is sufficient time left on the statute of limitations, the examining agent will prepare a report that will be reviewed by the examining agent’s manager. Once approved, the report is sent to the taxpayer along with a “30-day letter”. If there is not sufficient time left on the statute of limitations and the taxpayer will not agree to extend the statute, the report will be sent to the taxpayer with a statutory notice of deficiency (sometimes referred to as a “90-day letter”).

A 30-day letter gives the taxpayer an opportunity to protest the examining agent’s proposed adjustments to an administrative appeals officer. The taxpayer has 30 days within which to submit a written protest

outlining the taxpayer’s position on fact and law. Appeals officers are charged with evaluating the case *ex parte* based upon the record created by the revenue agent and as supplemented by the taxpayer. The appeals officer can uphold the examining agent; find for the taxpayer or attempt to reach a settlement with the taxpayer. The appeals officer is instructed to consider the “hazards of litigation” for both sides in his or her evaluation of the case. If the case is agreed at this level, the parties will sign an agreement permitting the Service to assess and collect the agreed amounts. If the parties can not reach an agreement or if the taxpayer does not respond to the 30-day letter, the appeals officer will issue a statutory notice of deficiency.

The Service must issue a statutory notice of deficiency before it assesses additional tax. The Notice gives the taxpayer one last chance to contest the proposed deficiency prior to paying it. A taxpayer has 90 days to file a petition with the Tax Court to redetermine the deficiency. If the taxpayer does not respond to the 90-day letter, the Service will assess the proposed deficiency and will issue a bill to the taxpayer. At this point, the taxpayer must pay the amount assessed. The taxpayer then has the opportunity to contest the assessment by filing a refund claim. If the refund claim is disallowed, the taxpayer may then file a refund suit in United States District Court or United States Court of Claims.

Statutes of Limitations

The Service does not have an unlimited time to examine a tax return. As a general rule, the Service may not assess a tax more than 3 years after the later of the date the return was due or the date the return was actually filed. A special rule applies if the taxpayer omitted from his or her return an amount of gross income that is greater than 25% of the amount of gross income that was included on the return. In such cases, the statute of limitations for assessment is 6 years. In the case of a false or fraudulent return with intent to evade tax, the tax may be assessed at any time. When no return was filed, the tax may be assessed at any time.

The decision to extend the statute of limitations must be made carefully. Under certain circumstances, giving consent to extend the statute may benefit the taxpayer.

In certain circumstances, a taxpayer may agree to extend the statute of limitations. This is done in writing on IRS Form 872 (Consent to Extend the Time to Assess Tax) or 872-A (Special Consent to Extend the Time to Assess Tax). A Form 872 extends the time to assess the tax to a specified date. A Form 872-A

³ Typically, the IRS has three years from the date a tax return was filed to determine and assess additional tax and penalties. This period is increased to six years when there has been a substantial (generally 25%) omission of income. The statute of limitations does not run if the tax return is fraudulent or if no tax return was ever filed.

is a consent extending the period of limitations on assessment for an indefinite period of time. The consent given on Form 872-A can be revoked by filing a Form 872-T, which starts the running of the 90-day period for assessment of tax or issuance of a notice of deficiency. Another special type of consent is a "Restricted Consent" which can be used to extend the statutory period of assessment with respect to specific restricted issues. The statute of limitations is allowed to expire with respect to all other issues. Special statute of limitations rules also apply to tax returns on which a taxpayer failed to include any information re-

quired with respect to a "listed transaction" as defined by Code Section 6707A(c)(2). In such cases, the time for assessment does not expire before the date which is one year after the earlier of the date the information is furnished to the Service or the date a material advisor provides the identifying information to the Service.

The decision to extend the statute of limitations must be made carefully. Under certain circumstances, giving consent to extend the statute may benefit the taxpayer. For example, in an unagreed case, consent may be given so that the case can be considered by the appeals division. In

other cases, extending a statute may simply provide the agent with additional time to identify and develop additional adjustments.

Conclusion

The IRS has broad authority to examine tax returns. An understanding of the rights and responsibilities of both taxpayers and the examining agent can help reduce the scope of a tax audit or examination and can lead to a more favorable disposition.

About the Authors

Robert M. Finkel is an AV-Rated attorney who has over 20 years experience in tax and business law, with his practice focused on the areas of individual and business taxation including tax controversy and tax litigation. Robert represents clients in audits and other controversies before the Internal Revenue Service, the Massachusetts Department of revenue and other taxing authorities, as well as in all phases of litigation before the United States State Tax Court and the Massachusetts Appellate Tax Board. He is an adjunct professor at both the Boston University School of Law Graduate Tax Program where he teaches partnership taxation and the Radzyner School of Law at the Interdisciplinary Center, Herzliya, Israel. Prior to joining the firm, he was a senior partner at Hutchins, Wheeler. Prior to joining Hutchins, Wheeler & Dittmar, Robert was a senior trial

attorney with the Office of the Chief Counsel of the Internal Revenue Service. Robert graduated cum laude from the University of Massachusetts and he earned J.D. and LL.M. in Taxation degrees at the Boston University School of Law.

Diana C. Española concentrates her practice in the areas of tax and business law. She advises individuals, businesses and non-profit organizations on a range of tax planning issues including tax controversy and tax litigation. Diana also represents clients before the Internal Revenue Service, the Massachusetts Department of Revenue, and other government agencies. Prior to joining the firm, Diana was an associate at Hill & Barlow in Boston and at Bowditch & Dewey in Worcester. Diana graduated from Amherst College and received an M.S. in Foreign Service from Georgetown University.

She earned her law degree, magna cum laude, from Boston College Law School, where she was managing editor of *The Third World Law Journal*. She received her LL.M. degree in taxation from Boston University School of Law.

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