

WHAT IS THE IRS EXAMINATION DIVISION UP TO TODAY?

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1. Customer Service

The name of the game today is customer service. The IRS has listened to the criticism heaped upon it in the Senate hearings, and to its credit, responded. Many of the changes were made by the IRS on its own. In addition, the 1998 Tax Act (Taxpayer Bill of Rights III) mandated many changes resulting in better customer service.

As an example, the IRS is pulling agents off “the front lines” and putting them on the phones during the filing season. During the 1997 filing season even agents as high as Grade 12 answered the phones. As a result, audit statistics should show a marked decrease for 1997.

2. Chance of Audit

Audit coverage has dropped off considerably from the mid-70's when it was at the 2.59% level overall, to the 1.38% level of today. This is especially true when one considers that arguably the percentage for today is inflated due to the IRS counting as an audit, inquiries that in the past were not counted as an audit. Some sample audit statistics for FYE 1996:

a. individuals:

- (i) overall, 1.67%;
- (ii) with total positive income \$100,000 and over, 2.85%;
- (iii) with a Schedule C with \$100,000 and over in total gross receipts, 4.09%.

b. corporations:

- (i) overall, 2.34%;
- (ii) with assets between \$1 million and \$5 million, 6.64%;
- (iii) with assets between \$5 million and \$10 million, 14.08%;

- (iv) with assets between \$10 million and \$50 million, 19.88%;
- (v) with assets over \$250 million, 49.61%.
- c. partnerships: overall, .49%
- d. estate tax:
 - (i) overall, 14.47%;
 - (ii) with gross estate between \$1 million and \$5 million, 21.42%;
 - (iii) with gross estate exceeding \$5 million, 49.33%.
- e. gift tax: overall, .89%

3. IRS Audit Plan

- a. There are several national strategies aimed at increasing compliance within the national automotive market segment and among tipped restaurant employees, individual repeat non-filers and tax return preparers.
- b. Emphasis continues in the employment tax area, with the focus on the employee/independent contractor issue.
- c. The estate and gift tax program emphasizes the valuation of fractured entities, such as limited family partnerships. Also, the plan directs districts to look for valuation issues when selecting returns for audit.
PRACTICE TIP: Well-prepared valuations will go a long way in heading off potential audits. Consider attaching the valuation to the return.
- d. Other priorities include fraud, money laundering, large business examination programs, computer security, and disclosure and federal-state programs.
- e. **PRACTICE TIP:** Examination continues to consider collectibility in all cases. If your client is in poor financial condition, your client may be able to avoid an audit in the first place.

4. Local IRS Compliance Initiatives

- a. IRA project where taxpayer is under 59 ½, reports a withdrawal from the retirement plan but does not report the 10% early withdrawal penalty.

- b. Abusive trusts located in foreign countries for which the income is not reported.
 - c. Passive activity losses.
 - d. Change in accounting method from cash basis where there are significant inventories involved.
 - e. No self-employment tax reported on returns with Schedule C profit.
 - f. Return preparer projects.
 - g. Miscellaneous additional initiatives: investment interest, KEOGH plans, earned income credit, non-cash contributions, sham Schedule C, and employee business expenses.
5. MACS--Midwest Automated Compliance System
- a. This is one of the computer tools available to the IRS to address non-compliance. It contains tax return data on all taxpayers in the Pacific-Northwest District. The system is particularly useful to the IRS if it wants to identify particular taxpayers.
 - b. It provides three years of data. The IRS can look at a single year or three years of information side-by-side.
 - c. The IRS can analyze filed returns by type of return, market segment, zip code, gross receipts, adjusted gross income, and the like. Examples of taxpayers the IRS could identify:
 - (i) All auto dealers within a certain income range.
 - (ii) All construction returns with gross receipts over \$1 million but not reflecting any inventory.
 - (iii) Non-filers, by attempting to match from other databases it has.
 - (iv) Schedule C or F taxpayers who do not reflect self-employment tax.
6. Source of Returns for 1996 Audits
- a. For fiscal year ended September 30, 1996, there were 23,501 returns audited in the state of Washington.

- b. The bulk of the returns audited involve DIF returns, amended returns and non-filers.
- c. For a breakdown of what revenue agents worked on as opposed to tax auditors, and where their work came from.

7. Targeted Industries and Issues

- a. The construction and fishing industries are two constant areas of scrutiny by the local IRS office. The IRS locally also has been focusing on mobile cart vendors, laundromats, car dealers, bed and breakfasts, and businesses involved with the Port of Seattle, e.g., freight forwarding, import/export businesses, and storage and transportation businesses.
- b. Issues of concern include employee vs. independent contractor (especially in the fishing and adult entertainment areas), lack of compensation in an S corporation context, Section 263A, payments between related parties, changes of accounting method vs. correction of an error, changes of accounting in the construction industry (cash to accrual), accumulated earnings, reasonable compensation, passive activity losses, and unreported income.
- c. With the addition of an International Tax Group in the Seattle office, there has been an increased tendency for revenue agents to be interested in international issues.

8. Financial Status Audits

- a. The IRS has taken a renewed interest in finding unreported income. The IRS wants agents to consider this issue in every audit, including audits of businesses.
- b. The basic idea is that the IRS will be looking at a taxpayer's lifestyle as a whole to determine whether the proper amount of income is being reported. Put another way, what is not on the return is just as important as what is on the return. For example, an agent might use a Form 4822 (or something equivalent) to determine how much a taxpayer spends annually so the amount can be compared with what is reported on the return.
- c. If the preparation of a "cash T" (a simple source and application of funds analysis) raises questions, the agent will dig deeper. The IRS likely would want to question the taxpayer. If the issue is not resolved by an interview of the taxpayer, indirect methods would be used in an attempt to find unreported income.

- d. **PRACTICE TIP:** Consider the extent of the protection afforded by the 1998 Tax Act with regard to the extension of the attorney-client privilege. In this type of audit, it is important not to hear something that might have to be testified to at a later point in time.
 - e. **PRACTICE TIP:** Staying one step ahead of the agent is a good way to manage the issue. The client should be asked enough questions about cars, boats, recreational vehicles, vacations, educational expenses, home improvements, health, hobbies, and bank accounts that a determination can be made as to whether there is a problem with the amount of income being reported on the return.
 - f. **PRACTICE TIP:** The accountant should also consider undertaking a simple bank deposits analysis by comparing total deposits into the taxpayer's bank accounts with total income reported on the tax return.
 - g. **PRACTICE TIP:** Handling a financial status audit requires thorough preparation. If the accountant does not know the answers to questions about the lifestyle of the taxpayer, the likelihood increases that the agent will insist on a personal interview of the taxpayer.
 - h. **PRACTICE TIP:** The AICPA Tax Division Financial Status Audit Working Group has issued guidelines for handling a financial status audit. These guidelines appear in the April 1996 issue of The Tax Adviser.
 - i. **PRACTICE TIP:** The 1998 Tax Act limits use of this type of audit to situations in which the IRS has a **reasonable indication** that there is a **likelihood** of unreported income.
9. Industry Guidelines/ Market Segmentation
- a. To improve audit selection and achieve more effective audits, the IRS is developing industry guidelines in connection with its Market Segment Specialization Program.
 - b. The IRS will gather information about an industry and use it to create an average profile for the industry as a whole. Actual returns will then be compared against the profile to help find compliance problems.
 - c. To date, the IRS has issued guidelines in some 40 markets that include the following: attorneys, architects, mortuaries, taxicabs, bed and breakfasts, gas retailers, ministers, trucking, Alaska commercial fishing vessels, Alaska commercial fishing industry, beauty and barber shops, reforestation industry, auto body and repair, and ports. The IRS expects to publish about 90 such guidelines in all.

- d. **PRACTICE TIP:** Effective representation of a client in an audit requires anticipating the return items in which the IRS will be interested. It is crucial to determine whether such guidelines exist. The guidelines (which are made available to the public) provide an excellent road map for handling an IRS audit.

10. Employee/Independent Contractor Audits

- a. This continues to be an area of focus for the IRS. Agents are raising the issue in connection with all types of audits. There has been a considerable amount of training in the district on the issue.
- b. On March 5, 1996, the IRS unveiled the Classification Settlement Program which gives employers who have misclassified workers the option of settling their cases with the IRS at reduced assessments. To obtain the reduced assessments, the taxpayer must agree to treat the workers as employees in the future. The assessments vary between 25 and 100 percent of the tax liability for one year, depending on the taxpayer's level of compliance with the Section 530 requirements.
- c. Along with the settlement program, the IRS issued a training manual for its agents that attempts to simplify the common law and statutory rules applicable in classifying workers as employees or independent contractors. In the training manual, the 20 common law factors are de-emphasized, in an attempt to get agents to focus on the issue of whether there is a right to direct and control the means and details of the work.
- d. Announcement 96-13 gives the taxpayer an early referral option of appealing an employment tax issue during an examination.
- e. **PRACTICE TIP:** The Small Business Job Protection Act (August 20, 1996) made significant changes in the worker classification area by modifying Section 530 of the 1978 Act, including shifting the burden of proof to the IRS if the taxpayer establishes prima facie a reasonable basis for having not treated workers as employees.
- f. **PRACTICE TIP:** The Taxpayer Relief Act of 1997 expanded Tax Court jurisdiction to include a de novo review of an IRS determination that a worker should be reclassified as an employee, or that the employer is not entitled to relief under Section 530. One significant advantage of filing in Tax Court is that it appears interest is tolled while the Tax Court case is pending.
- g. The Seattle office conducts "compliance checks" apparently in an attempt to circumvent any argument by a taxpayer that for Section 530 purposes there was a prior audit.

11. Resolution Rate Higher in Exam

- a. The Appeals Office has not been getting as many cases from Examination as in the past. One of the reasons: more cases are being resolved at the Examination level. This may be due in part to an increased willingness to listen on the part of more experienced agents. Also, many agents feel that they can negotiate a result better than the IRS would get at the Appeals Office level, based in part on their greater knowledge of the facts.
- b. **PRACTICE TIP:** Exam is resolving audits that in days past would have been resolved only in Appeals. Be alert to the possibilities. Although Exam does not consider litigation hazards, it does decide which issues to raise and which issues to concede based on poor facts. Thus, although exams are not "settled," they are often creatively "resolved."

12. IRS Attorney Involvement in Examinations

- a. There is an increased willingness on the part of agents to seek the advice of an IRS attorney on Exam issues and procedures. Seeking "field service advice" informally is a way for an agent to avoid the technical advice procedures and thereby effectively block the taxpayer from providing factual input on an issue.
- b. **PRACTICE TIP:** There is a need to find out where the agent is getting his or her information. Consider the importance of providing input to any IRS attorney involved behind the scenes. Even if that is not possible, it is the agent and the manager who have control over the audit. Although an IRS attorney's advice typically is followed, there is no requirement that it be followed.

13. Non-Filers

- a. In recent years, the IRS has made non-filers a top priority. In Seattle, there was a big push to go after non-filers several years ago. It is estimated that there are some 10 million non-filers in the United States.
- b. It is difficult to measure the success of the recent non-filer program. Although many non-filers took advantage of the program, it appears that fewer than 10% of all non-filers came forward.
- c. Due to lack of resources, the IRS has not been able to do as much recently with non-filers. There has been some emphasis put on repeat non-filers, as studies have shown that half the non-filers the IRS deals with are “repeaters” as soon as the IRS disappears from the scene.
- d. **PRACTICE TIP:** Getting to the IRS first before the IRS gets to the taxpayer has always been important. In general, in such circumstances, the IRS is more lenient than if the IRS knocks on the door of a taxpayer who is lying low.
- e. **PRACTICE TIP:** The IRS has gone back to its more restrictive voluntary disclosure policy. It abandoned its announced policy of no criminal prosecution after a voluntary disclosure and cooperation with the IRS, so long as there has been no contact by a special agent of the IRS. Now, once again, any contact from the IRS negates the possibility of a voluntary disclosure.
- f. The Seattle office did a project to consider the extent of non-filing by tax practitioners. Similar projects around the country routinely determine a non-compliance rate higher than 10%.
- g. **PRACTICE TIP:** To avoid an embarrassing situation if a member of your firm is a non-filer, consideration should be given to utilizing the fact-of-filing program. In this program, the IRS responds to requests from firms in the tax practitioner community that wish to determine if employees or associates filed tax returns. A "yes" or "no" will be forthcoming regarding each request. The fact-of-filing confirmation may be requested by the individual taxpayer or by the employer. If the request directs the confirmation to a third party (e.g., an employer), however, a consent form must be received for each taxpayer for whom fact-of-filing information is requested. Form 8821, Tax Information Authorization, is used for this purpose.
- h. Agents in Seattle have been known to verify the fact of filing for any practitioner who is assisting a taxpayer with an audit.

- i. A former IRS Regional Commissioner for the Western Region has stated that the ultimate goal of the IRS is that professionals, before they can renew their license, will need to obtain a "certificate of good standing" from the IRS.
- j. The IRS conducts W-4 compliance checks to detect non-filers. The IRS approaches large employers to get the names of employees who have claimed nine or more exemptions. These names are then cross-checked for returns. If no return is discovered, the employers are directed to withhold based on a single exemption.

14. TCMP Audits

- a. TCMP audits are part of a research program that measures and evaluates taxpayer compliance characteristics through in depth audits of randomly-selected returns. The data gathered serves as the basis for developing the DIF formula used to classify returns according to their tax change potential. TCMP audits have a reputation of being extremely onerous, as potentially every line item on the return is subject to verification.
- b. At the moment, officially, TCMP audits are dead. The program was indefinitely suspended in October of 1995. Having heard the general outcry from Congress about these "audits from hell," the IRS thought the smart thing to do, especially in view of budgetary cutbacks, was to terminate all plans for TCMP audits.
- c. Studies are under way as to how the IRS can meet its research needs without appearing overly intrusive. The speculation is that a much more limited-scale TCMP program will be introduced soon.