

# **SELECTED STRATEGIES IN HANDLING AN IRS AUDIT**

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## I. CHANCE OF AUDIT

Audit coverage has dropped off considerably from the mid-70s when it was approximately at the 2.5% level for all returns. This is due to a variety of reasons including a change in priorities, budget restraints and more returns being filed. In recent years, more emphasis has been put on audit coverage again. Some sample audit statistics for FYE 2004:

- Individuals: (i) overall, 0.77%;  
(ii) with total positive income \$100,000 and over, 1.39%;  
(iii) with a Schedule C with \$100,000 and over in total gross receipts, 1.86%.
- Corporations: (i) overall, 0.71%;  
(ii) with assets between \$1 million and \$5 million, 0.66%;  
(iii) with assets between \$5 million and \$10 million, 2.13%;  
(iv) with assets between \$10 million and \$50 million, 9.35%;  
(v) with assets over \$250 million, 39.81%.
- Partnerships: overall, 0.26%.
- Estate Tax: (i) overall, 7.41%;  
(ii) with gross estate between \$1 million and \$5 million, 6.20%;  
(iii) with gross estate exceeding \$5 million, 26.57%.
- Gift Tax: overall, 0.69%.

## II. AVOIDING AN AUDIT IN THE FIRST PLACE

Consider the following in attempting to avoid an audit:

1. Explain unusual items in a statement attached to the return. **Example:** When charitable contributions exceed published averages, attach substantiation to the return. **Example:** Submit proof with large medical deductions. **Example:** If a theft loss is involved, consider attaching a copy of the police report.
2. Keep deductions within published average guidelines.

3. Hire a professional to prepare the tax return.
4. Report all third-party income. **Example:** When your bank sends a Form 1099 reporting interest income paid to you.
5. Use the proper form. **Example:** When you have non-cash charitable contributions use Form 8283.
6. Avoid taking deductions for items subject to abuse, especially where not much is to be gained. **Example:** Home office deduction.
7. Watch ratios on return. **Example:** When losses make it appear that taxpayer has nothing on which to live, the return invites a financial status audit. **Example:** If taxpayer itemizes, use caution when the deductions total 35% or more of gross income. **Example:** When taxpayer owns a business, use caution if the deductions on a Schedule C are in the 50% to 60% range.
8. Do business in corporate or partnership form rather than as a Schedule C business.
9. Pay attention to cosmetics and arithmetic.
10. Operate a non-cash business.
11. Use employees rather than independent contractors.
12. Do not file an amended return. Amended returns invite scrutiny.
13. Move to Wisconsin where the chance of audit has been among the lowest. Audit coverage varies depending on where you live. Nevada's audit rate traditionally has been as high as twice the national average.

### III. IRS INTERVIEW REQUESTS

- A. Generally, the IRS would prefer to go directly to the source to get information rather than ask questions through the person handling the audit. On the other hand, usually the taxpayer would prefer to have the agent get answers from the person handling the audit.
- B. Persons without experience in dealing with the IRS who are interviewed tend not to understand the issues, tend to be nervous, tend to talk too much, and tend to volunteer information.

- C. Having the response come from the person handling the audit allows the taxpayer to maintain more control over the audit because the answers can be thoughtfully formulated with no immediate response required as compared to when the IRS agent is sitting across the table from the taxpayer.
- D. **PRACTICE TIP:** The best way to avoid a request for an interview is to be sure that the person handling the audit is well prepared. Generally, the IRS will not insist on an interview so long as the IRS is getting timely responses from the person handling the audit. If the person handling the audit is not knowledgeable, the IRS will insist on going directly to the source. However, the only way that the IRS can require the attendance of the person for an interview is if a summons is served.

#### IV. STATUTE OF LIMITATIONS EXTENSION REQUESTS

- A. Generally, the IRS has three years from the filing date or due date, whichever is later, to complete its audit. It is not unusual for an agent to request additional time to conduct the audit. If such request is denied, the agent normally will take whatever information is available at the time and send a notice of deficiency to the taxpayer. Thus, the audit comes to a close but the usual strategy at this stage requires the filing of a petition in Tax Court. Any decision to deny the IRS additional time must be made knowing that the likely result is to end up in court.
- B. When the IRS asks for an extension, consider whether the extension should be open-ended (Form 872-A) or to a particular date (Form 872). Some practitioners argue that a Form 872 provides an opportunity for the IRS to make a mistake and miss a statute expiration date. An open-ended extension still allows the taxpayer to terminate the extension within 90 days by filing a Form 872-T.
- C. **PRACTICE TIP:** Regardless of which form is used, the practitioner should consider whether the issues in the audit can be limited through a restricted consent. Such consent prohibits the IRS from raising an issue other than those listed in the consent. Perhaps because of certain legislative history in the 1998 Act, the IRS is more open to restricted consents than in the past. However, agents generally do not like them because of the hassle factor. Whether a restricted consent request should be made needs to be discussed with the client.

#### V. IRS REQUESTS FOR DOCUMENTS

- A. In order to have an accurate record of what has been requested so that the risk of misunderstandings is reduced, consider having all IRS requests in writing. This is especially true now that one of the requirements for the burden of proof to switch is that the taxpayer cooperate with the IRS. Putting document requests in writing

will help provide a clear record of what was requested so that the cooperation issue can be evaluated. Once the document request is received, the taxpayer or the representative must determine whether all such requests are relevant and whether the information is privileged.

- B. Avoid the situation where two years later when the matter is headed for the Appeals Office or trial, it is impossible to recall what documents were provided to the IRS. It is more difficult for an attorney to evaluate an issue for trial purposes when it is not clear what documents the IRS has in its possession.
- C. **PRACTICE TIP:** When the agent is on the taxpayer's premises, offer to make copies for the agent rather than simply give the agent access to a copying machine. Observe the "two copy rule." By making an extra copy of each requested item, the taxpayer can monitor the issues that the agent thinks are important.
- D. **PRACTICE TIP:** Information document requests (IDRs) can be negotiated. An agent normally does not want to force a taxpayer to produce information because the summons process is time consuming. Agents have limited resources and limited time to close audits. Having to seek enforcement of an IRS summons slows down the process.
- E. **PRACTICE TIP:** Produce only the records that have been specifically requested. Do not provide boxes of documents for the agent to review.

## VI. TIPS FOR DEALING WITH THE AGENT

Consider the following suggestions in dealing with the agent:

1. Find out as much as possible about the agent in advance.
2. With the potential shift of the burden of proof to the IRS being dependent on the cooperation of the taxpayer (through his representative), one must carefully document the cooperation issue.
3. Involve an expert when needed—for example, on a valuation issue.
4. Be on the alert for "badges of fraud."
5. Be prepared for the question about whether there is unreported income on the return or whether there is anything wrong with the return.
6. Attempt to deal with unresolved issues before the agent writes them up for inclusion in the revenue agent's report.

7. Treat the agent with respect.
8. Watch out for the involvement of a special agent.
9. Volunteer nothing unless it is in the taxpayer's interest.

## **VII. APPEAL OPTIONS**

If matters cannot be resolved at the Compliance level, a 30-day letter normally will be issued, giving a taxpayer the opportunity to contest the audit determination with the IRS Appeals Office. Typically, a Protest is filed in response, putting the IRS on notice as to why the taxpayer thinks that the revenue agent's determination is erroneous. Compliance then usually prepares a rebuttal to the Protest and sends the case to the Appeals Office. The Appeals proceeding is an informal, normally one-on-one, meeting, with an Appeals Officer at the Appeals Officer's office. The focus is on the hazards of litigation. Most matters (85% to 95% of all appeals) heard by Appeals are resolved at that level without litigation.

### **Mediation and Arbitration.**

The 1998 Tax Act added two alternatives to the dispute resolution process. The parties can elect mediation to attempt to resolve an unsettled case when the Appeals process is over. The procedures are described in Rev. Proc. 2002-44, IRB 2002-26, July 1, 2002. In addition, the IRS has established a pilot program providing for binding arbitration. Under this program, both the taxpayer and the IRS must agree to be bound by the arbitration. The procedures are described in IRS Announcement 2000-4. In addition, many audits qualify for "fast track mediation." This process takes place prior to Appeals consideration and involves an attempt by an Appeals Officer to bring Exam and the taxpayer to a mutually agreeable resolution. "Fast track settlement" provides the possibility of a litigation hazards-based resolution which used to be available only in Appeals. (Rev. Proc. 2003-40.)

#### **A. Factors In Deciding Whether To Take A Case To Appeals.**

1. Provides an opportunity for a taxpayer to settle the case without incurring the expense of litigation.
2. Allows time to settle the case without the time pressures inherent in a docketed Tax Court case.
3. Defers payment of taxes (but interest accrues).
4. Provides an opportunity to get information from IRS. Discovery in Tax Court is limited.

5. Keeps tax litigation forum options open, whereas, if the 90-day letter is received, a decision regarding forum must be made immediately.
6. Keeps the door open on the possibility of obtaining attorney fees if the case is eventually litigated. To obtain fees, administrative remedies must be exhausted.
7. Provides an opportunity for IRS to raise a new issue. Although this does not happen often, if there is another issue on the return which has not yet been raised but would cause problems if it were, may not want to go to Appeals.
8. Fails to provide the psychological advantage that actually filing a case in Tax Court does (one school of thought).
9. Fails to provide as fast a resolution of the case as by docketing the case in court.

**B. Tips In Dealing With Appeals.**

1. The Appeals Office settles based *only* on the litigating hazards involved.
2. Do research that is specific enough to conclude what court a matter would be litigated in if not settled.
3. Prepare the case as if it were going to go to trial in a situation where sufficient dollars are involved that it would make sense to do so.
4. As a practical matter, the goal is to get the Appeals Officer to agree on a settlement because the supervisor is unlikely to overturn the settlement.
5. There is a certain amount of pressure on the Appeals Officer from within the IRS to settle cases.
6. The Appeals Officer is generally more sophisticated in tax law than others lower on the totem pole.
7. Remember that the Appeals Officer, whose mission is to settle cases on an impartial basis, is an employee of the IRS.
8. Do not bring the client to the conference unless there is something to be gained by doing so.
9. Review the Internal Revenue Manual to understand the guidelines under which an Appeals Officer must operate.
10. Know thoroughly the facts of the case.

11. Put the revenue agent's report on "trial."
12. Anticipate and understand the Appeals Officer's side of the case.
13. Point out the Appeals Officer's misplaced reliance on inadmissible evidence.
14. Try to use evidence that technically might not be admissible at trial.
15. Do not make admissions that are damaging in later litigation.
16. Do not argue the law in the conference without giving the Appeals Officer advance notice.
17. Be prepared to make the opening offer in a conference.
18. Do not assume that the equities of the case will be important to the Appeals Officer.
19. Phrase the offer in terms of chances of ultimate success in court.
20. Keep in mind that an Appeals Office settlement can take any form.
21. Volunteer to do the Appeals Officer's work, to the extent possible.
22. Be alert in avoiding potential new issues.
23. Know more about the facts and law than the Appeals Officer.
24. Consider a FOIA request, or an informal request, to get a copy of the revenue agent's file.
25. File more than a skeleton Protest.
26. Attach copies of research done in connection with an issue.
27. *Listen* to the Appeals Officer.
28. Call the Appeals Officer prior to the conference to discover specific concerns.
29. Keep in mind that the Appeals Officer has deadlines to meet.
30. Keep in mind that a case is not settled until the appropriate supervisor has signed off.



31. Do not volunteer information.
32. Ask for a copy of the agent's rebuttal to the Protest.
33. Remember that preparation and organization are the key.

**C. Litigation Possibilities.**

1. If a settlement cannot be reached with the IRS Appeals Office or if a taxpayer decides not to respond to an IRS 30-day letter, a statutory notice of deficiency (90-day letter) will be mailed to the taxpayer. The 90-day letter is the Service's final determination of the amount due and owing. It is the taxpayer's "ticket to Tax Court" for most income, estate, and gift tax cases.
2. Tax Court is not the only forum available if a taxpayer wishes to dispute an IRS audit determination. The U.S. Court of Federal Claims and federal district court also are possibilities.
3. A taxpayer who is unable to pay the amount in dispute has no choice but to litigate in Tax Court, assuming the tax in question is the type for which the Tax Court has jurisdiction.
4. Precedent is an important factor in choosing a forum. A careful analysis of the case law on the issue will often dictate the court in which the case should be filed.
5. Federal district court is the only forum in which a jury trial may be had.
6. If a case involves a sophisticated issue of tax law, Tax Court judges have the most tax law expertise. Court of Federal Claims judges are next in line with about 30% of their cases involving taxes. Federal district court judges generally have little or no federal tax expertise.
7. Additional factors in choosing the appropriate court include differences in discovery, differences in the amount of publicity a case is likely to get, differences in the use of stipulations, and differences in potential exposure to additional issues being raised by the IRS.

**D. U.S. District Court.**

1. The U.S. District Court is the only court in which a jury trial can be had.
2. In order to litigate in federal district court, the amount in dispute must be paid beforehand.

3. After the amount in dispute is paid, the taxpayer files a claim for refund.
4. When the claim for refund is disallowed, or six months passes from the filing of the claim, the taxpayer may then file suit in federal district court.
5. Relatively few tax disputes are litigated in federal district court. Across the country at any point in time there are one to two thousand federal district court tax cases pending.
6. The government is represented by a lawyer from the Tax Division of the Justice Department in Washington, D.C.

**E. U.S. Court Of Federal Claims.**

1. The payment of the amount in dispute and the filing of a claim for refund are also prerequisites to filing a suit in the U.S. Court of Federal Claims.
2. The U.S. Court of Federal Claims is a national court based in Washington, D.C.
3. A Court of Federal Claims trial may take place in Washington, D.C. or the judge may travel to one or more cities to take testimony and receive evidence.
4. As noted above, about 30% of the cases pending before the U.S. Court of Federal Claims are tax cases.
5. Due to more favorable precedent, this forum may be particularly desirable for contesting trust fund recovery penalty assessments.
6. The government is represented by a lawyer from the Tax Division of the Justice Department in Washington, D.C.

**F. U.S. Tax Court.**

1. *Forum of Choice:* Statistically, the Tax Court is the forum of choice. Whereas there may be approximately 2,000 tax cases across the country pending in local federal district courts and the U.S. Court of Federal Claims, there are about ten times as many pending in the U.S. Tax Court. The main reason the Tax Court is favored is that it is the only court in which tax liability can be litigated without the necessity of the taxpayer first paying the amount in dispute.
2. *Where Based:* The Tax Court is based in Washington, D.C., although it regularly conducts trials and hearings in cities throughout the United States.

3. *Judges:* There are currently 19 presidentially-appointed positions for judges on the Tax Court. Each judge serves for a term of 15 years. Cases can also be heard by special trial judges or by retired senior judges.
4. *90-Day Letter Is Prerequisite:* It is a jurisdictional prerequisite that prior to going to Tax Court, the IRS must send the taxpayer a 90-day letter.
5. *Mailing of Petition:* The taxpayer must file a petition with the Tax Court within 90 days after the date of mailing of the 90-day letter. Traditionally, the only way to ensure that a petition will be deemed timely filed is to have a U.S. Postal Service postmark stamped on the envelope. Standard advice has been to send the petition to the U.S. Tax Court by certified mail, so that there is a receipt stamped by the post office showing the date of mailing. Some private companies that deliver overnight mail now qualify under the “timely mailing is timely filing” rule that applies to the Tax Court petition.
6. *Controlling Precedent:* The Tax Court considers itself bound by the law of the United States Court of Appeals that has appellate jurisdiction with respect to a specific Tax Court case. In the absence of such authority or a U.S. Supreme Court decision, the court does not consider itself bound by the decision of any other court.
7. *Who Can Practice Before U.S. Tax Court:* To practice in the Tax Court one must either be an attorney or have passed a special exam. Each Tax Court practitioner has a number assigned which is required to be placed on all pleadings.
8. *Request for Place of Trial:* When the petition is filed, generally a request for place of trial is also filed. If, for example, Seattle is requested, the Tax Court will forward a copy of the petition to Seattle Counsel’s office for assignment to an IRS attorney.
9. *Burden of Proof:* Traditionally, the burden of proof has been on the taxpayer with a few exceptions. For example, the Tax Court rules provide that the burden of proof is on the IRS with respect to fraud, new matters raised, and increases in deficiencies. The 1998 Tax Act puts the burden of proof on the IRS in court proceedings as to any factual issue if the taxpayer 1) introduces credible evidence on the issue; 2) complies with certain substantiation requirements; 3) maintains all required records; and 4) cooperates with reasonable IRS requests. Corporations, partnerships and trusts with a net worth exceeding \$7 million are not eligible for this provision.
10. *Rules of Evidence:* The Tax Court uses the Federal Rules of Evidence in its proceedings, the same as the federal courts.

11. *Rules of Procedure:* Although the Tax Court has its own procedural rules, they are patterned after the Federal Rules of Civil Procedure. There are significant differences regarding discovery. (See item 14 following.) Also, the Tax Court rules allow the issuance of a subpoena to compel the attendance of witnesses or the production of documents and other evidence from any place in the United States.
12. *Settlement:* Even though a case has been filed in Tax Court, it may very well be referred to the IRS Appeals Office so that settlement can be pursued. If the case previously has been considered by Appeals, it will be referred to Appeals only if Counsel's office believes there is a good reason to do so. If the case is not settled by the Appeals Officer, the Appeals Officer transfers the case back to Counsel, so that the IRS lawyer has time to prepare the case for trial.
13. *Stipulations:* Pursuant to Tax Court Rule 91(a)(1), the parties are required to develop to the extent possible a statement of all facts not in dispute which are relevant to the pending case. The idea is to cut down on the amount of time needed to present facts at trial. The stipulation process must be pursued in good faith before the parties resort to discovery (see next item).
14. *Discovery:* Although the Tax Court rules governing discovery are based on the Federal Rules of Civil Procedure, they are not as broad. As previously mentioned, the Tax Court rules mandate that the parties employ the stipulation process prior to resorting to the formal discovery rules. The rules governing the use of interrogatories are generally similar to the Federal Rules of Civil Procedure, except with respect to expert witnesses. Discovery depositions are allowed, but only in limited circumstances. With the consent of all parties to the case, a deposition for discovery purposes may be taken either of a party or a non-party witness. Depositions of non-party witnesses may be allowed without consent of all the parties, but only in extraordinary circumstances after all attempts to obtain the evidence informally, through the stipulation process or under the consensual deposition rules, have failed. The rules also provide for requests for production and requests for admission.
15. *Pretrial Order:* Tax Court judges employ standard pretrial orders that are sent when a trial calendar date is set. The pretrial order establishes time tables for the completion of discovery, submission of stipulations, filing of pretrial memoranda, and deals with other preliminary matters. A formal pretrial conference generally is not necessary in most deficiency proceedings.
16. *Trial Calendars:* The Tax Court generally conducts one or two calendar calls per year in locations where it sits. For example, in Seattle in recent years, there have been one or two regular trial calendars and one "S" (small case) calendar. These trial sessions usually last one to two weeks. The calendar call typically takes

place on the first day of the trial session. A tentative schedule for the trial of all cases called generally will be determined, and preliminary matters will be dealt with, at the calendar call.

17. *Trial:* In general, the trial of a Tax Court case proceeds in the same manner as a trial conducted in any other federal court. There likely will be an opening statement in which both parties set forth what they are going to prove, there will be testimony from various parties and witnesses, and the introduction into evidence of documents.
18. *Briefing:* When the trial concludes, the judge sets a briefing schedule for the parties. In the briefs, the parties propose findings of fact (citing the trial transcripts or filed stipulations) and make their legal arguments. It would not be uncommon for a judge to take up to one year to issue an opinion after the briefs are filed.
19. *Small Case Procedure:* The Tax Court rules permit a taxpayer contesting a tax deficiency of \$50,000 or less to elect the use of small case procedures. (This amount was increased from \$10,000 by the 1998 Tax Act.) If this procedure is elected, the trial is conducted in a more informal manner than in a regular Tax Court proceeding. If the small tax case procedure is elected, there is no appeal from a decision of the court. The trials are conducted before a special trial judge. The court will accept any evidence which it determines has probative value. Most taxpayers appear without counsel. Generally, briefs are not required.