

# Strategic Options for Taxpayers—Federal Tax Procedure 101

By  
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Charles Rettig and Edward Robbins provide a step-by-step overview of how the IRS audit and appeals processes work.

The IRS, a branch of the U.S. Department of Treasury, is the nation's tax agency and administers the Internal Revenue Code enacted by Congress. Its Mission follows:

... to provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

It is unequivocally the absolute best administrative tax agency in the world!

The IRS directly interacts with more Americans than any other public or private organization. The Commissioner of the IRS has been delegated the authority to administer and enforce the Internal Revenue laws and has the final administrative authority concerning substantive interpretation of the tax laws as reflected in legislative and regulatory proposals, revenue rulings, letter rulings and technical advice memoranda. In its most recent fiscal year, the IRS collected more than \$2 trillion in revenue and processed

approximately 222 million tax returns. It costs about 48 cents for each \$100 collected by the IRS. The IRS annually assists more than 97 million taxpayers who call the toll-free automated telephone line, write letters or visit one of the more than 400 offices the IRS maintains nationwide.

Historically, tax administration in the United States has been sidelined by a Congress that has routinely kept the IRS underfunded and confused. IRS collection and examination enforcement staffing has been reduced by 36 percent from fiscal year 1996 (approximately 25,000 staff) to fiscal year 2003 (approximately 16,000 staff). About 45 percent of the current IRS Revenue Agents and Revenue Officers are eligible to retire within five years.

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From 1952 to 1998, the IRS was organized in a three-tier geographical structure with a multi-functional National Office, Regional Offices and District Offices. The IRS National Office was, and remains, located in Washington, D.C. and assumes primary responsibility for decisions regarding tax laws for guidance of IRS personnel. Previously, there were four regional offices (the Northeast Region, headquartered in Manhattan, New York; the Southeast Region, headquartered in Atlanta, Georgia; the Midstates Region, headquartered in Dallas, Texas; and the Western Region, headquartered in San Francisco, California), with a Regional Commissioner coordinating the affairs in each region, together with a Regional Counsel and a Regional Director of Appeals. Each region consisted of various District Offices that were primarily responsible for the assessment and collection of taxes, examination of returns, collection of tax liabilities and investigation of potential tax fraud. District Directors coordinated various divisions, including the Examination Division, the Collection Division, the Criminal Investigation Division and the District Counsel. There were 33 District Offices, 10 Service Centers and three Computing Centers.

The IRS Restructuring and Reform Act of 1998<sup>1</sup> dictated implementation of an IRS organizational restructuring. As a result, the IRS was reconfigured into four separate operating divisions servicing particular groups of taxpayers with similar needs. The four operating divisions presently include the Wage and Investment Division, the Tax-Exempt/Governmental Entities Division, the Small Business/Self-

Employed Division and the Large and Mid-Sized Business Division with each having a Division Commissioner reporting directly to the IRS Commissioner.

The **Wage and Investment Division (W&I)** headquartered in Atlanta, Georgia services approximately 122 million mostly wage-earner taxpayers through five IRS Service Centers.

The **Tax Exempt/Governmental Entities Division** headquartered in Washington, D.C. services approximately three million Employee Plans, Exempt Organizations and Governmental Entities ranging from small community organizations and municipalities to universities, pension funds state governments and complex tax-exempt bond funds controlling more than \$7.9 trillion in assets and paying more than \$220 billion in employment tax and income tax withholding. Exempt Organization taxpayers represent more than 1.6 million tax-exempt organizations—including about 400,000 religious organizations—having approximately \$2.4 trillion in assets. Employee Plans taxpayers include private and public retirement plans with \$4.1 trillion in assets. Government Entities include outstanding tax-exempt bonds with a total value of \$1.4 trillion, 86,000 federal, state and local entities and over 550 federally recognized Indian tribes.

The **Small Business/Self-Employed Division (SB/SE)** headquartered in New Carrollton, Maryland has primary responsibility for all taxpayers filing Schedule Cs, Schedule Fs, Schedule Es, Forms 2106, Partnership and S

Corporation Returns and Corporate Returns with assets under \$10 million. It services approximately 45 million mostly self-employed individuals and small businesses. In 2001, SB/SE hired approximately 1,500 Revenue Agents, Revenue Officers and Tax Compliance Officers (“Office Auditors”). In 2002, there were an additional approximately 750 Revenue Agents, Revenue Officers and Tax Compliance Officers. Currently, the IRS is attempting to employ several thousand additional Revenue Agents, Revenue Officers and Tax Compliance Officers.

The ongoing SB/SE Exam Re-engineering Project represents

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a revision of the normal SB/SE audit process. Examining agents now often begin building a case before actually contacting the taxpayer and, generally, may have reviewed the previous returns in an effort to determine “material audit issues” and patterns. The taxpayer will then be contacted and advised as to the scope of the audit. Essentially, this project is based on the materiality test of focusing on the most significant issues that are current compliance issues. The agent should not unilaterally extend the scope of an audit without a materiality review, which would include the agent’s manager and, possibly, the IRS Territory Manager.

The **Large and Mid-Sized Business Division (LMSB)** headquartered in Washington, D.C. services approximately 210,000

corporations and partnerships having assets in excess of \$10 million. For FY 2002, corporate taxpayers served by LMSB reported a tax liability of \$152.6 billion. Currently, LMSB has approximately 6,000 employees consisting of highly skilled agents, specialists and international examiners. LMSB expects to hire up to 400 technical employees in FY 2004 and has submitted a budget request to further increase their technical employees in FY 2005. LMSB enforcement activities in FY 2002 recommended an additional \$15.5 billion in tax deficiencies.

LMSB is organized among five industries: Communications, Technology and Media; Financial Services; Heavy Manufacturing and Transportation; Natural Resources and Construction; and Retailers, Food, Pharmaceuticals and Healthcare. There are also Field Specialists operating in a support function for these operations. The current strategic priorities of LMSB include Globalization (dealing with a global economy), Issue Management (attempt to resolve potential tax disputes earlier in the process), Abusive Tax Shelters (LMSB's highest enforcement priority) and Assess Compliance Risks within the LMSB taxpayer population. Other high-risk issues requiring additional research and appropriate compliance improvement action involve executive compensation, offshore tax avoidance transactions, flow-through entities, special purpose entities and financial versus tax reporting discrepancies. Components of the strategy to expand LMSB enforcement capability include efforts to:

- reduce cycle time and improve the currency in LMSB examinations;
- re-engineer compliance processes to develop methods,

such as the limited issue focused examination (LIFE) process, to better manage high-risk issues and to resolve cases efficiently and timely;

- increase Revenue Agent staffing to balance the LMSB enforcement caseload;
- partner with the SB/SE Division and other IRS business units to address issues of noncompliance prevalent across the spectrum of business-related taxpayers;
- issue formal guidance quickly on issues prone to abuse or improper interpretation and application by taxpayers; and
- redirect resources to balance compliance across the entire taxpayer base served by LMSB.

**Abusive Tax Avoidance Transactions (ATAT).** Developing an efficient strategy to deal with abusive tax shelters is a significant strategic initiative of the IRS and LMSB. Tax shelters have been described as providing IRS with a "target rich environment." "Tax shelters" are generally defined by Code Sec. 6662(d)(2)(C)(iii) as a "partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such arrangement is the avoidance or evasion of Federal income tax." The IRS and the Treasury are publishing legal guidance as early as possible when they believe a transaction is abusive. A "listed transaction" is a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation or other form of published guidance as a listed transaction for purposes of Code Sec. 6011. This process is designed to deter subsequent

promotion ("death by publication") and investment in abusive transactions and to facilitate identification of investors and promoters. It also ensures consistent treatment of such transactions by IRS field agents.

LMSB is pursuing these transactions with an emphasis on promoting disclosure required by the Jobs Act and Treasury Regulations and increasing promoter investigations and investor examinations. Curbing abusive "tax shelters" is a priority for the IRS and the Treasury. Numerous individual and business taxpayers have been identified as participants in transactions that offset gains or defer gain recognition. These transactions typically involve highly complex fact patterns, significant amounts at issue over multiple tax years, and are often structured among multiple related entities and may appear on the corporate return or on the corporate officer or shareholder return *via* a flow-through from a partnership, S corporation or other entities. In October 2003, LMSB field agents had more than 4,000 investor tax returns with shelter issues under examination.

Listed transactions often involve financially sophisticated tax professionals and promoters, and the structure and marketing of the transactions are difficult to detect. The Jobs Act and Treasury regulations require promoters to register certain tax shelters and make lists of investors available to the IRS upon request. Further, those who invest in these transactions are required by Treasury regulations to disclose such positions claimed on their tax returns.

LMSB currently has over 100 investigations of (tax shelter) promoters underway. SB/SE has more than 900 promoters under

investigation. LMSB investigates promoters to ensure their compliance with registration and list maintenance requirements. If the promoters do not provide investor lists, the IRS and the Treasury may issue summonses. To date, at least 315 administrative summonses have been issued to secure investor lists. The IRS seeks summons enforcement when promoters do not comply with a summons; at least 114 have been referred to the Justice Department for enforcement. The IRS also can seek approval from the U.S. District Court to serve “John Doe” summonses on promoters to secure investor identities. To date, at least five such summonses have been authorized in promoter investigations.

**Executive Compensation.** LMSB is leading the coordination, development and implementation of a strategy to identify and address executive compensation compliance issues. LMSB is currently reviewing executive compensation issues as part of the examinations of at least 24 corporation tax filings. Expansion of this activity will be commensurate with the results of those cases.

Executive compensation has evolved dramatically in recent years, in creativity, complexity and dollar value. Stock options, deferred compensation, fringe benefits and other “noncash” alternative forms of compensation are becoming increasingly popular and making up larger and larger parts of executives’ overall compensation packages. The size or dollar value of executive compensation is not under the jurisdiction of federal tax administration; it is a corporate governance matter that is the responsibility of the employer’s board of directors or other governing body. There are, however, multi-faceted tax implications for all forms of executive

compensation: income and employment tax issues for the employers who pay the compensation and the executive employees who receive it. In addition to the increasing use of noncash compensation, the use of partnerships and trusts (both domestic and offshore) in the handling of compensation is also increasing. These factors add considerable complexity in determining current and future year tax liabilities for executives and their employers.

**Globalization Compliance Issues.** As the business world continues to globalize, tax planning is increasingly focused on worldwide effective tax rate minimization. As a result, taxpayers often have an incentive to adopt structures or arrangements, such as transfer pricing that inflate expenses in high tax jurisdictions and/or shift income to low tax jurisdictions.

While many cross-border transactions are clearly contemplated and addressed under domestic law or treaty provisions, others involve emerging issues that may constitute unacceptable tax avoidance or evasion.

**Issue Resolution Alternatives.** LMSB compliance improvement is not limited to enforcement actions. Resolution processes are in place to assist taxpayers who want to resolve complex issues that would otherwise likely be disputed in contentious post-filing examinations or litigation. Alternatives are in place to resolve issues at both pre-filing and post-filing stages of the tax return process. The pre-filing approach includes issuing published guidance on the IRS’s position on complex

technical issues, including corporate tax shelter promotions so that taxpayers do not invest in abusive schemes.

Pre-filing agreements may be requested by taxpayers in advance of filing a tax return to obtain specific guidance on tax issues whose resolution had been uncertain. The Industry Issue Resolution (IIR) process results in formal guidance that establishes a consistent position for issues that are common to many large business taxpayers. The IIR process addresses the tax treatment of the issue on an industry-wide basis rather than a case-by-case basis. The fast track issue resolution process, which

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is a joint effort with IRS Appeals, incorporates settlement authority and mediation techniques to offer taxpayers accelerated resolution while LMSB retains jurisdiction.

## IRS Audit Process

### Introduction

Representation of clients involved in an audit or dispute with the IRS requires the exercise of considerable judgment, discretion and caution. There are often unknown, potentially sensitive issues that might unexpectedly arise during the course of any audit. Throughout, the representative must balance his duties to his client with the representative’s ethical and legal obligations. Effective representation requires that

the representative understand the entire administrative process and the inherent limitations involved at each level of the administrative process. Further, the representative must be able to acknowledge his or her own limitations.

### *Selection of Returns for Audit*

A taxpayer's return may be selected for audit through a variety of different ways. The most common historical selection process was the computer-generated audit. Although the returns selected for audit in this manner may not initially raise the suspicions of an examining agent, with the exception of the few items that may have exceeded certain tolerance levels set on the IRS computer, a good agent is capable of ferreting out relevant issues through a thorough bank deposit, net worth or expenditures analysis and basic investigative techniques. There are, however, many other ways in which a return may be selected for audit:

**National Research Project (NRP).** In certain years, tax returns have been randomly selected for audit based upon the ending digits of taxpayer identification numbers. The National Research Program (NRP) is an ongoing comprehensive effort by the IRS to measure payment, filing and reporting compliance for different types of taxes and various sets of taxpayers. Historically, the IRS relied heavily on time-intensive, Taxpayer Compliance Measurement Program (TCMP) audits to establish a baseline measure of reporting compliance. The TCMP return and all related returns were subjected to a detailed "line-by-line" verification procedure. The most recent TCMP cycles have involved audits of 1976, 1979, 1982, 1985, 1988 and 1992 re-

turns. A scheduled TCMP audit of approximately 150,000 1994 returns was canceled for budget and other reasons. NRP information allows the IRS to replace outdated audit formulas and better target its compliance efforts. It should lead to redesigned forms, improved communications, suggested tax law changes and enhanced enforcement focused on noncompliant taxpayers. NRP provides the IRS a road map for selecting future audits—a crucial point because audits of compliant tax returns are unnecessary, burdensome and not cost effective for taxpayers or the IRS. The IRS implementation of NRP audits has been referred to as the "Son of the TCMP."

**Discriminate Income Function (DIF) System.** The DIF system is a computer-based technique used by the IRS to classify income tax returns according to their tax-change potential. In the two-stage process, the return is scored by the IRS computer using sophisticated mathematical formulas designed to identify returns for audit potential. In the second stage, returns with the highest scores are manually screened to determine if examination is warranted. The screening process is designed to consider schedules and other explanatory information attached to the return, which cannot be recognized by the computer. Each line of the return is scored and if the total score exceeds a certain level, the return is identified by computer for examination. Often, returns are selected for audit through this process, because certain items (e.g., excessive contribution deductions, employee business expenses, etc.) on the returns have exceeded tolerances on the IRS computer, thus increasing the total DIF

score associated with the return. Given the changing focus of audit activity, TCMP and DIF scores haven't been as important—other methods are better able to detect unreported income or overstated deductions.

**Unreported Income Discriminate Index Formula (UIDIF).** The IRS has unveiled the existence of its UIDIF as a methodology for detecting returns with a high probability of under-reported income.

**Examinations of Related or Associated Taxpayers.** This "lateral entry" selection process can be quite damaging to the audit target, because the examining agent begins the audit with a substantial amount of information, both documentary and sometimes testimonial, developed in the audit of a third party's return. A prime example of this type of audit is the audit of a local check cashing agency that routinely cashed the checks of its customers, most of whom were private business people who had the habit of cashing checks received in their businesses for personal use. The IRS is aware that there remains a likelihood that the cashed checks were not reported on the various individuals' business books and records as gross receipts.

**Public Records.** Examinations sometimes arise from an agent's review of legal filings, newspaper articles or other local, state or national publicity sources, and court records.

**Agency Information Referrals.** Federal, state and local regulatory and law enforcement agencies can provide source information that could lead to an audit. These agencies include police departments, the Securities and Exchange Commission, the Federal Bureau of Investigation, the Drug Enforcement Agency, the

State Department of Insurance and other cooperating agencies.

**Nonfiler Information.** The IRS computer identifies taxpayers who have failed to file returns and this information could result in a direct referral of the matter to an examining agent. Also, this information is sometimes developed by an IRS Collection representative (a “Revenue Officer”) as a “Tax Delinquent Investigation” (TDI), which can be transferred to an IRS examining agent for the review of returns which have been obtained by the Revenue Officer or for further development of income information where the taxpayer has to file the outstanding returns.

**Other IRS Projects—Credit Card Project; High-Risk, High-Income Taxpayers; etc.** The IRS has received substantial information through its Offshore Credit Card Program (based on a belief that individuals are using credit cards based in foreign “tax haven” countries to evade payment of U.S. taxes). Summons enforcement proceedings regarding MasterCard, American Express and VISA have provided a wealth of information to be reviewed and analyzed. The IRS has also been matching K-1 forms from passthrough entities and, using various filters, is attempting to identify high-income, high-risk taxpayers.

### *Audit Preparation*

Following receipt of an audit notice, the representative should thoroughly review the return(s) to be audited and attempt to determine if there are any potentially sensitive issues that may arise during the course of the audit. The representative must also review and reconcile the taxpayer’s books of account, income statements, balance sheets, general

ledgers, summary records of business operations (*i.e.*, cash receipts and disbursements journals, sales journals, *etc.*), and the taxpayer’s state and federal returns.

With respect to audits of returns for individuals or closely held businesses, while preparing for the audit the representative should attempt to reconcile bank deposits with reported gross receipts for the period(s) under audit. Further, the returns of any related entities (entities in which the taxpayer may hold an interest or entities controlled by the taxpayer) should also be carefully reviewed. Any apparent discrepancies must be reconciled. It may be beneficial to provide reconciliation schedules to the government early in the audit process if, during preparation for the audit, the representative has determined that there are unintentional inaccuracies in the return.

Following receipt of an audit notice, it is sometimes beneficial to contact the government agent in order to possibly streamline the scope of information being sought. Most initial audit notices are accompanied by a relatively lengthy list of generic information that is requested to be available at the commencement of the audit. Contacts with the examining agent prior to the audit may allow the representative to narrow the information being sought thereby reducing the overall efforts involved and possibly limiting the length of the audit.

If the representative is not appropriately prepared, the audit should be postponed. It is unlikely that the agent would oppose a representative’s timely request (a request that occurs more than a few days prior to the scheduled commencement date of the audit)

for a postponement of the audit. Most agents have many different matters pending and can readily schedule other appointments if a request for postponement is obtained within a reasonable time before the scheduled commencement of the audit.

The government frequently requests that the audit occur at the taxpayer’s place of business, such that relevant books and records will be readily available. However, a representative should likely schedule the audit to occur in a secure environment, away from the taxpayer’s place of business or, if the audit must occur at the taxpayer’s place of business, away from the tax or accounting departments of the taxpayer. Further, the government agent should not be located near auditors for other federal or state agencies that may be auditing the taxpayer at the same time. Casual conversations between government representatives are usually not beneficial for the taxpayer.

It is incumbent upon the representative to assist the government in understanding the nature and type of the taxpayer’s business activity. If there are significant internal controls, the representative should thoroughly describe the relevant internal controls as a method of providing credibility to the taxpayer and the taxpayer’s return(s).

Positions presented during the course of the audit should be well documented. Copies of any documents provided should be retained in a separate audit file. All requested documents and information should be provided in a timely and orderly fashion. Although the representative may already have copies of documents being provided, copies of any requested documents should be made in duplicate—one copy

for the government and an extra copy to be maintained in a separate audit file specifically identifying documents provided during the course of the audit. It is important to know exactly which documents are of importance to the government.

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During the course of an audit, the representative should reasonably attempt to limit the scope of the inquiry, avoid the presentation of false or misleading information, avoid false statements by the taxpayer and the taxpayer's representative and limit the information provided so as to avoid the waiver of any potential privileges. It is generally recommended that separate files be prepared for relevant documents that might be requested by the government and documents that contain potentially confidential, privileged information.

Counsel should typically make determinations as to any potential privileges that might apply with respect to information or documents that may be requested by the government during the course of an examination of the taxpayer's returns. A privilege cannot generally be invoked if the otherwise privileged information has already been disclosed. In this regard, where potentially privileged information may exist, it is especially important to carefully review all relevant information and documentation

with the intention of avoiding any inadvertent disclosures.

It is generally advisable to attempt to resolve any civil tax dispute at the earliest opportunity. A lengthy audit may be costly from the perspective of the expenditure of time and effort involved, as well

as the taxpayer's degree of frustration with the normal administrative process. Further, a prolonged audit is more likely to uncover potentially sensitive issues that could

generate increased tax deficiencies, penalties, or the possibility of criminal sanctions.

Finally, the administrative process should not be abused merely because of the taxpayer's desire to delay the determination and collection of any potential liability. Collection-related issues should be sorted out through an installment payment arrangement that would be negotiated through the normal collection process following conclusion of the audit process.

### *The Examination*

The IRS examination function has been significantly enhanced due to increased transaction and information reporting, better developed audit plans and techniques focusing on specific industries or issues, and substantially increased access to computerized data banks. In addition, with respect to individuals involved in cash-intensive businesses (restaurants, bars, etc.), or Schedule C businesses, there has been a movement away from the mechanical examination of a return in favor of a somewhat

generic investigation of the taxpayer's financial activities.

The impact of more focused IRS investigative techniques is readily apparent in various provisions set forth in the IRS Restructuring and Reform Act of 1998 (RRA '98). Various investigative techniques employed by the IRS have often compromised the relationship between nonlawyer tax practitioners and their clients. In response, RRA '98 provided nonlawyer tax practitioners a limited statutory privilege for tax-related communications that is similar to common law protections of confidentiality relating to legal communications between a taxpayer and counsel.<sup>2</sup> Although nonlawyer tax practitioners received a limited privilege, there remains the potential for information disclosed to the nonlawyer tax practitioner to be discoverable by the government or others in subsequent criminal tax proceedings or civil litigation.

If there are potentially sensitive issues, the taxpayer should be interviewed by counsel in order to determine whether there is a need to fully preserve potentially privileged information. In turn, counsel should consider engaging the accountant to coordinate the audit on behalf of the taxpayer. Under the doctrine of *Kovel*,<sup>3</sup> the investigative accountant may be clothed with an extension of the attorney's privilege. Further, and of significant importance to the accountant, the accountant might become the subject of a malpractice action if not engaged by the taxpayer's counsel in the event information revealed to the accountant during or in preparation of an audit is ultimately required to be unnecessarily disclosed to others.

Effective representation of a taxpayer during an examination

requires a thorough review of the taxpayer's general financial activities not otherwise set forth on the returns. Code Sec. 7602(d) has been added to the Internal Revenue Code to prohibit the use of "financial status" or "economic reality" examination techniques to search for unreported income unless there is a "reasonable indication" that there is a likelihood of unreported income.<sup>4</sup> Under the financial status approach, a taxpayer's total financial situation is evaluated to assure that the tax return accurately reflects reportable income. It is an approach designed to compare information set forth on a return with the taxpayer's financial lifestyle or business activities. It is also an attempt by the IRS to increase compliance and search out potentially fraudulent situations.

Historically, conventional audit techniques were discovered to be grossly inadequate for the purpose of demonstrating an understatement of taxable income. In such event, the government often resorted to one or more indirect methods of detecting unreported income.<sup>5</sup> Indirect methods may generally be pursued, even though the taxpayer's books and records appear reliable. In fact, the indirect method often provides strong evidence that the taxpayer's books and records are otherwise unreliable.<sup>6</sup> In *Holland*, the Supreme Court stated: "To protect revenue from those who do not render true accounts, the government must be free to use all legal evidence available to it in determining whether the story told by the taxpayer's books accurately reflects his financial history."<sup>7</sup> Further, indirect methods as a basis of providing reliable estimates of the taxpayer's taxable income have been consistently affirmed on the basis

that: "To require more would be tantamount to holding that *skillful concealment* is an invincible barrier to proof."<sup>8</sup>

A better-equipped IRS has been able to ferret out potentially sensitive issues in a manner often compromising the relationship between a taxpayer and their nonlawyer tax practitioner. Has the IRS examination function been somewhat prevented from applying various indirect methods (bank deposits analysis, cash expenditures analysis, net worth analysis, mark-up analysis) to determine if there is a "reasonable indication" of unreported income? Historically, a more in-depth investigation did not occur unless there was otherwise some inability to reconcile a taxpayer's income. Calculations based on an indirect method have always required corroboration through proper and competent evidence, including interviews with the taxpayer, records furnished by the taxpayer and third-party sources. As such, Code Sec. 7602(d) has not had a significant impact on the use of indirect methods of proving a taxpayer's income.

Prior to the commencement of an IRS examination, a representative should review any relevant IRS Audit Technique Guidelines issued pursuant to the IRS Market Segment Specialization Program (MSSP). The MSSP was designed to improve compliance by focusing on taxpayers as members of particular groups. These groups have been defined by type of business (*i.e.*, gas stations, grocery stores, *etc.*), technical issues (passive activity losses), types of taxpayer (*i.e.*, returns lacking economic reality) or method of operation (*i.e.*, cash businesses). As agents focused on the tax compliance of a particular group, they gained

experience on specific issues to be examined for particular types of businesses, whether or not the issues are set forth on a return.

Under MSSP, agents attempt to reconcile discrepancies when income and/or expenses set forth on a return are inconsistent with the typical market segment profile, or where the reported net income seems inconsistent with the standard of living prevalent in the geographic area where the taxpayer resides. As a result, the taxpayer's economic activities may become a barometer for judging the accuracy of the taxpayer's returns based on information developed through MSSP and audits of other taxpayers.

There are many publicly available audit guidelines that have been prepared pursuant to the MSSP. Each audit guideline instructs the agent on typical methods of auditing a particular group of taxpayer, including typical sources of income, questions to be asked of the taxpayer and their representative during the audit, *etc.* A representative should not proceed with an audit without having become generally familiar with any potentially relevant MSSP audit guidelines. Some would even suggest consulting these audit guidelines before the returns are prepared.

A review of IRS MSSP audit guidelines would lead a tax practitioner to conclude that the IRS examination of a return actually begins before the first audit meeting. The audit guidelines direct IRS agents to conduct a comprehensive pre-audit analysis. The analysis occurs prior to the agent actually meeting the taxpayer or the taxpayer's representatives and consists of both asset searches (through Department of Motor Vehicle records,

real property records, court records, *etc.*) and income searches (through transcript information detailing Form 1099 income from interest, dividend, rental income, *etc.*, and from currency reports). The audit process then entails the usual document requests and, in certain cases, the gathering of third-party information, a request for a taxpayer interview and other forms of fact gathering.

### Interviews and Techniques

Agents often seek testimonial evidence through interviews of the taxpayer, the return preparer and third parties. A taxpayer has the right to resist an examining agent's request for an interview. Pursuant to Code Sec. 7521(c), the taxpayer's representative may represent the taxpayer before the examining agent and is not required to produce the taxpayer for questioning, unless an administrative summons is served on the taxpayer. There are several considerations that the taxpayer's representative should weigh before allowing the taxpayer to submit to an interview, especially if potential fraud issues are involved.

A question most often presented is whether the taxpayer and others should consent to interviews by the agent, force the issuance of summonses or invoke various Constitutional protections. Certainly, if there are extremely sensitive (*i.e.*, potentially criminal) issues, the taxpayer should not consent to an interview and should invoke his Fifth Amendment privilege against self-incrimination. It is always preferable for a taxpayer to avoid providing incriminating information when compared with the possibility of propelling a civil tax examination into a criminal tax investigation/prosecution.

Agents typically seek to interview taxpayers near the commencement of an audit. Unfortunately, near the commencement of the audit, the representative typically does not have sufficient information to determine whether there are potentially sensitive issues that might arise during an interview of the taxpayer. If possible, it is often preferable to postpone a taxpayer interview if the representative is otherwise able to provide prompt responses to relevant inquiries. If it occurs, the interview should occur toward the end of the audit, possibly with an understanding that if the taxpayer submits to an interview and answers the questions, the agent will proceed to close the audit. However, the representative must take extreme caution, since such an understanding is not likely a basis for challenging the use of statements from the interview in a subsequent proceeding.

If a taxpayer interview is necessary and otherwise unavoidable (it is always avoidable in a potentially criminal sensitive-issue case), the interview should occur far into the audit process such that the representative can appropriately assist the taxpayer in preparing for the interview. The representative should attempt to obtain as much information about the issues, the information within the agent's possession, and the agent's position with regard to the issues, before agreeing to submit the taxpayer to an interview. Under any situation, the representative must prevent presentation of false or misleading information or the presentation of false statements by the taxpayer or the taxpayer's representative. Presentation of false statements or documents significantly enhances the potential for penalties and a possible criminal investigation/prosecution

(that may include an investigation of the representative!).

Agents have been trained to utilize various interview techniques, including the need to make appropriate eye contact, put the taxpayer at ease, use appropriate types of questions (probing, leading, open-ended, *etc.*), use "silence" appropriately, paraphrase or restate comments received, listen, pace the interview, know when to move on to the next question, maintain a calm manner, have the taxpayer demonstrate the flow of transactions, read the taxpayer's nonverbal language (body language), be aware of the agent's nonverbal language, be conscious of note taking so as not to distract the taxpayer, use humor when appropriate, be courteous, be business-like and firm in their approach, consider issues in the proper order (volatile versus nonvolatile), schedule the interview at a convenient time and allow adequate time for completion, appear interested in responses, control the interview, appear confident, maximize the value of what they know (such as various audit technique guides) and adapt the agent's appearance to be appropriate for the circumstances.

Additional interview techniques implemented by agents are to provide feedback to the taxpayer, be observant, feign (act dumb) when appropriate, be prepared, use spontaneous follow-up questions (react when they receive new information), know their limitations, read the taxpayer (know when they have lost the taxpayer's attention), read the taxpayer's perception of the agent, dispel any negative image of the agent, be on time, use appropriate small talk, use easily understood language, do not anticipate answers, clarify

responses, use reflection, ask for examples, recognize the agents' biases, be assertive and persistent, avoid debate or argument, give the taxpayer an opportunity to ask questions, express appreciation, verbally pin down the taxpayer when appropriate, have an open mind, maintain composure, adapt questions to the situation, have the taxpayer explain their terminology, be precise, come from a position of knowledge, work to establish rapport with the taxpayer, respect the taxpayer's views, know their authority, make a positive first impression, maintain an inquisitive mind, contain their excitement (and surprise), note unusual hostility or irritability on the part of the taxpayer, consider the need to question both spouses, don't interrupt the taxpayer, be methodical and refresh the taxpayer about important points in prior interviews.

The representative should attempt to obtain actual questions, or determine areas that the agent will question, in advance of the interview. This will substantially assist the representative in preparing the taxpayer for the interview, especially for the "hard questions." An interview at the representative's office provides the taxpayer with a more supportive environment for what might be an extremely agonizing experience. Conversely, the taxpayer should be less intimidated and should feel more comfortable than in the unfamiliar confines of an IRS office. Also, the representative should, in most instances, attempt to keep the interview from occurring at the taxpayer's place of business, to help ensure the taxpayer is better focused for the interview and also to avoid the intrusion in the taxpayer's daily activities.

If potential fraud issues are manifest, it may not be possible

for the taxpayer to answer questions relating to problematic transactions without self-incrimination. In this situation, tax counsel must consider having the client assert the Fifth Amendment privilege against self-incrimination. Unfortunately, invoking the Fifth Amendment privilege may well dramatically increase the potential of a referral to CI. However, it is almost always better to allow the taxpayer to claim the Fifth Amendment and place the burden back on the government to prove its case, rather than allowing the taxpayer to provide damaging, irreversible admissions. For obvious reasons, this is usually the most difficult judgment call to make during a sensitive civil audit. The

taxpayer should be cautioned against making any false or misleading statements, making damaging admissions or giving an explanation that is even partially misleading.

Sometimes an examining agent may request that the taxpayer complete a Taxpayer History Questionnaire (a detailed list of questions regarding source and application of taxable and nontaxable sources of income, expenditures and the taxpayer's net worth at various points in time) or may ask these questions during an interview of the taxpayer. Extreme caution should be followed before allowing completion of a Taxpayer History Questionnaire. The taxpayer may be admitting to having committed civil or criminal tax fraud depending on the particular issues involved. It may be preferable to submit responses, if

at all, in the form of a narrative statement and only to the extent certain questions are capable of being answered. Tax counsel should likely be consulted before certain questions are answered.

All relevant information must be closely scrutinized to determine plausible and supportable explanations for any potentially sensitive audit issues, whether or not such issues are set forth on the return. Although there may be plausible explanations for potentially sensitive issues that arise during the course of an audit, responsive statements by

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*IRS agents are instructed to discontinue a civil examination upon discovery of "firm indications of fraud" and to refer the case to IRS Criminal Investigation.*

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the taxpayer should not merely be repeated to an agent. Any potential explanation should be supported by credible evidence to avoid further inquiries arising from the explanation.

During the information gathering stage of an audit, an agent may either ask for information verbally, or may issue an informal Information Document Request (IDR). If responses to an IDR are not forthcoming or are clearly insufficient, the agent may issue an administrative summons. The IRS has broad authority to summons books and records, the taxpayer or any person having custody of records in order to ascertain the correctness of the taxpayer's return, to make a return or to determine the liability of a taxpayer.<sup>9</sup>

The summons will set forth the date, time and place, where the summoned party is to ap-

pear, although at least 10 days' prior notice of appearance is required.<sup>10</sup> Compliance with the summons may take the form of a formal question-and-answer session under oath, an informal interview or the submission of (or providing access to) the records being summoned. The witness summoned is entitled to decline to produce documents or to answer particular questions if a good-faith basis exists for an objection to compliance.<sup>11</sup>

If a taxpayer fails to comply with a summons, the IRS may proceed with summons enforcement. To succeed in enforcing a summons, the IRS must demonstrate (1) that the investigation is being conducted pursuant to a legitimate purpose; (2) that the inquiry is relevant to that purpose; (3) that the information sought is not within the possession of the IRS; and (4) that the IRS has followed the administrative steps required by the Internal Revenue Code.<sup>12</sup> Jurisdiction to enforce a summons is in the U.S. District Court for the district in which the summoned person resides.<sup>13</sup> A District Court Judge has the power to imprison anyone required to respond to a summons. Typically, if the IRS proceeds to issue a summons, it intends to enforce compliance with the summons through a District Court proceeding, if necessary.

### *Potentially Sensitive Issue Examinations*

In civil tax audits that include potentially sensitive issues, taxpayers often engage a team of representatives, including counsel and a forensic accountant. Engagement of the accountant by counsel should extend the attorney-client privilege to advice rendered by the accountant pursuant to the

engagement.<sup>14</sup> Although the RRA '98 extended common law protections of confidentiality to tax advice rendered between a taxpayer and a federally authorized tax practitioner (to the extent such communications would be considered privileged if they occurred between a taxpayer and counsel), this statutory privilege only applies to noncriminal tax matters before the IRS and noncriminal tax proceedings in federal court.

The statutory privilege is not available when it is truly needed the most—when a civil tax proceeding moves into the criminal arena. It also may not be available in certain state-related tax proceedings, or nontax civil litigation.<sup>15</sup> However, if the accountant is appropriately engaged by counsel, the common law attorney-client privilege should apply to all communications rendered in furtherance of the legal services being provided to the client, both during the investigative stages of the audit and, if necessary, during any subsequent civil or criminal litigation. This privilege will not extend to the actual return preparation.

The critical inquiry is often whether counsel should retain the taxpayer's prior accountant or a new accountant. Many practitioners prefer to engage a new accountant to avoid the necessity of delineating between nonprivileged communications (communications prior to counsel's engagement of the accountant) and privileged communications (communications following counsel's engagement of the accountant).

Counsel's engagement of the accountant should be in writing, and should indicate that the accountant is acting under the direction of counsel in con-

nection with counsel's rendering of legal services to the client, communications between the accountant and the client are confidential and are made solely for purposes of enabling counsel to provide legal advice; the accountant's workpapers are held solely for counsel's use and convenience and subject to counsel's right to demand their return; and the accountant is to segregate their work papers, correspondence and other documents gathered during the course of the engagement and designate such documents as property of counsel.<sup>16</sup>

### *The Criminal Fraud Referral*

IRS agents are instructed to discontinue a civil examination upon discovery of "firm indications of fraud" and to refer the case to IRS Criminal Investigation.<sup>17</sup> The criminal referral typically occurs without being disclosed to the taxpayer or the taxpayer's representative. As such, the referral is often identified by a long, unexplained silence on the part of the examining agent. In this process, the Agent will likely be assessed by an IRS Fraud Referral Specialist—an experienced, highly trained IRS representative charged with assisting the agent in framing proper inquiries and preparing an appropriately detailed criminal referral.

In making the criminal referral, the agent must detail all potential adjustments (unreported income and potential deductions, expenses or offsets) and list any specific statements made by the taxpayer or their representative that might indicate an intent to defraud or evade taxes, as well as explanations or potential defenses provided by the taxpayer, the return preparer or the taxpayer's

representative. Criminal referrals must also set forth a description of the alleged violation (*e.g.*, evasion, failure to file, *etc.*); the taxpayer's age, health, marital status and education; the taxpayer's sources of reported and potentially unreported income; the types of records available and the taxpayer's method of accounting; the estimated unreported income; and the amount of tax potentially due.

During the course of a civil examination, the agent may not enter the realm of a criminal investigation. In certain situations, however, agents acting in a "Special Agent capacity" have contributed to the suppression of admissions made by the taxpayer or their representative.<sup>18</sup> Federal criminal tax investigations are conducted by Special Agents of the IRS CI. They are either conducted directly through the normal administrative investigatory process or as an adjunct to a federal grand jury proceeding.

Although there are various "badges of fraud," civil agents are more inclined to consider a criminal referral if there is a substantial unexplainable understatement of taxable income, fictitious or improper deductions, accounting irregularities (occurring in more than one year), acts or conduct of the taxpayer relating to false statements, attempts to hinder the examination, destruction of books and records, transfers of assets for purposes of concealment or patterns of consistent failure to report or under-reporting of income. Certain behavior patterns on the part of the examiner may indicate that the Agent is considering a criminal referral—excessive time devoted to the audit; extensive copying of basic financial records, bank records, accountant work papers,

*etc.*; or attempts to determine the taxpayer's net worth over a period of several years.

A taxpayer typically discovers that a criminal administrative investigation has been commenced when visited by IRS Special Agents. Most visits consist of at least two IRS Special Agents to ensure an additional witness to any statements or conduct by the taxpayer. At the initial interview, the Special Agent will advise the taxpayer that he has the right not to cooperate, the taxpayer has the right to contact counsel and anything the taxpayer says during the interview may be used against him in any subsequent proceeding.

Notwithstanding these warnings, taxpayers often make damaging admissions to Special Agents. Since the Special Agent interview is noncustodial, full Miranda warnings are not required. Certainly, if a representative anticipates a potential criminal referral, the taxpayer should be advised not to discuss their matter with anyone and, particularly, not to discuss the matter with individuals identifying themselves as Special Agents from IRS Criminal Investigation. For whatever reason, many taxpayers believe (wrongly) that they have the ability to explain away the criminal investigation during the initial meeting with the Special Agents. Taxpayers should decline the opportunity to have a discussion with the Special Agents, request their cards, look at their identification and indicate that the taxpayer's counsel will follow up with them. The taxpayer should then promptly contact experienced counsel.

Sophisticated schemes and the complex business society often test the analytical ability of financial investigators to filter complex arrays of financial records. Records

of transactions are moving from paper ledgers to computers to off-site, online storage. Previously, CI agents might have located a single personal computer; now they encounter multiple computers, often linked together in a network, each having the capacity to hold several vast quantities of documents. As a result, CI has developed techniques to locate and retrieve those records, wherever situated. CI designed the Electronic Crimes Program (ECP) to organize its expertise in computer and network forensics. Computer Investigative Specialists (CISs) use specialized equipment and techniques to preserve digital evidence and to recover financial data, including data that may have been encrypted, password protected or hidden by other electronic means.

CISs participate in search warrants with investigating agents and are responsible for the seizure and processing of evidence contained in various types of digital media. Their primary mission is to secure the data, reduce it by eliminating programs and other files of nonevidentiary value, and then return the critical information to the investigating agent. The CI agent can then electronically review evidence, which is much faster than historical manual paper procedures. This technique, together with the scanning of paper documents, puts the entire criminal investigation in a digital format that allows the investigation team and prosecutors to locate items of interest, move files among themselves and digitally present evidence in today's electronic courtrooms.

CI has developed ILOOK<sup>®</sup>, a forensic software tool that automates the hard drive analysis process and makes it possible for a CIS to timely review the multi-gigabyte

drives found in today's computers. The ILOOK Imager allows the CIS to image almost every PC-based machine encountered, including mass data storage systems and non-Microsoft operating systems. The ILOOK Investigator recovers all data (including deleted files) from the target drive image and assists the investigator search for specific details. It also allows the investigator to insert foreign language character sets to search for information. ILOOK® is supported by the FBI and NASA and has been distributed to many state and local law enforcement agencies.

Following the investigatory process, if the Special Agents believe that criminal prosecution is warranted, the matter will be referred to the Tax Division, Criminal Section, of the U.S. Department of Justice in Washington, D.C. for review and a conference with the taxpayer or their representative. If the Department of Justice believes that prosecution is warranted, the matter is referred to the local U.S. Attorney's Office where the taxpayer resides for indictment and prosecution in the U.S. District Court. Many tax-related criminal investigations are now commenced through a grand jury proceeding significantly accelerating the process to a criminal indictment.

### Civil Closing

Following a criminal prosecution (or termination of a criminal investigation), the case is returned to the examination function of the IRS for a civil closing. The case may either be closed on an agreed or unagreed basis. If closed on an unagreed basis, the taxpayer will receive either a 30-Day Letter accompanied by a Revenue Agent's Report, or a Notice of Deficiency (90-Day Letter). If the taxpayer re-

ceives a 30-Day Letter, an informal protest should be filed with the IRS (as indicated in the 30-Day Letter) within 30 days of the date of the letter. It is possible to obtain an extension of the 30-day time period, provided the request for the extension occurs prior to the expiration of the 30-day time period.

A written protest (for liabilities in excess of \$2,500) to a 30-Day Letter should contain the taxpayer's name and address, a statement that the taxpayer wants the examination findings appealed to the IRS Appeals Division, the date and symbols from the IRS 30-Day Letter which proposes the adjustments and findings, the tax periods or years involved, an itemized schedule of the changes with which the taxpayer disagrees, a statement of facts supporting the taxpayer's position, and a statement setting forth the law or other authorities supporting the taxpayer's position. A copy of the 30-Day Letter should be attached to the Protest. The Protest must be executed by either the taxpayer or their authorized representative.

If the applicable statute of limitations within which an assessment must occur is going to expire within approximately six months (and the statute of limitations is not otherwise extended), the IRS will often issue a Notice of Deficiency (90-Day Letter) in order to preserve the interests of the government.<sup>19</sup> In such event, the taxpayer must file a Petition with the U.S. Tax Court (not with the IRS) within 90 days of the date of the Notice of Deficiency (in the manner indicated in the Notice of Deficiency).<sup>20</sup>

Within 60 days after the Tax Court serves a copy of the Petition on the IRS, Counsel for the IRS will file an Answer to the Tax Court Petition. Often, IRS Counsel requests an extension of the 60-day time

period while they are awaiting receipt of the administrative case file from the Examination Division. It is typically advisable to stipulate to the extension of time, since it is highly unlikely that the Tax Court would enter a default against the IRS under these circumstances.

Extending the statute of limitations and filing a Protest to a 30-Day Letter generally provides an extended opportunity to resolve a matter without litigation. Often, additional time is required to obtain relevant information or documentation. If a Notice of Deficiency has been issued and a Tax Court Petition has been filed, the matter may arise on a Tax Court calendar before the relevant information or documentation is available. Currently, matters are being calendared for trial in the Tax Court within approximately one year of the filing of the Petition.

### IRS Appeals

Following issuance of a 30-Day Letter or a Notice of Deficiency (if a matter has not already been transferred to IRS Appeals), the matter will generally be referred to Appeals. IRS Appeals is the civil administrative dispute resolution division of the IRS.<sup>21</sup> The Mission Statement for Appeals presently provides:

The Appeals mission is to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.<sup>22</sup>

IRS Appeals is an independent function within the IRS that considers cases from W&I, TE/GE,

SB/SE and LMSB. Appeals is authorized to expedite the settlement of tax disputes without a formal trial based on the relative hazards of proceeding to litigation. Appeals consolidated its Specialty Area—now called Technical Guidance—to a national position in the organization allowing a better coordination of issues within the Industry Specialization Program (ISP) and the Appeals Coordinated Issues (ACI) programs—which have been particularly important in the tax shelter area. Appeals maintains a separate structure for the Appeals Team Case Leaders, reporting directly to the Chief, Appeals allowing them to maintain appropriate focus on the largest cases and key initiatives—like Fast Track Mediation and Fast Track Settlement.

Fast Track Mediation is available in SB/SE disputes and represents a streamlined process designed to expedite disputes involving some audits, offers in compromise and trust fund recovery penalties. Appeals and Settlement Officers serve as mediators to resolve disputes while cases are still within the jurisdiction of SB/SE.<sup>23</sup> LMSB Fast Track Mediation and Settlement allow taxpayers and LMSB examiners to use Appeals resolution techniques for specific disputed issues, while cases are still within the jurisdiction of LMSB.<sup>24</sup>

Appeals Officers attempt to settle cases on the basis of the probable outcome of each disputed issue in the event of litigation. A fair and impartial resolution is one that reflects on an issue-by-issue basis the probable result in the event of litigation, or one that reflects mutual concessions for the purpose of settlement based on relative strength of the opposing positions where there is substan-

tial uncertainty of the result in the event of litigation.

Traditionally, Appeals held mostly face-to-face conferences. While still available, Appeals often encourages telephone or correspondence conferences when they can significantly shorten the overall time of the Appeals process. The Appeals Officer will consider the probative value of evidence likely to be presented, the credibility and availability of witnesses (including the taxpayer), the ability of the taxpayer to demonstrate the accuracy of his position and the likelihood that evidence the taxpayer can present will support the taxpayer's position, and will attempt to resolve potential doubts as to relevant facts and legal issues.

There may be more than one informal conference with the Appeals Officer.<sup>25</sup> The Appeals Officer may enlist the assistance

of IRS Counsel, the examination function, the National Office and independent experts to further develop the factual and legal basis for resolving a case.

A matter may be returned to the examination function if substantial additional information is required to resolve an important issue or if there are significant unresolved factual issues. If a matter is returned to the examination function, it is usually returned to the same examiner who performed the initial audit. As such, during an audit, it is not usually beneficial to withhold information on the theory that it would receive more beneficial consideration from IRS Appeals. Often it is desirable to attempt

to avoid having a matter returned to examination since the direct involvement of the agent may adversely influence the decisions of the Appeals Officer (since the agent may be somewhat entrenched in their position and want to support their recommendations).

Prior to meeting with an Appeals Officer, the representative must be thoroughly prepared with respect to the facts and relevant legal authorities. It is often beneficial to submit a Freedom of Information Act (FOIA) request in advance seeking a copy of the IRS administrative file, which would include the internal memoranda and documents prepared by the examining agent or received from third parties.

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*IRS Appeals Officers are expected to exercise their best judgment in identifying and defining the “real issues” for purposes of being able to structure a potential resolution.*

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It is usually preferable not to have the taxpayer present during the meeting with the Appeals Officer, since matters can be discussed in a more objective manner. Sometimes, it is beneficial to provide statements from potential witnesses. It is important to verify the most significant facts through independent sources and be prepared to provide and summarize relevant business records and other documentary evidence.

The Appeals Officer will usually not raise any new issues, unless the basis for such action is substantial and the potential effect upon the tax liability is material.<sup>26</sup> “Substantial grounds” for the raising of a new issue generally means that the Ap-

peals Officer is “quite certain” at the time a new issue is raised that the IRS would prevail if the issue were litigated.<sup>27</sup> However, an Appeals Officer can raise an “alternative issue” (one that represents the real issue that should be in controversy), even though they are not “quite certain” that the issue would prevail. If an alternate issue is not strong, the Internal Revenue Manual indicates that it should not be raised even though it might otherwise strengthen the government’s position.<sup>28</sup>

IRS Appeals Officers are expected to exercise their best judgment in identifying and defining the “real issues” for purposes of being able to structure a potential resolution. Matters are resolved on an issue-by-issue basis after balancing the relevant facts and legal authorities.<sup>29</sup> It is usually beneficial to attempt to anticipate the IRS position with respect to each issue. In any event, it is always beneficial to anticipate various settlement possibilities.

If the taxpayer agrees to the resolution of issues and a Notice of Deficiency has not been issued, the resolution will usually be presented in the form of IRS Form 870, IRS Form 870-AD or IRS Form 906.<sup>30</sup> IRS Form 870, *Waiver of Restrictions on Assessment*, allows the IRS to assess an agreed liability without issuing a Notice of Deficiency. Although similar, IRS Form 870-AD, *Offer to Waive Restrictions on Assessment and Collection of Tax Deficiency and to Accept Overassessment*, represents a final binding agreement between the taxpayers and the IRS. (Taxpayers are precluded from pursuing a refund if they have executed a Form 870-AD, but are not precluded from pursuing a refund if they execute a Form 870.)

IRS Form 906, *Closing Agreement on Final Determination Covering Specific Matters*, is a

binding agreement that is often utilized to resolve the tax treatment of specific items that may occur in years subsequent to the tax year(s) at issue before Appeals. If a Notice of Deficiency has been issued and a timely Petition has been filed with the Tax Court, the matter is typically resolved through the filing of a stipulation of the agreement with the Tax Court.<sup>31</sup>

### Tax Court Litigation

If it is not possible to resolve a matter on an agreed basis, the taxpayer may proceed to litigation in the U.S. Tax Court. However, if the taxpayer has not filed a timely Petition to the Tax Court, or if the taxpayer has previously satisfied the entire liability at issue, the taxpayer would proceed through the filing of an administrative Claim for Refund with the IRS followed by the filing of a Complaint for Refund in either the U.S. District Court or the U.S. Court of Claims.

If the taxpayer elects not to go the Tax Court route and pays the asserted liabilities, he or she will have the opportunity to file a claim for refund with the IRS for the amounts paid within the applicable statute of limitations. If the refund claim is denied, he or she should then have the ability to proceed to IRS Appeals. If the IRS issues a Notice of Deficiency (*i.e.*, 90-Day Letter) and the taxpayer desires to proceed to Tax Court, the case is initiated by filing a Petition with the Tax Court within the 90-day period set forth in the Notice of Deficiency. Thereafter, the only trial court that can resolve the case is the Tax Court—the taxpayer has waived the right to go to any other trial court to have his case decided.

A benefit of proceeding to Tax Court is the fact that the taxpayer does not have to pay the liability

until the Tax Court case is completed—which could be several years in the future. If the taxpayer is not successful in Tax Court, the government has the right to collect the tax deficiencies (including interest and penalties) even though they may appeal the case to the Circuit Court of Appeals. If the taxpayer prevails on appeal, any excess payments will be refunded.

If there are a series of similar cases, there may be somewhere between two and five cases combined for an initial “test case.” The case would be litigated before a single Tax Court judge, normally in the community where the taxpayer resides. Where there may be several test cases with taxpayers located in different parts of the country, the case may be litigated outside the taxpayer’s community.

After the Tax Court trial is completed, each party is normally allowed the opportunity to file two briefs—in most cases, each party is allowed to file an opening brief up to approximately 90 days after the trial, with each party then having approximately 45 days to respond to the brief of the other party. These periods of time are subject to the discretion of the trial judge and can vary. The brief sets forth proposed findings of fact based upon the trial testimony, the exhibits and any facts that are agreed upon before trial. The argument portion deals with the conclusions that the Tax Court should reach as a result of the proposed factual findings and the arguments in support.

After all of the briefs are in, the Tax Court reviews the transcript, exhibits, agreed-upon facts and briefs and will typically issue a written opinion between six months and 18 months after the trial date. The parties are then requested to prepare computations of the amount of tax due based

on the opinion. If the parties cannot agree on the computations, the Tax Court will schedule a hearing or briefing schedule for each party to set forth the reasons why that party's computations are correct and the other party's computations are incorrect. The parties usually agree on the computations once the Tax Court issues an opinion.

Either party has the right to appeal the Tax Court opinion to the Court of Appeals for the Federal Circuit in which the party resides. There have occasionally been situations where the same Tax Court decision is appealed to different circuits (because the different taxpayers live in different areas of the country), with the circuits rendering inconsistent decisions.

### Refund Claims/Litigation

If the taxpayer elects not to go to Tax Court (by not filing the Petition within the requisite 90 days), the tax deficiencies (including interest and penalties) are "assessed," which is followed by a billing from the IRS.

After the bill is received, the IRS has the right to proceed with enforced collection. The tax deficiency will continue to bear interest (approximately five percent at the present time). If payment is not timely made, there may also be a late payment penalty that starts at 0.5 percent per month and moves up to one percent per month, with a cumulative maximum of 25 percent. If the taxpayer is unable to pay the amount of tax as proposed by the Notice of Deficiency, he may negotiate an installment payment arrangement.

After satisfying the liability for taxes, interest and penalties for a given year, the taxpayer has a right to file an administrative claim for refund of any taxes paid within the two years prior to filing the claim. As a practical matter, the taxpayer must make full payment within the two years after his first payment so as to be able to claim a full refund. Once the claim is filed, it will be reviewed by the IRS examination function and either disallowed or allowed in whole or in part. There

may or may not be a negotiation process available. After the examination function issues a formal notice of its action, the taxpayer can typically file an appeal with IRS Appeals and attempt to resolve the case at that level.

If the claim for refund is not successful, the taxpayer has the right to file a Complaint for Refund in the U.S. District Court or the U.S. Court of Claims. The earliest a Complaint can be filed is six months after the filing of the claim with the IRS (even if the claim has not been acted on) or, if sooner, once the IRS has rejected the administrative claim for refund. The last date for filing the Complaint for Refund is two years after the IRS rejects the claim. If not rejected, there is no limit within which the Complaint must be filed. Once the Complaint is filed, the case will normally proceed to trial within one year. The decision on a refund action will be appealable to the appropriate Court of Appeals. Interest at the statutory rate is recoverable on any refund.

### ENDNOTES

<sup>1</sup> Act Sec. 1001 of the IRS Restructuring and Reform Act of 1998 (P.L. 105-206), enacted July 22, 1998.

<sup>2</sup> Act Sec. 3411 of P.L. 105-206 added Code Sec. 7525 to the Internal Revenue Code providing Uniform Application to Taxpayer Communications with Federally Authorized Practitioners.

<sup>3</sup> *L. Kovel*, CA-2, 62-1 USTC ¶9111, 292 F2d 918.

<sup>4</sup> Act Sec. 3412 of P.L. 105-206.

<sup>5</sup> *M.L. Holland*, SCt, 348 US 121, 75 SCt 127 (1954); *E.A. Tafoya*, CA-5, 85-1 USTC ¶9341, 757 F2d 1522 (bank deposits method associated with payments to an assassin); *H.H. McGuire*, CA-6, 65-1 USTC ¶9299, 347 F2d 99, cert. denied, 382 US 826 (1965) (expenditures method).

<sup>6</sup> *Holland*, supra.

<sup>7</sup> *Id.*, 75 SCt, at 135.

<sup>8</sup> *Johnson*, SCt, 319 US 503, 517, 63 SCt 1233, 1240 (1943).

<sup>9</sup> Code Sec. 7602.

<sup>10</sup> Code Sec. 7605.

<sup>11</sup> *Reisman v. Caplin*, SCt, 375 US 440, 84 SCt 508 (1964).

<sup>12</sup> *Powell*, SCt, 379 US 48, 57-58, 85 SCt 248 (1964); *Arthur Young & Co.*, SCt, 465 US 805, 104 SCt 1495 (1984) (accountant's tax accrual work papers discoverable by administrative summons; the IRS is not required to establish relevance in a technical, evidentiary sense).

<sup>13</sup> Code Sec. 7604(a).

<sup>14</sup> *Kovel*, supra note 3.

<sup>15</sup> Code Sec. 7525.

<sup>16</sup> *Kovel*, supra note 3.

<sup>17</sup> IRM 4.23.9.6.2 and IRM 4.23.9.6.5.

<sup>18</sup> *A. Toussaint*, DC Tex., 78-2 USTC ¶9793, 456 FSupp 1069 (statements made by a taxpayer to the Examining Agent after the Agent had firm indications of fraud, were suppressed); *N.J. Tweel*, CA-5, 77-1 USTC ¶9330, 550 F2d 297 (upon direct questioning by a taxpayer's

representative, the IRS has an affirmative duty to disclose the actual criminal nature of a purportedly civil examination); and *A.L. Caceres*, SCt, 79-1 USTC ¶9294, 440 US 741, 99 SCt 1465, 1979-1 CB 465 (admissions by a taxpayer to a civil Revenue Agent "acting as a Special Agent", were admissible).

<sup>19</sup> Code Sec. 6212.

<sup>20</sup> Code Sec. 6213.

<sup>21</sup> IRM 8.1.1.2.

<sup>22</sup> IRM 8.1.1.1.

<sup>23</sup> Pub. 3605 and Rev. Proc. 2003-41, IRB 2003-25, 1047.

<sup>24</sup> Rev. Proc. 2003-40, IRB 2003-25, 1044.

<sup>25</sup> IRM 8.6.1.2 and IRM 8.6.1.2.1; Reg. §601.106(c).

<sup>26</sup> IRM 8.6.1.4.

<sup>27</sup> IRM 8.6.1.4.2.

<sup>28</sup> *Id.*

<sup>29</sup> IRM 8.6.1.3.4.

<sup>30</sup> Reg. §601.106(d)(2).

<sup>31</sup> Reg. §601.106(d)(3).

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