

2014 Tax Enforcement Priorities and Practice Tips from the Tax Trenches

By Charles P. Rettig

IRS examinations can be a source of frustration and confusion. Tax attorneys can best serve their clients by understanding the IRS's enforcement priorities and audit procedures. These practice tips can help mitigate some of the confusion that may arise from an examination and possibly prevent further issues.

HISTORICALLY, INTERNAL REVENUE SERVICE (IRS) examiners were assigned to audit taxpayers in many different industries. One day, an examiner audited a grocery store and on the following day the examiner may have audited a computer retailer or a medical doctor. As a result, experience gained in one audit did not significantly enhance the examiner's experience for purposes of conducting other audits.

More recently, the IRS has been attempting to identify and reduce non-compliance through efficiency, tax form simplification, education, and enforcement. In addition, the IRS has significantly modified its examination process in a manner designed to increase the available resources and experience of its examiners.

The primary operating divisions of the IRS include Small Business/Self-Employed (SB/SE), Wage and Investment (W&I), Large Business and International (LBI) and Tax Exempt and Government Entities (TEGE). Other principal offices supporting the core functions of the IRS include the Office of Chief Counsel, Taxpayer Advocate Service, Criminal Investigation, Appeals, Return Preparer Office, Office of Professional Responsibility (OPR), Communications and Liaison, Whistleblower Office, and the Office of Privacy, Governmental Liaison and Disclosure.

IRS Enforcement Priorities

The international arena will continue to test the enforcement resources of the IRS for many years. Issues regarding undeclared foreign source earnings and financial accounts will continue to generate considerable interest from the IRS and the Department of Justice.¹ The IRS has long encouraged participation in the voluntary disclosure process for all taxpayers, those with interests in offshore accounts and otherwise.

The IRS policy concerning voluntary disclosure provides that a taxpayer's voluntary disclosure is a factor that "may result in prosecution not being recommended."² To obtain this qualified benefit, the disclosure must be "truthful, timely, complete," and must demonstrate willingness by the taxpayer to cooperate, and actual cooperation, in determining the tax liability. It must also include "good faith arrangements" by the taxpayer to pay the tax, interest, and any penalties in full.

Those with interests in foreign accounts that have not previously been disclosed should immediately consult competent counsel. If not yet contacted by the government, they likely remain eligible for the ongoing IRS Offshore Voluntary Disclosure Program, mitigating the possibility of a

future criminal prosecution.³ Undeclared foreign accounts present a target-rich environment for the government. The IRS is committed to enforcement concerning offshore accounts and the changing environment concerning bank secrecy may lead the government to many taxpayers with undisclosed interests in foreign financial accounts. For those with undeclared foreign accounts, now is the time to come into compliance. Waiting is simply not a viable option.

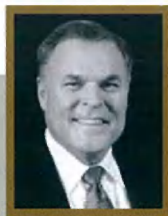
Other examination priorities based on a perceived degree of noncompliance include the potential abuse of mortgage interest limitations⁴ by claiming deductions exceeding limitations in multiple years and Section 1031 like-kind exchanges, including the abuse and possible back-dating of documents intended to circumvent the 45-Day Rule⁵; and Net Operating Loss (NOL) carryforwards.⁶ An additional examination issue includes real estate dispositions where the taxpayer is unable to adequately support the amount realized and the adjusted basis, or fails to appropriately provide for the recapture of items when a negative capital account exists.

Examiners are also looking closely at employment tax and worker classifications where the IRS is conducting employment tax examinations, including a focus on worker classification issues (independent contractor v. employee status), together with issues regarding executive compensation and fringe benefits.

S-corporation examinations with an emphasis on determining the built-in-gains tax focusing on asset valuations for C-corporation assets on conversion to S-corporation status together with compensation for S-corporation officers are also a priority.

Examinations involving sales of partnership interests will attempt to assure that reported interests match the actual ownership interests reflected in the partnership agreements; that income is properly recognized on distributions of installment notes; and that debt cancellation, general income and expense items reported on partners' returns, including proper reporting from Schedule K-1, is correctly reported. Examinations of estate and gift tax returns will continue to focus on valuations and discounts associated with closely-held entities and properties, fractional interests, sales that occur close to death, under-funded marital trusts and over-funded bypass trusts upon the death of the surviving spouse.

For matters involving tax exempt organizations, the changes between the historical and the recently revised Form 990 provide a roadmap of issues deemed important to the government, including executive compensation for senior management and key employees, conflicts of interest



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and—an old favorite—abuse of donor-advised funds. Non-filers, Schedule C taxpayers and cash intensive businesses provide a target-rich environment for the IRS. Return preparers and advisors provide a unique opportunity to leverage ongoing IRS compliance efforts that simply won't be ignored.

California Franchise Tax Board (FTB) Enforcement Priorities

Current individual enforcement priorities of the FTB include Section 1031 like-kind exchanges, Schedule D, real estate losses, residency, California adjustments arising from IRS examinations, head of household filing status and federal/state adjustments. In the corporate arena, the FTB remains interested in the sales factor (nexus, cost of performance, intangible sales, throwback sales, etc.), business/non-business income, credits, filing method, and water's-edge issues. For S Corporations, there is interest in basis issues, taxable distributions, credits, liquidations, and built-in gains. Returns relating to estates and trusts should anticipate inquiries regarding apportioning, credits, and deductions. Charitable remainder trusts could anticipate valuation inquiries. Partnerships and other flow-thru entities create interest regarding real estate dispositions, basis and recapture issues surrounding sales of partnership interests, tax shelters, and issues arising as a result of final year returns.

Tips from the Tax Trenches

Taxpayer Advocate Service

If an examination problem seems overwhelming, consider contacting the Taxpayer Advocate Service (TAS).⁷ TAS is an independent organization within the IRS whose employees assist taxpayers who are experiencing economic harm, who are seeking help in resolving tax problems that have not been resolved through normal channels, or who believe that an IRS system or procedure is not working as it should.⁸ Assistance is available by filing Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order), or asking an IRS employee to complete it on your behalf.⁹ There is also a Taxpayer Advocate for each of the California taxing authorities.¹⁰

Engagement Letters

Engagement letters should specify the scope and terms of the engagement. Services rendered should be within the scope of the engagement as clearly set forth in the engagement letter. If additional services are to be provided, additional engagement letters should be obtained. If a client relationship is terminated for any reason, written confirmation of the termination should be promptly provided to the client and the opposition. If the government has been involved, the government should also be clearly advised of the termination of the client relationship.

Schedule C Examinations

Upon receipt of an examination notice for a Schedule C taxpayer or a taxpayer involved in a cash intensive business (restaurant, bar, etc.), require the preparation of a simple bank deposit analysis. The analysis should add the deposits for the year under consideration and for the month immediately preceding and following the period involved. That figure should then be divided by 14 and multiplied by 12 to determine an approximation of an amount deposited during the year. If the total deposits bear no relation to reported gross receipts, further inquiry may be warranted which might include a more in-depth bank deposits analysis, a cash expenditures analysis, a net worth analysis, and/or a mark-up analysis.

Clients with Multiple Return Filing Requirements

If involved in the preparation of returns for a taxpayer having other return filing requirements (sales tax returns, etc.), request copies of all other relevant returns for the tax period(s) at issue. Often, businesses prepare certain returns internally and seek to have others prepared by their outside tax advisors. Gross Receipts on sales tax returns for the same tax period as an income tax return should be somewhat comparable. If you haven't received copies of all related returns, ask for them.

Audit Technique Guides

The IRS Audit Techniques Guides (ATGs)¹¹ focus on developing highly trained examiners for a particular market segment or issue. These guides focus on taxpayers as members of particular groups or industries and contain examination techniques, common and unique industry issues, business practices, industry terminology, interview questions, procedures and other information to assist examiners in performing examinations.

These groups have been defined by type of business (including attorneys, auto body/repair shops, bail bondsmen, check cashing establishments, farmers, restaurants and bars, various segments of the entertainment industry, gasoline distributors, insurance agencies, parking lot operators, real estate agents/brokers, taxicabs, the trucking industry), technical issues (passive activity losses, alternative minimum tax), and types of taxpayer or method of operation (i.e., cash intensive businesses).

The Attorneys ATG¹² provides background information about the legal profession, identifies issues unique to the industry of which the revenue agents should be aware, and sets forth specific techniques that the examiner should follow in conducting audits of attorneys. A practitioner should not proceed with an audit without being generally familiar with any potentially relevant IRS ATGs. Often, it may be beneficial to review relevant ATGs earlier in the process, perhaps while preparing the return.

Avoiding Delays

The administrative process should not be abused merely because of the taxpayer's desire to delay the determination and collection of any potential liability. 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. 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.

Extension of Statute of Limitations

It is often a good practice to provide an extension of the applicable statute of limitations during the course of any audit or examination. However, it is also good practice to have extensions signed by the client, rather than the client's authorized representative (even though authorized by the power of attorney). Years later, the client may not recall having authorized you to extend the statute of limitations. If their signature is on the extension (Form 872), the situation will not likely escalate. Further, it is almost always preferred to sign a limited extension with a specified expiration date (Form 872) rather than an indefinite extension for an unspecified term (Form 872-A).

Freedom of Information Act Request

It is often advisable to submit a request under the Freedom of Information Act (FOIA) following the un-agreed resolution of a federal tax examination. It should also help tailor your discussions at the next administrative level while providing insight into what the next government representative assigned to the case will be reviewing.¹³

Taxpayer Interview

A question often presented is whether the taxpayer and others should consent to interviews by the government, 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 their Fifth Amendment privilege against self-incrimination. It is always preferable for a taxpayer to avoid providing incriminating information when compared to the possibility of propelling a civil tax examination into a criminal tax investigation/prosecution.

The government typically seeks to interview taxpayers near the commencement of an examination. Unfortunately, at that time, the practitioner 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 practitioner is otherwise able to provide prompt responses to relevant inquiries. If it occurs, the interview should occur toward the end of the examination, possibly with an understanding that if the taxpayer submits to an interview and answers the questions, the government will proceed to close the examination. However, the practitioner 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 criminally sensitive 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 government'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 or prosecution (which may include an investigation of the representative).

During an interview, taxpayers often assert that unexplained amounts represent accumulations of wealth over a period of time. Common interview questions include whether the taxpayer routinely keeps more than \$1,000 on hand? If so, what do the accumulated funds consist of? (For example, paper money, coin, money orders, cashier checks, etc.). In what denominations were the funds accumulated? Where are the accumulated funds maintained? How long have the accumulated funds been kept in the foregoing location? What kind of container were the accumulated funds kept in?

Further questions could ask the amount of cash or the equivalent on hand at the beginning and end of the year under audit? Why were the funds accumulated and not deposited in a financial account? What is the original source of the funds? Were there additions or withdrawals from the accumulated funds? Was the taxpayer accompanied by another individual when the accumulated funds were accessed? Does anyone else know about the accumulated funds?

Although there are various "badges of fraud," civil revenue agents are more inclined to consider a criminal investigation 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 they are 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. Amending returns during an examination might be the last link necessary for a civil examination to be referred to the Criminal Investigation office.

Examination Techniques

There are various indirect examination techniques available to corroborate or refute a taxpayer's claim about their business operations or nature of doing business. A significant indicator that income has been underreported is a consistent pattern of losses or low profit percentages that seem insufficient to sustain the business or its owners. Other indicators of unreported income include a lifestyle or cost of living that can't be supported by the income reported; a business that continues to operate despite losses year after year, with no apparent solution to correct the situation; a Cash T showing a deficit of funds; bank balances, debit card balances and liquid investments that increase annually despite reporting of low net profits or losses; accumulated assets that increase even though the reported net profits are low or a loss; debt balances that decrease, remain relatively low, or don't increase while low profits or losses are reported; a significant difference between the taxpayer's gross profit margin and that of their industry; and unusually low annual sales for the type of business.

Audit or investigative techniques for a cash-intensive business might include an examiner determining that a large understatement of income could exist based on return information and other sources of information. Common indirect methods include the Source and Application of Funds Method (an analysis of a taxpayer's cash flows and comparison of all known expenditures with all known receipts for the period); the Bank Account Analysis Method (comparing total deposits with the reported gross income, for all accounts, whether designated as personal or business); the Bank Deposits and Cash Expenditures Method (distinguished from the Bank Account Analysis by the depth and analysis of all the individual bank account transactions, the accounting for cash expenditures, and a determination of actual personal living expenses); the Markup Method (reconstructing income based on the use of percentages or ratios considered typical for the business under examination in order to make the actual determination of tax liability); and the Net Worth Method (determination of the actual tax liability is based upon the theory that increases in a taxpayer's net


worth during a taxable year, adjusted for nondeductible expenditures and nontaxable income, must result from taxable income).

Recognize Limits

Advise clients that discussions held between a client and a non-lawyer may have to be disclosed in the event of a criminal investigation or prosecution. Section 7525 of the Internal Revenue Code does not protect information provided to a non-lawyer representative from disclosure in a criminal investigation or prosecution.

Throughout, treat all government representatives with respect and act like the professional that you want others to know and respect. Do not mislead, affirmatively or otherwise, anyone at any time. Always maintain the appearance of reasonableness, even in times where the government may appear to be anything but reasonable. If you have problems with an agent during the course of an examination, ask to speak to their manager. If you have problems, it is likely that other representatives have previously had similar discussions with the agent's manager. While the manager may appear to be supporting the agent when meeting with you, it is also likely that the manager will have a direct conversation with the agent outside your presence and that your future interactions with the agent will be significantly improved.

Many untoward consequences can flow from what is included—or excluded—in a tax return. The government is to be commended for its strong, ongoing tax enforcement efforts. Practitioners must respect the basis for these efforts and provide meaningful assistance to help taxpayers appropriately respond to their tax-related obligations.

Effective representation requires the ability to utilize all available resources, detailed preparation, and diligence in providing timely responses to examination inquiries. All should be reminded that an income tax return is simply not an offer to negotiate later with the government. Work with your clients and spend the extra effort to get it right. 

¹ FBAR, or Report of Foreign Bank and Financial Accounts, filings are due June 30 for the prior calendar year. Financial Crimes Enforcement Network (FinCEN) Form 114, formerly Form TD F 90-22.1.

² See Internal Revenue Manual (IRM) 9.5.11.9 (06-26-2009).

³ See "2012 Offshore Voluntary Disclosure Program," <http://www.irs.gov/uac/2012-Offshore-Voluntary-Disclosure-Program>, last updated January 24, 2014.

⁴ IRC §163(h)(3).

⁵ See Treas. Reg. §1.1031(K)-1.

⁶ Taxpayers should be prepared to fully document losses incurred in the recessionary economy of 2008-2013.

⁷ See "Taxpayer Advocate Service," <http://www.irs.gov/Advocate>, revised March 7, 2014.

⁸ Local taxpayer advocates are also available. Check local listings and IRS Publication 1546-EZ: Taxpayer Advocate Service—Your Voice at the IRS.

⁹ See <http://www.irs.gov/advocate>.

¹⁰ Look to the respective taxing authorities' site for contact information regarding their Taxpayer Advocate.

¹¹ See Audit Techniques Guides, <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Audit-Techniques-Guides-ATGs>, updated February 3, 2014.

¹² Attorneys Audit Techniques Guide, March 2011, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Attorneys-Audit-Technique-Guide>, revised November 6, 2013.

¹³ See IRS Freedom of Information, <http://www.irs.gov/uac/IRS-Freedom-of-Information>, last reviewed February 6, 2014.