

Practice

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IRS Audit Techniques Guides and Current Tax Enforcement Priorities

Historically, IRS examiners were assigned to audit taxpayers in many different industries. On 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 noncompliance 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 IRS Audit Techniques Guides (ATGs) focus on developing highly trained examiners for a particular market segment or issue. A market segment may be an industry such as construction or entertainment, a profession like attorneys or real estate agents or an issue like passive activity losses, hobby losses, litigation settlements or executive compensation—fringe benefits. These guides contain examination techniques, common and unique industry issues, business practices, industry terminology, interview questions and procedures and other information to assist examiners in performing examinations.

The ATGs have significantly improved audit efficiency and compliance by focusing on taxpayers as members of particular groups or industries. These groups have been defined by type of business (artists, attorneys, auto body shops, bail bond industry, beauty shops, child care providers, gas stations, grocery stores, entertainers, liquor stores, pizza restaurants, taxicabs, tour bus industry, etc.), technical issues (passive activity losses, alternative minimum tax), and types of taxpayer or method of operation (*i.e.*, cash intensive businesses). As examiners focus on the tax



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compliance of a particular industry, they have gained experience on specific issues to be examined for a particular type of business, whether or not the issues are set forth on a tax return. Examiners often spend the majority of their time auditing taxpayers in the particular market segment for which the examiner has become a specialist. Some may specialize in examining the construction industry while others may specialize in examining restaurants.

IRS examiners are routinely advised about industry changes through trade publications, trade seminars and information sharing with other examiners. As such, there is an increased understanding of the market segment, its practices and procedures, and the appropriate audit techniques required to identify issues unique to the market segment under examination. Utilizing an ATG, examiners attempt to reconcile discrepancies when income and/or expenses set forth on a taxpayer's return are inconsistent with a typical market segment profile or where the reported net income seems inconsistent with the standard of living prevalent in a geographical area where the taxpayer resides. As a result, information and experience gained through the examination of returns for other taxpayers becomes the barometer for judging the accuracy of a particular return under examination.

Issues are continually being identified by their unique features requiring specialized audit techniques, technical or accounting knowledge, or the need to comprehend the specific business practices, terminology and procedures. The IRS has published numerous ATGs, including attorneys, auto body/repair shops, bail bondsmen, beauty/barber shops, car washes, child care providers, check cashing establishments, childcare businesses, construction contractors, farmers, restaurants and bars, various segments of the entertainment industry (motion picture/television, athletes and entertainers, music), garment industry, gasoline distributors, grocery stores, insurance agencies, jewelry dealers, liquor stores, mobile food vendors, parking lot operators, pizza parlors, real estate agents/brokers, real estate developers, recycling businesses, scrap metal businesses, taxicabs, the trucking industry, direct sellers and auto dealers.

Once the IRS identifies a particular market segment project, an audit group may develop an ATG based upon the market segment's unique business activities. The audit guides are used by examiners to develop a pre-audit planning strategy. The ATGs explain the nature of each respective market segment or industry, the type of documentation that should generally be

available and the nature and type of information to search for during a tour of the business premises. They identify potential sources of additional income not otherwise readily apparent from the type of business activity being examined.¹

The ATGs identify issues to be raised during an audit interview with the business owner/operator, including the need for a detailed discussion about internal controls (weak internal controls in a small business environment does not preclude the necessity of determining the reliability of the books and records since every taxpayer has a method of conducting business and safeguarding business operations), source of funds utilized to start the business, a complete list of suppliers, identification or business records that might be available and the individual that maintains the business records. The examiner will also explore the manner of business operations, including the hours and days it is open, the number of employees, the responsibilities of each employee, identification of the individual that maintains control over inventory (beer, wine, *etc.*), cash and credit card receipts and the cash register tapes. Examiners are advised to search out payments of nonbusiness or personal living expenses by the owner/operator from the business operations.

ATGs are designed to focus IRS examiners on the typical methods of operation for businesses operating within a particular market segment. For example, with respect to cash intensive businesses, the audit guides identify the potential for skimming in liquor stores, pizza restaurants, gas stations, retail gift stores, auto repair shops, restaurants and bars. However, the ATGs acknowledge that "chain" or "franchise" businesses may not participate in skimming to the same extent due to the somewhat intensive internal controls typically required in their operations. Internal controls are often stronger in franchises due to independent audits and verifications performed by the franchisor. Typically, the franchise fee is based on the gross revenue of the business. The franchisee usually must buy products from the franchisor to maintain the franchise. The franchisor also requires maintenance of certain books and records in a format determined by the franchisor and may conduct audits of the franchise operations.

Specific Industry Applications of Audit Techniques

IRS examiners are advised to make specific inquiries based on the type of taxpayers under examination. For example, in the retail liquor industry, examiners

are advised to search for off-book inventory including purchases outside of the liquor distributor, *i.e.*, local wholesaler, bottle redemption and check cashing as well as contacting for check with local/state beverage department for pending or completed investigations involving taxpayer and/or known suppliers of the taxpayer. For pizza restaurants, examiners are cautioned to reconcile the difference of the number of boxes sold versus the number of boxes used (less some account for spoilage boxes) as possible additional unreported sales. For gasoline service stations, examiners are advised use the indirect mark-up method of determining income (gallons purchased multiplied by the average selling price as representing total sales) and inquire about imaging reimbursements, incentive agreements, accommodations, blending and rebates.

For restaurants and bars, examiners are advised to inquire about rebates to franchisees from suppliers, compare restaurant averages (sales *v.* cost), reported net profits as compared to the industry average, spillage, whether “point of sales” machines, using bar averages (pour) to calculate income, *etc.* With respect to grocery stores, examiners are advised to search for potential sources of unreported income that might include coupon processing rebate fees, cash discounts from vendors, rebates from vendors, receipt of high dollar promotional items from vendors, use of vending machines (*i.e.*, newspaper), pinball machines/arcade games, bottle/can redeeming, money orders, credit card sales, food stamp sales and prepaid telephone cards.

Financial Status Audit Techniques (FSAT)

There are various audit and investigative techniques available to corroborate or refute a taxpayer’s claim about their business operations or nature of doing 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. The use of indirect methods of proving income, also referred to as the FSAT, is not prohibited by Code Section 7602(e).² Indirect methods include a fully developed Cash T, percentage mark-up, net worth analysis, source and application of funds or bank deposit and cash expenditures analysis. However, examiners must first establish a reasonable indication that there is a likelihood of underreported or unreported income. Examiners must then request an explanation of the discrepancy from the taxpayer.

If the taxpayer cannot explain, refuses to explain, or cannot fully explain the discrepancy, a FSAT may be necessary. Common FSATs include:

The Source and Application of Funds Method is an analysis of a taxpayer’s cash flows and comparison of all known expenditures with all known receipts for the period.³ This method is based on the theory that any excess expense items (applications) over income items (sources) represent an understatement of taxable income. Net increases and decreases in assets and liabilities are taken into account along with nondeductible expenditures and nontaxable receipts. The excess of expenditures over the sum of reported and nontaxable income is the adjustment to income. The Source and Application of Funds Method is typically used when the review of a taxpayer’s return indicates that the taxpayer’s deductions and other expenditures appear out of proportion to the income reported, the taxpayer’s cash does not all flow from a bank account which can be analyzed to determine its source and subsequent disposition, or the taxpayer makes it a common business practice to use cash receipts to pay business expenses.

Sources of funds are the various ways the taxpayer acquires money during the year. Decreases in assets and increases in liabilities generate funds. Funds also come from taxable and nontaxable sources of income. Unreported sources of income even though known, are not listed in this computation since the purpose is to determine the amount of any unreported income. Specific items of income are denoted separately. Specific sources of funds include the decrease in cash-on-hand, in bank account balances (including personal and business checking and savings accounts), and decreases in accounts receivable; increases in accounts payable; increases in loan principals and credit card balances; taxable and nontaxable income, and deductions which do not require funds such as depreciation, carryovers and carrybacks, and adjusted basis of assets sold.

Application of funds are ways the taxpayer used (or expended) money during the year. Examples of applications of funds include increases in cash-on-hand, increase in bank account balances (including personal and business checking and savings accounts), business equipment purchased, real estate purchased, and personal assets acquired; purchases and business expenses; decreases in loan principals and credit card balances; and personal living expenses. Determining the beginning amount of

cash-on-hand and accumulated fund for the year is important. See IRM 4.10.4.6.8.3 below for possible defenses the taxpayer might raise regarding the availability of nontaxable funds.

The Bank Account Analysis compares total deposits with the reported gross income for all accounts, whether designated as personal or business. The examiner will review the taxpayer's business and personal bank accounts (including investment accounts); *i.e.*, statements, deposit slips, and canceled checks, etc. looking for unusual deposits (size or source), the frequency of deposits, deposits of cash, specific deposits that do not follow the taxpayer's normal routine or pattern, nontaxable deposits such as loans and transfers, commingling of personal and business activities and cash-backs when a deposit occurs.

The examiner will attempt to total the deposits and reconcile deposits of nontaxable funds and transfers between accounts focusing on transfers in, out, and between accounts as previously unknown accounts may be identified. Checks deposited by the taxpayer but later returned by the bank (*e.g.*, the maker of the check did not have sufficient funds in the account to pay the check) are categorized as nontaxable transactions. Nontaxable funds, transfers-in and returned deposits need to be subtracted from total deposits to get "taxable deposits." The examiner will determine disbursements by adding the opening bank balance to the total deposits and then subtracting out the ending balance. To the extent possible, cancelled checks will be reviewed to determine whether nondeductible expenditures (personal expenses, investments, payments on asset purchases, etc.) are included with business expenses and if so, the amount. If cancelled checks are unavailable, transactions will be traced from the bank statement to the check register and the original document. Significant commingling of accounts may warrant a more in-depth analysis by the examiner. When nondeductible expenditures are deducted from the total disbursements the remainder should approximate the deductible business expenses on the tax return (other than noncash expenses such as accruals and depreciation).

If the analysis results in the identification of excess deposits over the reported gross income, the excess represents potential unreported income. If specific transactions or deposits can be identified as the source of the understatement, the examiner may assert a specific item adjustment to income supported by the direct evidence of excess deposits. If the specific transactions or deposits creating the understatement are not identi-

fied, an adjustment to taxable income may be made based on the circumstantial evidence. If the business expenditures paid by check are less than the deducted business expenses on the return, then the taxpayer may be overstating expenses, paying expenses by cash (unreported income), or paying expenses from an undisclosed source of funds. If the analysis indicates significant commingling of funds, then the internal controls are weak and the books and records may be unreliable.⁴

The Bank Deposits and Cash Expenditures Method is distinguished from the Bank Account Analysis by the depth and analysis of all the individual bank account transactions, and the accounting for cash expenditures and a determination of actual personal living expenses. The Bank Deposits and Cash Expenditures Method computes income by showing what happened to a taxpayer's funds based on the theory that if a taxpayer receives money it can either be deposited or it can be spent.⁵ This method is based on the assumptions that proof of deposits into bank accounts, after certain adjustments have been made for nontaxable receipts, constitutes evidence of taxable receipts; expenditures as disclosed on the return, were actually made and could only have been paid for by credit card, check or cash. If outlays were paid by cash, then the source of that cash must be from a taxable source unless otherwise accounted for and it is the burden of the taxpayer to demonstrate a nontaxable source for this cash.

The examiner will consider whether there are unusual or extraneous deposits which appear unlikely to have resulted from reported sources of income? The examiner may limit the examination to large deposits or deposits over a certain amount. However, the identification of smaller regular deposits may be indicative of dividend income, interest, rent or other income, leading to a source of investment income. An item of deposit may be unusual due to the kind of deposit, check or cash, in its relationship to the taxpayer's business or source of income. An explanation may be required if a large cash deposit is made by a taxpayer whose deposits normally consist of checks. Also, a bank statement noting only one or two large even dollar deposits, in lieu of the normal odd dollar and cents deposits, would be unusual and require an explanation.

Many taxpayers, due to the nature of their business or the convenience of the depository used, will follow a set pattern in making deposits. Deviation from this pattern may be reason for more in depth questioning. Bank statements or deposit slips which indicate repeat deposits of the same amount on a monthly basis, quarterly or semi-annual basis may indicate

rental, dividend, interest or other income accruing to the taxpayer.

The examination of deposit slips may indicate items of deposit which appear questionable due to the location of the bank on which the deposited check was drawn. It is common practice when preparing a deposit slip to list either the name of the bank, city of the bank or identification number of the bank upon which the deposited check was drawn. If an identification number is used, the name and location of the bank can be determined by reference to the banker's guide. In all cases, if the location of the bank on which the check for deposit was drawn bears little relation to the taxpayer's business location or source of income, it may indicate the need for further investigation.

The examiner should identify all loan proceeds, collection of loans or extraneous items reflected in deposits. If loan proceeds are identified, the examiner may request the loan application documents to verify the source and amount of the nontaxable funds and attempt to determine whether such information is consistent with other information; *i.e.*, cash flows, assets, anticipated gross receipts, etc.

If repayments of loans are identified, the examiner will request the debt instruments to establish that a loan was made, the terms of the debt and the repayment schedule. Before an examiner can reach any conclusion about the relationship between deposits and reported receipts, transfers and redeposits must be eliminated. For example, if a taxpayer draws a check to cash for the purpose of cashing payroll checks and then redeposits these payroll checks, the examiner would be incorrect if total deposits were compared to receipts reported without adjusting for this amount. The taxpayer has done nothing more than redeposit the same funds in the form of someone else's checks.

The Markup Method produces a reconstruction of 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.⁶ It consists of an analysis of sales and/or cost of sales and the application of an appropriate percentage of markup to arrive at the taxpayer's gross receipts. By reference to similar businesses, percentage computations determine sales, cost of sales, gross profit or even net profit. By using some known base and the typical applicable percentage, individual items of income or expenses may be determined. These percentages can be obtained from analysis of Bureau of Labor Statistics data or industry publications. If known, use of the taxpayer's actual markup is required.

The Markup Method is similar to how state sales tax agencies conduct audits. The cost of goods sold is verified and the resulting gross receipts are determined based on actual markup. The Markup Method is often used when inventories are a principal income producing factor and the taxpayer has nonexistent or unreliable records or the taxpayer's cost of goods sold or merchandise purchased is from a limited number of sources such that these sources can be ascertained with reasonable certainty, and there is a reasonable degree of consistency as to sales prices.⁷

The Net Worth Method for determining 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. This method requires a complete reconstruction of the taxpayer's financial history, since the government must account for all assets, liabilities, nondeductible expenditures and nontaxable sources of funds during the relevant period.

The theory of the Net Worth Method is based upon the fact that for any given year, a taxpayer's income is applied or expended on items which are either deductible or nondeductible, including increases to the taxpayer's net worth through the purchase of assets and/or reduction of liabilities. The taxpayer's net worth (total assets less total liabilities) is determined at the beginning and at the end of the taxable year. The difference between these two amounts will be the increase or decrease in net worth. The taxable portion of the income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible items and subtracting that portion of the income, which is partially or wholly nontaxable.

The purpose of the Net Worth Method is to determine, through a change in net worth, whether the taxpayer is purchasing assets, reducing liabilities or making expenditures with funds not reported as taxable income. The use of the Net Worth Method of proof requires that the government establish an opening net worth, also known as the base year, with reasonable certainty; negate reasonable explanations by the taxpayer inconsistent with guilt; *i.e.*, reasons for the increased net worth other than the receipt of taxable funds. Failure to address the taxpayer's explanations might result in serious injustice; establish that the net worth increases are attributable to currently taxable income; and, where there are no books and records, willfulness may be inferred from that fact coupled with proof of an understatement of taxable income. But where the books and records appear correct on

their face, an inference of willfulness from net worth increases alone might not be justified.⁸ The government must prove every element beyond a reasonable doubt, though not to a mathematical certainty.

Circumstances that might support the use of an indirect method include a financial status analysis that cannot be easily reconciled—the taxpayer's known business and personal expenses exceed the reported income per the return and nontaxable sources of funds have not been identified to explain the difference; irregularities in the taxpayer's books and weak internal controls; gross profit percentages change significantly from one year to another, or are unusually high or low for that market segment or industry; the taxpayer's bank accounts have unexplained deposits; the taxpayer does not make regular deposits of income, but uses cash instead; a review of the taxpayer's prior and subsequent year returns show a significant increase in net worth not supported by reported income; there are no books and records (examiners should determine whether books and/or records ever existed, and whether books and records exist for the prior or subsequent years. If books and records have been destroyed, the examiner will attempt to determine who destroyed them, why, and when); no method of accounting has been regularly used by the taxpayer or the method used does not clearly reflect income as required by Code Sec. 446(b).

When considering an indirect method, the examiner will look to the industry or market segment in which the taxpayer operates, whether inventories are a principle income producing activity, whether suppliers can be identified and/or merchandise is purchased from a limited number of suppliers, whether pricing of merchandise and/or service is reasonably consistent, the volume of production and variety of products, availability and completeness of the taxpayer's books and records, the taxpayer's banking practices, the taxpayer's use of cash to pay expenses, expenditures exceed income, stability of assets and liabilities and stability of net worth over multiple years under audit.

Cash Intensive Business ATG

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. A cash intensive business is one that receives a significant amount of receipts in cash. This can be a business such as a restaurant, grocery or convenience

store that handles a high volume of small dollar transactions. It can also be an industry that practices cash payments for services, such as construction or trucking, where independent contract workers are generally paid in cash.

The IRS has long been interested in business operations that receive most of their income in cash. Since certain businesses do not always deposit all of their cash receipts, the Cash Intensive Business ATG provides various methods by which an examiner may be able to reconstruct total gross receipts and expenditures. Cash transactions are believed to be anonymous, leaving no trail to connect the purchaser to the seller, which may lead some individuals to believe that cash receipts can be unreported and escape detection. Cash can be misappropriated cash from a business by being skimmed from receipts and pocketed before it is recorded. If this happens it will not be discovered by auditing the books. It can be stolen after it has been recorded by being removed from the cash register or goods stolen from the shelf for future resale. A fraudulent disbursement can be created such as a payment to a vendor that is actually cashed by the owner.

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 life style 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 shows a deficit of funds; bank balances, debit card balances and liquid investments increase annually despite reporting of low net profits or losses; accumulated assets increase even though the reported net profits are low or a loss; debt balances decrease, remain relatively low or don't increase, but 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.

If the examiner believes the business may not be reporting all of its income, the examiner may issue a summons to suppliers and other third parties for records of sales or deliveries to the business, including original purchase invoices, during the period under examination. The examiner may then mark-up the purchases by a reasonable amount based upon ATG industry standards to determine what are known as the audited sales for the business. Absent a reasonable explanation for a discrepancy between audited sales and reported sales, the IRS will determine income

tax adjustments (and maybe penalties) based upon the discrepancy.

The examiner will formulate interview questions based on the preliminary Cash-T information, and, at the initial interview, the taxpayer may respond that no loans or gifts were received nor was a cash hoard maintained. When questioned, the same taxpayers respond that unexplained deposits or cash represents loans and gifts from relatives who may live outside the United States although there are no records to support the claim that the amounts are loans or gifts, except a copy of a letter from a relative stating that the relative gave the amounts at issue.

If the examiner believes the unexplained amounts represent unreported income, the ATG advises the examiner to ask the taxpayer for the specific dates and amounts of the currency received from friends or family—a vague and self serving letter from a friend or relative is not likely a sufficient response. The examiner will inquire about exactly how much currency was received on each specific date. Was it U.S. currency or foreign currency? Can the loan be verified by any other source? Can the lender show it was withdrawn from their bank on that date? Were FinCEN forms filed if currency was brought into the country? What day did the taxpayer get the money? How much did the taxpayer receive on that day? What did the taxpayer do with the money that day?

The examiner will ask for the name, address, telephone number of each person providing cash loans and inform the taxpayer that the examiner will be contacting these individuals for proof, including requesting copies of their tax returns or other documents. How the foreign currency was converted to U.S. currency? Where did the lender convert the currency? The examiner will ask for a copy of the exchange receipt issued by the bank or whoever exchanged the foreign currency for U.S. currency. If the lender converted the currency and brought it into the U.S., the examiner will request a copy of their passport showing entry to the U.S. on that day. If the taxpayer converted the currency, the examiner will request a copy of the exchange receipt.

The examiner is advised to get specific information from the taxpayer and that the taxpayer must have records of this, because if currency was received, the taxpayer would know how much it was. If it is a loan, the taxpayer would typically know amounts borrowed so they can pay it back. They will need to know when it was borrowed to calculate interest. If the taxpayer cannot provide specific information the examiner is advised that they should question

the credibility of the statements. This questioning is often intensive and highlights inconsistencies if the cash loans do not exist.

Specific dates and amounts are important, because a large cash expenditure in January can't be explained by a trip to a foreign country to obtain cash in March of the same year. The examiner should consider issuing an IDR to obtain this information. If the taxpayer has sufficient detailed information, the examiner is to summons the lenders or cash donors for an interview and additional documents would be appropriate. Also, summoning bank records for the specific deposits would be appropriate.

When foreign currency is given by gift or loan, exchange rates can be found for the transfer dates. If they were not favorable, it is unlikely a friend or relative would have exchanged the currency at that time unless it was absolutely necessary. And, if it was absolutely necessary, the money would go into the bank or into the business immediately. If the amounts in issue are asserted to be a loan, the examiner is advised to inquire about repayment and how interest is calculated. The loan will have occurred in the examination year, and by time of the later examination, the taxpayer should have paid some of it back. If the taxpayer is repaying by taking currency to the foreign country, the examiner will ask for the same type of specific information (exchange receipts and copies of their passport, etc.). Does the business show enough profit to be able to pay back loans on those dates? If only one payment is made during the year, it would likely be a larger than normal loan payment. Can withdrawals be found in the amount claimed to be paid back? Examiners are advised to analyze the cash in and cash out for the week of the repayment.

Examiners are to interview the lenders and review their tax returns. They will inquire about the specific dates and amounts provided to the taxpayer. Was it foreign or U.S. currency? Who converted the currency to the United States? When? Where? What records do you have to prove this? What records do you have to guarantee the money will be repaid? Have any repayments been made? When? Where? How much? If not, why not? They will ask to see copies of their passports to show they traveled into the country when they say they did and copies of their bank withdrawals if money was withdrawn to lend to the taxpayer. It is possible that, when face to face with the examiner, the lender will make statements inconsistent with the taxpayer's statements or give some evidence that they did not really have the ability to make these suggested loans.

Typical Interview Questions Addressing Accumulated Funds

Taxpayers often assert that unexplained amounts represent accumulations of wealth over a period of time. Common interview questions include whether the taxpayer keeps more than \$1,000 on your person, at your home, at your business or in any other location?⁹ 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 include how much accumulated funds did the taxpayer have on hand at the beginning and end of the year under audit? How much in accumulated funds does the taxpayer have on hand presently? Over what period of time were the funds accumulated? Do the accumulated funds solely belong to the taxpayer or does it belong to more than one person? Identify each person having ownership of these accumulated funds. Do any of the other owners have access to these accumulated funds? Identify the increase or decrease in accumulated funds for each access. Identify the type of records kept to identify the name(s), date(s) and effect on the accumulated funds each time there was an access.

Why were the funds accumulated and not deposited in a financial account? What is the original source of the money included in the accumulated funds? How often are the accumulated funds accessed? What is the effect of each access? Are there additions or withdrawals from the accumulated funds? Was the taxpayer accompanied by another individual when the accumulated funds were accessed? If yes, provide the name and address of the persons involved. Does the taxpayer count the accumulated funds every time they are accessed? If not, provide the dates and purpose for when the funds were counted. Does anyone else know about the accumulated funds? If yes, provide the name, relationship, address and phone number for the person. Also, determine whether these persons have access to the accumulated funds and if so, the manner and circumstances under which their access was made.

Current Tax Enforcement Priorities

The international arena will continue to test the enforcement resources of the IRS for years to come. Issues

regarding undeclared foreign source earnings and financial accounts (FBAR¹⁰ filings are due June 30 for the prior calendar year) will continue to generate considerable interest from the IRS and the Department of Justice (the “Department”). The IRS has long encouraged participation in the voluntary disclosure process for all taxpayers, those with interests in offshore accounts and otherwise. The Department has a somewhat similar policy regarding the nonprosecution of taxpayers who have made a timely voluntary disclosure. The IRS policy concerning voluntary disclosure¹¹ provides that a taxpayer’s voluntary disclosure is a factor that “may result in prosecution not being recommended.” To obtain this qualified benefit, the disclosure must be “truthful, timely and complete” and must demonstrate a willingness by the taxpayer to cooperate, and actual cooperation in determining the tax liability, and must 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. They likely remain eligible for the benefits of the longstanding IRS voluntary disclosure program mitigating the possibility of a future criminal prosecution. The IRS is expected to at least temporarily continue its current procedures for a criminal pre-clearance and for disclosures made according to the “three-page letter”.¹² 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 not a viable option.

Other examination priorities based on a perceived degree of noncompliance include the potential abuse of mortgage interest limitations¹³ by claiming deductions exceeding limitations in multiple years; Code Sec. 1031 like-kind exchanges including the abuse and possible back-dating of documents intended to circumvent the 45-Day Rule¹⁴; 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; employment tax and worker classifications where the IRS is conducting employment tax examinations including a focus on worker classification issues— independent contractor versus 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 the C-corp assets on conversion to S-corp status together with compensation for S-corporation officers; 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 K-1s—is correctly reported.

Additional examination issues include NOL carryforwards (taxpayers should be prepared to fully document losses incurred in the recessionary economy of 2008–2011); 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 and—an old favorite—abuse of donor-advised funds. Nonfilers, Schedule C taxpayers and “cash intensive” businesses provide a target-rich environment for the IRS. Finally, and of significant importance, return preparers and advisors provide a unique opportunity to leverage ongoing IRS compliance efforts that simply won't be ignored.

Summary

The IRS 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 use all available resources, including the ATGs. Preparers representing clients in an industry or having issues covered by an ATG should thoroughly review the ATG with the client before the return is prepared. Before engaging an IRS examiner in an audit, review all potentially relevant ATGs. Preparation and diligence in representation will help streamline the examination process.

ENDNOTES

- ¹ Copies of many of the ATGs are available online at <http://www.irs.gov/businesses/small/article/0,,id=108149,00.html>.
- ² Internal Revenue Manual 4.10.4.6.1 sets forth the requirements for examining income and FSATs. The indirect method need not be exact, but must be reasonable in light of the surrounding facts and circumstances; *M.L. Holland*, SCt, 54-2 USTC ¶9714, 348 US 121, 134, 75 SCt 127; “Examination techniques” include examining and testing the taxpayer's books and records, analytical tests, observing and interviewing the taxpayer. These techniques are unique to the use of a formal indirect method and will not routinely trigger the limitation of Code Sec. 7602(e).
- ³ See IRM 4.10.4.6.3 (09-11-2007); *W.R. Johnson*, SCt, 46-1 USTC ¶9155, 327 US 106, 66 SCt 464.
- ⁴ See IRM 4.10.4.3.3.4. (08-09-2011).
- ⁵ See IRM 4.10.4.6.4.1 (09-11-2007); *L.M. Gleckman*, CA-8, 35-2 USTC ¶9645, 80 F2d 394.
- ⁶ See IRM 4.10.4.6.5.1 (08-09-2011); *Fior D'Italia, Inc.*, SCt, 2002-1 USTC ¶50,459, 536 US 238, 122 SCt 2117.
- ⁷ See IRM 4.10.4.6.5.2 (05-27-2011).
- ⁸ See IRM 4.10.4.6.7.1 (06-01-2004); *M.L. Holland*, SCt, 54-2 USTC ¶9714, 348 US 121, 75 SCt 127.
- ⁹ See IRM Exhibit 4.10.4-1.
- ¹⁰ Form TD F-90-22.1, *Report of Foreign Bank and Financial Accounts* (commonly known as an FBAR).
- ¹¹ See IRM 9.5.11.9 (06-26-2009).
- ¹² Available online at www.irs.gov.
- ¹³ Code Sec. 163(h)(3)—Acquisition and refinance indebtedness.
- ¹⁴ See Reg. § 1.1031(K)-1.

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