

Practice

Overview: IRS Examination Process

By Charles P. Rettig

The IRS, a branch of the United States Department of Treasury, is the nation's tax agency and administers the Internal Revenue Code enacted by Congress. The IRS Mission is 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.

In fiscal year 2013, the IRS collected more than \$2.855 trillion in revenue (more than 90 percent of all collected federal revenue¹) and processed approximately 237 million tax returns while enforcement efforts by the approximately 19,531 enforcement personnel² were responsible for more than \$53.35 billion in total collections. The IRS annually assists more than 90 million taxpayers who call the toll-free automated telephone line, wrote letters or visited one of the more than 400 offices the IRS maintains nationwide and had more than 456 million visits on irs.gov. In FY 2013, the IRS collected \$255 for each dollar it received in appropriated funds.³

Historically, tax administration in the United States has been sidelined by a Congress that has routinely kept the IRS underfunded and confused. The IRS workforce has been reduced from nearly 95,000 full-time equivalent employees in FY 2010 to about 87,000 in FY 2013, a decrease of about eight percent.⁴ The IRS training budget has been slashed from about \$172 million in FY 2010 to about \$22 million, an almost unbelievable 87-percent reduction.⁵ Thus, the IRS not only has fewer employees, but those who remain are less equipped to perform their jobs.⁶

About 45 percent of the current IRS Revenue Agents and Revenue Officers are eligible to retire within the next five years. As succinctly stated recently by Nina Olson, the IRS National Taxpayer Advocate, "tax compliance requires a combination of high quality taxpayer service, outreach and education, and effective tax-law enforcement, and the IRS should continue to maintain a balanced approach toward that end."⁷ An under-funded, under-respected IRS does not serve to somehow enhance the voluntary compliance system of taxation nor is it good for the people of the United States.



CHARLES P. RETTIG is a Principal with Hochman, Salkin, Rettig, Toscher & Perez, P.C. in Beverly Hills, California. Mr. Rettig is Past-Chair of the IRS Advisory Council, a member of the Advisory Board for the California Franchise Tax Board and for the California State Board of Equalization and a Regent and Elected Fellow of the American College of Tax Counsel.

IRS Audit Process

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 their duties to their 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 their own limitations.

Historically, tax administration in the United States has been sidelined by a Congress that has routinely kept the IRS underfunded and confused.

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 based on a statistical formula. 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 interview techniques. There are, however, many other ways in which a return may be selected for audit, including:

- **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. 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.

- **Discriminate Function System (DIF)**—The DIF system is a computer-based technique used by the IRS to classify income tax returns according to an estimate the likelihood that an audit of the taxpayer's return would produce an adjustment (*i.e.*, a higher DIF generally corresponds to lower reporting compliance). 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 within 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.
- **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 which 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, newspapers 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 which 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.

- **Non-filer 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: Risk, High-Income Taxpayers, etc.**—The IRS has also been matching K-1 forms from pass-through 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 examining 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.

It is generally advisable to attempt to resolve any civil tax dispute at the earliest opportunity.

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 examining 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 examining agent 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.

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.

Privileges

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.

Audit Technique Guidelines

Prior to the commencement of an IRS examination, a representative should review any relevant IRS Audit Technique Guidelines (ATGs). The ATGs are 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.

Examining 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 ATGs instructing 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 ATG. Some would suggest consulting these audit guidelines before the returns are prepared.

A review of recently issued IRS ATGs 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 the 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.

Civil Closing

An examination 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 receives 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 \$25,000) 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.⁸ In such event, the taxpayer must file a Petition with the United States 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).⁹ The 90 days is extended to 150 days if the Notice of Deficiency is addressed to a person outside the United States.

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, the 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.

Summary

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.

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.

ENDNOTES

¹ See GAO, GAO-14-169, Financial Audit: IRS's Fiscal Years 2013 and 2012 Financial Statements 26 (Dec. 2013).

² Revenue Officers—4,748; Revenue Agents—12,234 and Special Agents—2,549.

³ The IRS National Taxpayer Advocate 2013 Annual Report to Congress.

⁴ The IRS National Taxpayer Advocate 2013 An-

nual Report to Congress citing the IRS Chief Financial Officer, Corporate Budget. Some calculations in this section are affected by rounding. Percentage changes were computed using actual numbers rather than rounded numbers.

⁵ The IRS National Taxpayer Advocate 2013 Annual Report to Congress citing the IRS Chief Financial Officer, Corporate Budget. Some cal-

culations in this section are affected by rounding. Percentage changes were computed using actual numbers rather than rounded numbers.

⁶ *Id.*

⁷ The IRS National Taxpayer Advocate 2013 Annual Report to Congress.

⁸ Code Sec. 6212.

⁹ Code Sec. 6213.

This article is reprinted with the publisher's permission from the JOURNAL OF TAX PRACTICE & PROCEDURE, a bi-monthly journal published by CCH, a part of Wolters Kluwer. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF TAX PRACTICE & PROCEDURE or other CCH, a part of Wolters Kluwer Journals please call 800-449-8114 or visit CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH, a part of Wolters Kluwer or any other person.
