IRS Audits

Background

The Internal Revenue Service (**IRS**) AUDIT is an expansive subject. One needs to know a few of the basics of the U. S. history of the INCOME TAX to gain perspective on IRS audits. The history of income TAXATION in the United States is nearly as old as the United States itself. George Washington's administration levied the first taxes based on income. But there were three later major developments in the income tax law in the United States that made it a permanent fixture in U. S. political, economic, and legal culture.

The first major development occurred when Congress created the Office of the Commissioner of Revenue in 1862. The second major development came after the Civil War and various financial and economic crises of the late nineteenth century with the Sixteenth Amendment of the U. S. Constitution, ratified in 1913. This amendment states that "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without APPORTIONMENT among the several states, and without regard to any CENSUS or enumeration." The income tax was permanently established shortly thereafter. The third major development came in the middle of World War II. In 1942, Congress enacted a law that required employees to withhold taxes owed by their employees from the employees' wages and salaries.

Besides mandated withholding, Congress provided the IRS with an extensive array of powers to persuade the American people to meet their tax obligations. Tax returns must be:

- Accurate
- Filed
- Paid on time

The IRS has a variety of ways to choose which returns to audit, but only a relatively small number of individual taxpayers are actually selected for audits.

The prospect of an Internal Revenue Service (IRS) audit can create a good deal of anxiety in any taxpayer. An audit is a type of investigation used to determine whether the information provided to the government on the information/tax return is accurate. The audit is used in turn to determine whether the taxpayer paid the proper amount of tax. Audits are also used to uncover FRAUD. The taxpayer bears the burden of proof during an audit. That is, the taxpayer must prove to the IRS that the information the taxpayer reported on the income

TAX RETURN is true and correct.

Whether taxpayers need outside assistance such as an accountants or an attorneys when they are faced with an audit depends on their particular circumstances. If their tax matters are fairly simple, they may be able to handle the audit entirely on their own. But if the tax issues are complex or if they do not fully understand taxes, it is a good idea for them to hire a professional to assist them.

Types of Audits

Some audits are fairly routine, and some result in only minor changes for the taxpayer. Some audits do result in additional taxes, penalties, or interest that the taxpayers must pay, but some audits do result in refunds. These results come from any of three basic types of audits:.

- The mail audit: In these cases, the IRS will send a letter requesting an explanation or additional information. Note that an "Automatic Adjustment Notice," simply states that a taxpayer owes a certain amount of additional tax. These are usually the result of a calculating error.
- The interview audit: Here, a taxpayer appears at an IRS office with all receipts and crucial documents ready for the audit.
- The field audit: The IRS schedules field audits at the taxpayer's home or business. This is the usual form of audit for small businesses and for businesses operated from the home.

In some audit situations, a taxpayer may not need to actually meet in person with an IRS agent. These kinds of audits are conducted entirely by mail (sometimes known as "correspondence audits"). In an audit by mail, a taxpayer is commonly requested to justify or explain some part of a tax return by providing additional information through the mail.

If taxpayers are asked to provide documents to the IRS through the mail, they must send copies, as the IRS may misplace the originals. It is also a good idea to use certified mail, return receipt requested, to mail documents to the IRS. This method will provide proof that the response was mailed by the deadline the IRS gave the taxpayer. While phone calls can be more expeditious in some cases, that is not usually the case with the IRS. However, if taxpayers find it necessary to call the IRS about their audit, they should be sure to keep a detailed log of the call. They should record the date and time of the call, the name and title of any IRS employee with whom they speak, the general content of their discussion, and any advice or directions that they receive.

When taxpayers first hear from the IRS about an audit, they will receive a copy of the IRS publication, "Your Rights as a Taxpayer." This pamphlet contains an explanation of the Taxpayers' **B**ILL OF **R**IGHTS, which has been enacted by Congress. It will also describes how the IRS conducts audits and collects unpaid taxes.

It is a very bad idea to ignore correspondence from the IRS about taxes. Doing so may expose taxpayers to NEGLIGENCE penalties; it may also lead to a full-blown audit that might otherwise have been unnecessary.

If the IRS determines that an audit should be conducted in person, it will either take place in an IRS office or in the taxpayer's home or business. The IRS conducts most field audits in offices, which are preferable often preferable to taxpayers. Even if the IRS asks to conduct the audit in the taxpayer's home or business, the taxpayer can keep the auditor away by providing all of the financial records to the tax adviser and asking that the audit be conducted at the tax advisor's place of business. If the IRS seems insistent that the audit takes place at the taxpayer's home or office, individuals need to keep in mind that they cannot be compelled to admit them to their home or place of business. In cases where this is an issue, taxpayers may need to show that an audit would be disruptive to their home or business to keep the auditor away from these places.

The IRS will allow taxpayers several weeks to prepare for an audit. Individuals need to use this time to gather the documents they will need to support the entries on their return. If taxpayers need extra time to prepare or to retrieve documents, they may request a change from the original appointment time set by the IRS. If their request is reasonable, the IRS is likely to grant it.

How the IRS Selects Taxpayers to Audit

The IRS conducts audits on approximately 2% to 3% of individual tax returns submitted every year. Because there are about 130 million tax returns individual tax returns filed annually, about 4 million of them will be audited.

There are several methods the IRS uses to determine if which tax returns to audit. Three of the most common are:

1. The Differential Income Factor (DIF) Method. Each tax return filed with the IRS is assigned a score based on the amount of income reported and the kind and amount of deductions claimed. The IRS will include tax returns in the pool of returns for auditing if the DIF score a tax return receives exceeds a particular threshold for income reported on the return. The higher the expenses relative to the income, the higher the DIF score.
2. The Information Returns Factor Method. The IRS receives copies of all W-2s and 1099s every year. The IRS also records the social security numbers from these documents and matches them to the social security numbers on the tax returns that are filed. If a taxpayer fails to report all of the income from their forms W-2 or 1099 on their tax return, the IRS will catch this discrepancy. This discrepancy will help to select that taxpayer's tax return for audit.
3. The Random Selection Method. All tax returns receive a random, computergenerated number. Tax returns with high DIF scores and non-matched information are taken out. A certain number of these tax returns are picked at random to audit.

Once the IRS has selected a pool of tax returns for auditing, they are assigned to Internal Revenue agents and revenue officers. When a tax return is chosen for audit, it is assigned a certain transaction code (TC). The TC identifies it as being selected for audit.

Every taxpayer who submits tax returns to the IRS has a record that is maintained by the IRS. These records are known as Individual Master Files (IMF). Since 1974 the **F**REEDOM OF **I**NFORMATION **A**CT has allowed taxpayers to access their IMFs. The IMF provides data on a computer-generated report concerning each taxpayer the IRS has on record. The IMF can reveal whether a taxpayer's return

- Has been received by the IRS
- Has been selected for audit
- Has been assessed additional taxes
- What the final collection date is for the tax return

Agents are assigned individual audits up to six months before the taxpayer is even notified of an audit. Therefore, a copy of the taxpayer's IMF can tell him or her whether the taxpayer's tax return has been selected for audit.

The most likely groups to be audited are taxpayers who own sole proprietorships. These taxpayers file a

Schedule C that is attached to their Form 1040. Taxpayers with high incomes are also frequently targeted for audits. Others likely to be targets of auditors are taxpayers who work in businesses that conduct a lot of businesses in cash, for example, owners of bars, restaurants, vending machine services, or laundromats. This is true whether or not the taxpayer files Form 8300 (Report of Cash Payments Over $10,000 Received in a Trade or Business). On the average, cash businesses are subject to auditing much more than other types.

Time Limits for the IRS

IRS auditors must complete audits within 28 months of the date the audited taxpayer filed the tax return, or by the date it was due, April 15, whichever is later. Actually, the law gives the IRS eight additional months after that (for a total of 36 months, or three years), but auditors need to leave at least eight months in which the IRS can process appeals. This means that taxpayers need to keep their tax records and supporting documents for at least that long. This three-year limit does not apply, however, if they underreported their income by more than 25 percent. In those cases, the IRS has six years in which to conduct an audit and assess additional taxes if they are warranted. There is no time limit at all for audits in cases where taxpayers file FRAUDULENT returns. Given these factors, the common wisdom says that taxpayers should retain tax records for at least six years.

Sometimes the IRS is not able to complete an audit within its three-year time limit. In such cases, the IRS may extend this time limit. Taxpayers do not have to agree to an extension, but the IRS can make the audit very unpleasant if they do not get an extension. The IRS will typically respond to a refusal by disallowing every questionable item on the return being audited. It may be a better strategy to negotiate an extension with a definite expiration date and to restrict the extension to only those items in question when the extension is granted. This keeps the IRS from expanding its audit to other areas of the return during the extension period.

Occasionally a taxpayer will be notified by the IRS about an impending audit, but then the taxpayer will not hear from the auditor for a long time. This can mean several things. For example, the auditor may no longer work for the IRS or may have changed jobs within the IRS. It is possible that the taxpayer's file is being processed somewhere else within the IRS. If and when the file again comes to the IRS's attention, it may be assigned to a new auditor who is working under a shortened deadline to close the audit. This can work in the taxpayer's favor. So, although the taxpayer may be tempted to inquire about the status of the audit, it may be best to remain silent.

It may be a good idea for the taxpayer to have the person who prepared the taxes (if the taxpayer had a paid tax preparer) appear at the audit with him to explain how the taxes were figured. If an attorney, **CPA**, or an "enrolled agent" prepared the tax return, that person can even appear in the taxpayer's place. Other kinds of tax preparers may accompany their clients to an audit, but they cannot represent clients at the audit. In some cases where permissible, it may be better for the taxpayer not to attend the audit, since the professional representing the taxpayer has no emotional involvement in the outcome of the audit. These people may be less likely to irritate or raise the suspicions of the auditor.

Perhaps the best advice about audits is never to provide more information than the IRS requests. Most audits are limited to specific areas of a return, which the taxpayer knows in advance. At the audit, the taxpayer should limit his response only to inquiries the auditor makes about these specified areas. If the auditor attempts to examine other areas of the return, the taxpayer should refuse to discuss them until he has received a formal request to audit that portion of the return. Although most audits are limited in scope, there are a small number of taxpayers (about 50,000) that are subjected to a Tax Compliance Measurement Audit. This kind of audit examines every item on the tax return. Naturally, these taxpayers must respond to all of the auditor's inquiries.

What Happens at an Audit

For any audit, IRS agents must review the following four issues:

- Income: The IRS will want to see bank statements, records from the sale of assets, documents relating to prizes, ALIMONY, pensions, and state and federal tax refunds.
- Previous audits: If the taxpayer previously had an audit, the agents will review information about when the previous audit took place, the results, and any recent correspondence the taxpayer has had with the IRS.
- Other returns: Agents will examine whether the taxpayer filed subsequent and prior years' returns on time and whether adjustments were necessary.
- Penalties: IRS agents must inquire whether the taxpayer has previously been assessed tax penalties. Of course, they will determine whether penalties should be assessed as a result of the current audit.

All audits begin with the taxpayer receiving a notice in the mail from the IRS. People should not panic if they do receive correspondence from the IRS in the mail. In fact, what they receive may not even be an audit notice at all, but an "automated adjustment notice," (also called a CP2000) informing them about additional taxes they owe. Automated adjustment notices reveal errors taxpayers made in computing income or taxes. The IRS sends automated adjustment notices to certain taxpayers because they failed to report some income to the IRS which was reported to it on a 1099 form, such as dividends or interest.

Even though a taxpayer receives an automated adjustment notice does not mean that the taxpayer must pay the amount assessed without question. In fact, the IRS itself makes miscalculations of taxes or enters income data about incorrectly. Federal law gives taxpayers the right to appeal an automated adjustment notice in writing within 60 days of receipt of the notice.

If people receive a notice from the IRS that they will be audited, they should first contact the revenue agent assigned to their case to schedule a mutually convenient time to meet. The taxpayer bears the burden of proof, which means the taxpayer must prove that the tax return in question, as well as the taxpayer's records are accurate and complete. The taxpayer will be assessed additional taxes if the taxpayer cannot prove the questionable aspects of the reported income and/or deductions. This possibility makes it important to maintain organized and accessible financial records.

Audited taxpayers should expect the IRS to ask some or all of the following questions or look into the following issues:

- Did the taxpayer report all of his or her business sales and receipts?
- Did the taxpayer write off any personal living expenses as business expenses?
- Does the taxpayer's lifestyle seem to exceed the amount of reported self-employment income?
- Did the taxpayer write off automobile expenses for travel that was not business-related?
- Did the taxpayer claim large business entertainment expenses?
- Are the taxpayer's workers classified as independent contractors when they are really employees?
- Does the taxpayer make payroll tax deposits in a timely manner?
- Did the taxpayer report all cash transactions — especially large cash transactions?

When the IRS revenue agent completes the audit, the taxpayer will get a report describing the agent's recommendation and a statement of the amount of money the taxpayer owes. The agent will probably ask the taxpayer to sign a WAIVER of the appeal rights at that time. When the agent asks the taxpayer to sign the waiver the taxpayer has three options:

1. Go ahead and pay the additional tax; if the taxpayer disputes the additional amount, the taxpayer can file for a refund.
2. The taxpayer requests an appeal with the IRS APPELLATE division. The taxpayer does not pay the tax bill and interest on the tax bill continues to accumulate during the appeal process. Even so, this is a small item compared to the tax savings that result from most appeals.
3. The taxpayer signs the waiver and pays the tax.

Occasionally the IRS will conclude that a taxpayer knowingly violated the tax laws. In these cases the IRS can recommend to the U. S. Department of Justice that the taxpayer be charged with a crime. Some of these taxpayers are prosecuted for specific tax violations, including knowingly failing to file a return or knowingly filing a fraudulent return. Recently, the IRS criminal referrals have been increasingly based on statutes relating to MONEY LAUNDERING, drugs, and other currency violations.

It is important to remain as objective as possible during an audit. The audit is, after all, strictly about numbers. However, taxpayers need not be subject to an auditor who is rude or unpleasant. In such cases, taxpayers are legally entitled to request the assignment of a different auditor.

Contesting the Audit

At the audit, the taxpayer will need to SUBSTANTIATE the information on the return. This means that the taxpayer will need plenty of DOCUMENTARY EVIDENCE. The taxpayer will need cancelled checks, receipts, bank statements, and all other documented financial records related to the tax return. Of course, the taxpayer can also TESTIFY in person about information on the return. While some of the proof may not be sufficient for the actual audit, it may be accepted on appeal or even before the tax court, though the audit appeal may be the easiest, quickest, and least expensive route to at least partial success.

There are three principal reasons for appealing an audit:

1. The appeals process is relatively simple and costs the taxpayer nothing (unless the individual hires a tax attorney or accountant, which are not required).
2. In most cases, appeals result in some tax, PENALTY, or interest savings, although appeals rarely result in a total victory for the taxpayer.
3. An appeal can delay for months a tax bill based on the audit; this can buy individuals time to raise the money they may owe under the audit.

The IRS agent's financial conclusions are not absolutely binding. Taxpayers can appeal by sending a protest letter to the IRS within 30 days of receiving the audit report. In fact, taxpayers may question the auditor's report at a number of levels:

- Before an appeals' officer
- Before the agent's manager
- Before the U. S. Tax Court

If a taxpayer requests an appeal, the taxpayer will be granted a meeting with an Appeals Officer. This person will not be part of the IRS division that performed the taxpayer's audit. There are important time limitations related to each of these levels of appeal. Taxpayers need to make sure they know what they are and that they stay within them so that their rights to appeal an audit are not lost through such a technicality.

Although it is very unusual, the appeals officer may raise issues the auditor may have missed. So, if a taxpayer is concerned that a particular item will be discovered and the taxpayer will owe even more in taxes, it may be advisable for the taxpayer to go directly to Tax Court where new issues cannot be raised. Before the taxpayer bypasses an appeal, however, it is wise for the taxpayer to consult a tax or legal professional.

If the appeal does not result in a change in the audit report, an aggrieved taxpayer can file a petition in tax court. For audit bills less than $50,000, this is a fairly inexpensive and simple process. If the audit bill is more than $50,000, taxpayers are well advised to seek the services of a tax attorney. It is generally a good idea to contest an audit report. Appeals and LITIGATION in tax court result in a lower tax bill for about half the people who challenge their audit report.

In some cases, a particularly aggrieved taxpayer may consider taking his appeal to the U. S. Supreme Court. However, it is unlikely that the Supreme Court will hear the case unless the tax issue is one that will have a far-reaching effect.

The Small Case Division of the Federal Tax Court

The federal Tax Court has a special "small case" division. This division has JURISDICTION over cases in which the IRS claims that amount of taxes and penalties for a taxpayer in any one tax year is $50,000 or less. Cases that qualify for ADJUDICATION in the small case division are known as "small cases" and receive an "S" designation.

Most people who file a small case in Tax Court end up getting their taxes reduced by some amount. And some taxpayers never even make it to court. In almost every case, before the trial date, the IRS will ask the taxpayer to meet with its lawyer to try to reach a SETTLEMENT. It is quite possible that the taxpayer may be able to settle for an amount that is less than the additional tax originally imposed by the auditor. This is because Appeals Division officers weigh the cost of litigation and the risk that the IRS might lose a court appeal against the chances of success. Statistics have shown that most cases (9 out of 10, in fact) heard by the Appeals Division are settled.

If a taxpayer does not settle with the IRS or otherwise proceeds to court, that taxpayer will discover that the small case division of the tax court operates much like a small claims court. One simply tells the judge his or her story and shows whatever EVIDENCE he or she may have. Laypersons need not know legal procedures or technical legal jargon. Conversely, the IRS will send a lawyer to advocate for its side. A typical case lasts just an hour or two. Of course, the taxpayer can always hire someone to represent him. A lawyer, especially one with training and experience in tax law, can represent the taxpayer; so can an enrolled agent or CPA who has been admitted to practice before the Tax Court.

The odds are that about half of all taxpayers will be audited at least once, and the odds increase with the amount of income the taxpayer reports. In the end, the best way to avoid an IRS audit is to minimize the possibility that the income tax return raises questions when the taxpayer files it with the IRS. To do this, the taxpayer should be sure to file all the required forms and answer all the questions asked on the return, even if they seem unrelated to the taxpayer's situation. Finally, the taxpayer should check the accuracy of W-2 and 1099 forms and report all the income on these forms to the IRS.

Additional Resources

Disagreeing with the IRS. Edited by Crouch, Holmes F. and Irma J. Crouch, eds. Allyear Tax Guides, 1998.

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Organizations

Council Oon State Taxation

122 C Street, NW, Suite 330
Washington, DC 20001-2109 USA

Phone: (202) 484-5222
Fax: (202) 484-5229
URL: http://www.statetax.org/index.html

Federation of Tax Administrators (FTA)

444 N. Capital St., NW, Suite 348
Washington, DC 20001 USA
Phone: (202) 624-5890
URL: http://www.taxadmin.org/

National Tax Association (NTA)

725 15th St., NW #600
Washington, D.C., DC 20005-2109 USA
Phone: (202) 737-3325
Fax: (202) 737-7308
E-Mail: natltax@aol.com
URL: http://ntanet.org/

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