

IRS Audits and Appeals

Dallas Bar Association
Tax Section

March 6, 2006

Presented by

Bob Probasco
robert.probasco@tklaw.com

IRS Audits and Appeals

- **IRS enforcement efforts over time**
- **How the process has changed and is changing**
- **How to approach an audit and appeal**

IRS Mission and New Operating Premise

- **MISSION CIRCA 2000:** “Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.”
- **2004 OPERATING PREMISE:**
“Service + Enforcement = Compliance”

To Put it Another Way

“As a cop, the IRS has to balance customer service and law enforcement. Stated another way, the agency’s motto could be: We’re your friend. But if you push that friendship too far, we’ll ruin your life and then throw you in jail.”

– Christopher Bergin

IRS Enforcement Priorities

- **Combat abusive tax shelters, both for corporations and high-income individuals**
- **Assure that attorneys, accountants and other tax professionals adhere to professional standards and follow the law**
- **Detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity**
- **Discourage and deter noncompliance within tax exempt and government entities, and misuse of such entities by third parties for tax avoidance purposes**

The “Tax Gap”

- **Tax gap: Estimated difference between tax owed under law and amount paid**
- **Gross tax gap for 2001 (updated estimate): \$345 billion**
- **Net tax gap (after collections and enforcement) for 2001: \$290 billion**
- **Voluntary compliance rate – 85%**
- **Compliance rates for income subject to withholding or Form 1099 reporting – 98.5%**
- **Sources of the tax gap:**
 - ▶ **Underreporting – 80%**
 - ▶ **Non-filing and underpaying – 10% each**

Closing the Tax Gap v. Political Reality

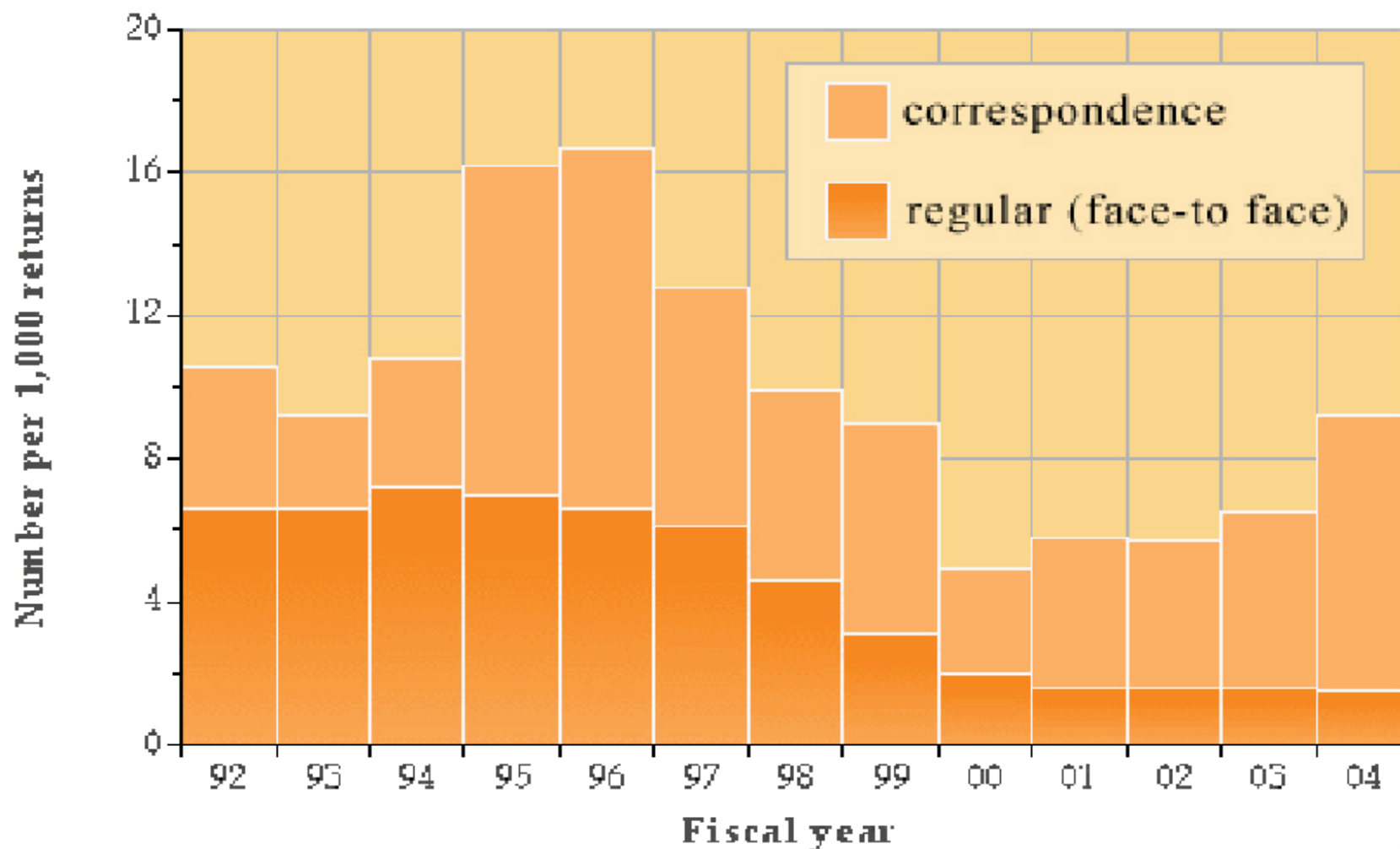
“We are starting with high-income individuals and corporations not because they are the biggest contributors to the tax gap – they are not. But there is political resonance and a sense of fairness that comes from compliance at the high end.”

– Commissioner Mark Everson

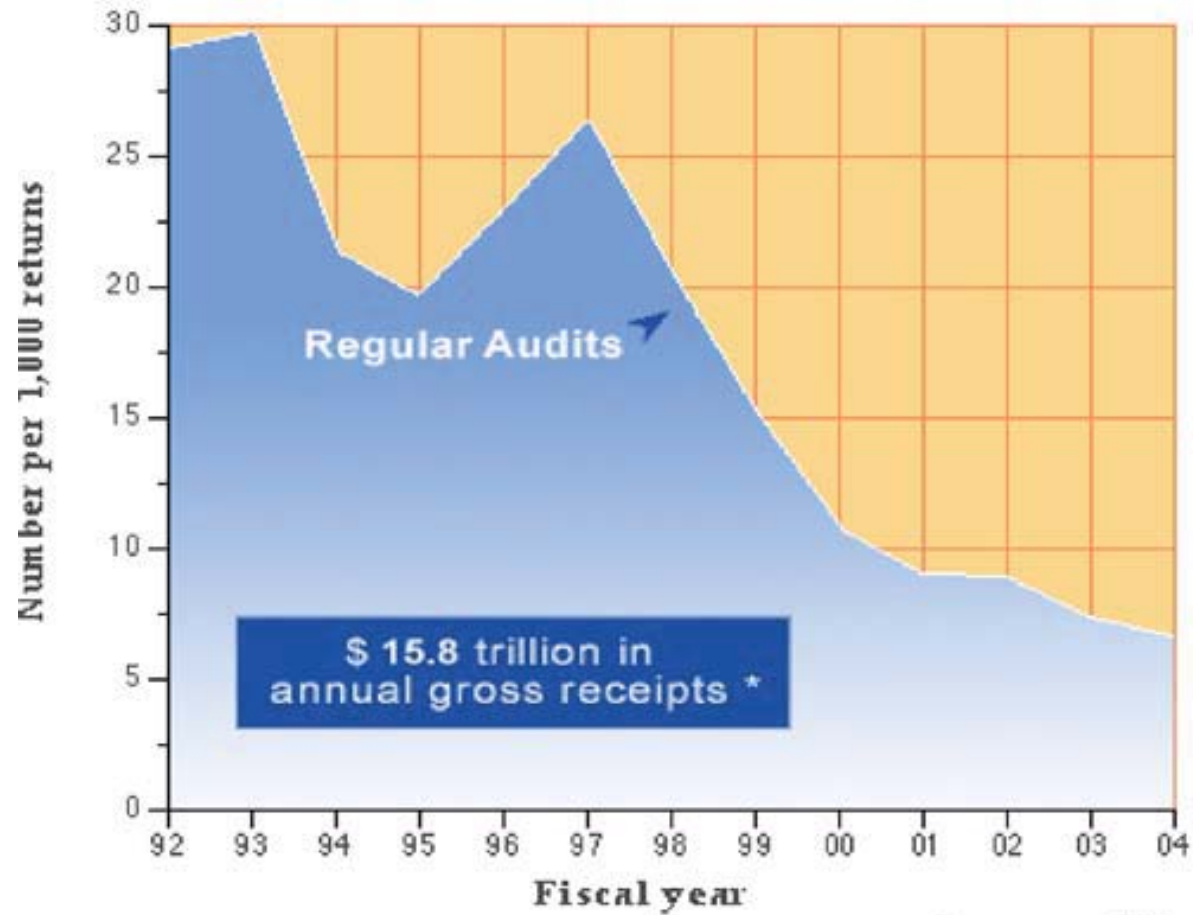
IRS Enforcement Results for 2005

- ▶ **Audit rate: high income individuals (>\$100,000) – 1.58%**
- ▶ **Audit rate: all individuals – .93%**
- ▶ **Audits of businesses with < \$10 million assets: increased 145% (17,867 audits)**
- ▶ **Audits of businesses with > \$10 million and < \$50 million assets: increased 31.8% (3,539 audits)**
- ▶ **Audits of businesses with > \$250 million assets: increased 11.7% (almost 5,000 audits)**
- ▶ **\$47.3 billion examination collections – 10% increase over 2004 and 40% increase over 2000**
- ▶ **6% decrease in criminal referrals to DOJ from 2004**

Audits of Individual Income Tax Returns



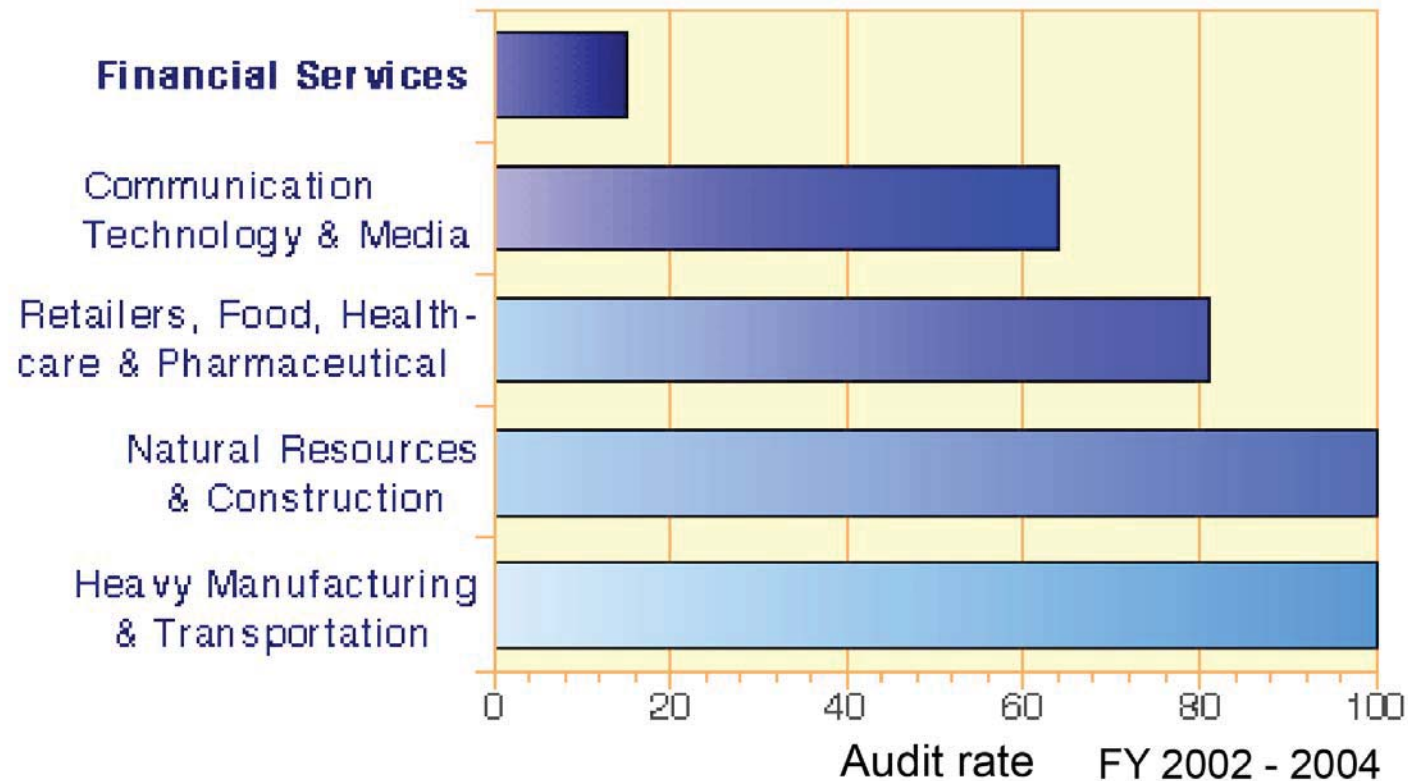
Audits of Corporations



© 2005 TRAC

*tax year 2002

Audit Rate for Large Corporations*



© TRAC 2005

*assets of \$250 million or more

IRS Audits and Appeals

- IRS enforcement efforts over time

➔ **How the process has changed and is changing**

- How to approach an audit and appeal

Re-engineering Efforts

- **Industry Issue Resolution Program, Notice 2000-65, Rev. Proc. 2003-36**
 - ▶ **Identify frequently disputed issues for published guidance rather than the audit process**
 - ▶ **Pilot program in 2001, made permanent in 2002**
 - ▶ **Ask taxpayers to suggest issues and options for resolution**
 - ▶ **Focus on factual issues common within particular industries**

Re-engineering Efforts

- **Limited Issue Focused Examinations (LIFE), News Release 2002-133**
 - ▶ Agreement to restrict to limited issues, usually based on materiality criteria
 - ▶ Agreement to cooperate and to certain time frames
 - ▶ Goal is to accelerate audit cycles and close taxable years more promptly
 - ▶ When there are a limited number of material items, taxpayer is willing and able to meet the requirements timely, and there are no tax shelter transactions or indications of fraud

Re-engineering Efforts

- **Fast Track Mediation / Settlement, Rev. Proc. 2003-40,41**
 - ▶ Appeals acts as mediator between Audit and taxpayer
 - ▶ Appeals is mediator only, no settlement authority
 - ▶ In most cases, resolved quickly (in LMSB, over 80% of cases are resolved <120 days)

Tax Shelter Initiatives

- Promoter investigations
- Offshore Compliance Program
- Taxpayer settlements – global and targeted
 - ▶ Son-of-BOSS, Announcement 2004-46 – very successful
 - ▶ Omnibus, Announcement 2005-80 – ?????
- Targeted settlement offers to promoters

Targeted Settlement Offers to Promoters

- Approximately 100 accounting firms, law firms, and banks
- Firm concedes allocable share (based on fees received) of section 6707 penalty
- Government concedes section 6708 penalty
- Firm produces investor lists, promotional materials, and tax opinions
- Firm identifies professionals who drafted the opinions
- Civil Division will not refer firm to the Criminal Investigation Division – but no guarantee firm will not be prosecuted

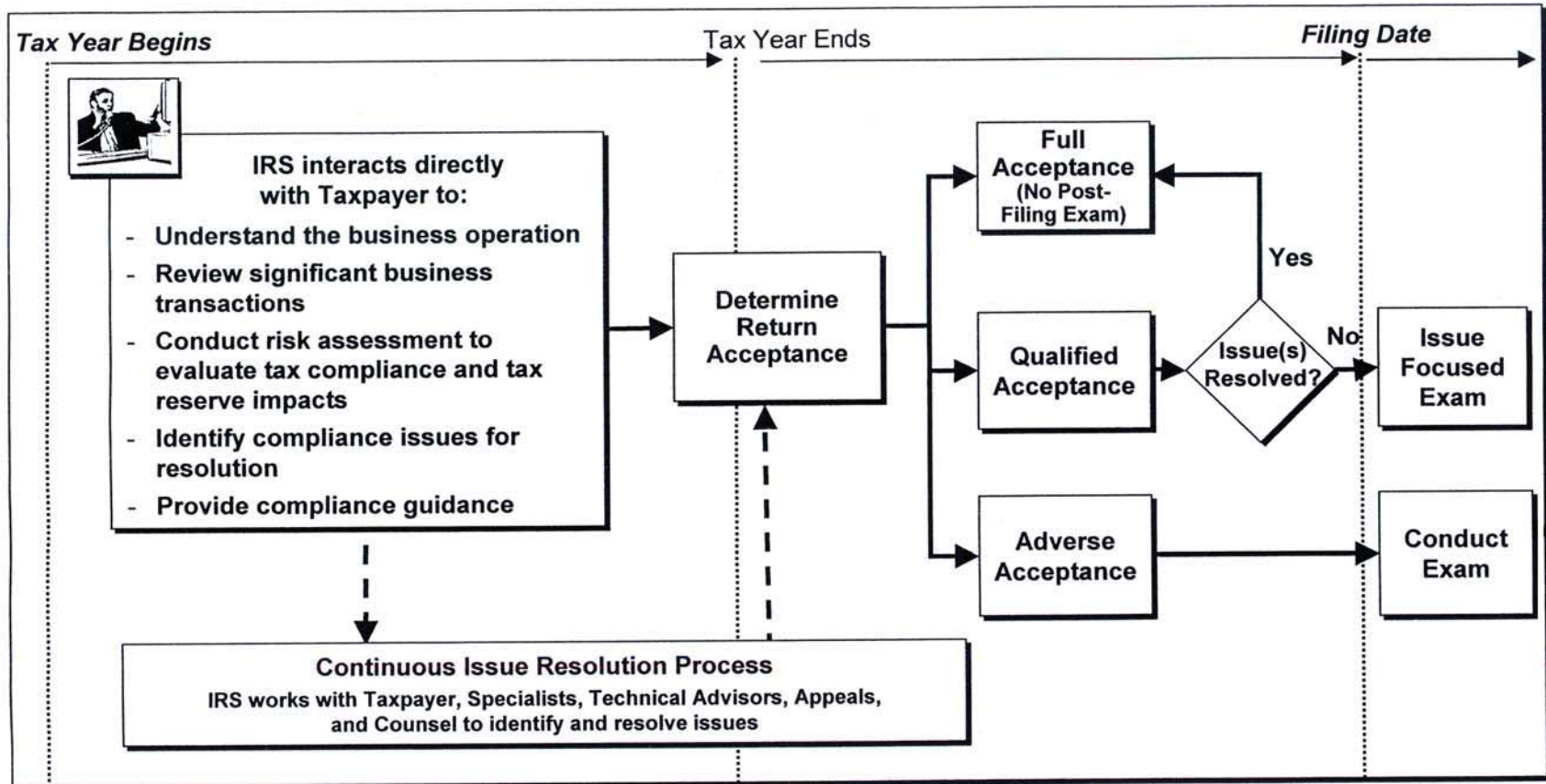
“Coming Revolution” in LMSB Exams

- **Schedule M-3**
 - ▶ More transparency
- **Corporate e-filing**
 - ▶ Speedier exams
 - ▶ Increased ability to analyze data
- **Compliance Assurance Process**
 - ▶ Real-time audits

Compliance Assurance Process

- Identify issues and material transactions as they arise
- Continuous issue resolution
- May avoid or limit need for post-filing exam
- Fewer resources required to review contemporaneously (when records and personnel are readily available) than to reconstruct after the fact
- Pilot program in 2005 with 17 taxpayers (selected as leaders in their industries and interested in improving tax administration)

Key CAP Components Are Real-Time Taxpayer Interaction With Issue Identification and Resolution



LMSB

Thompson & Knight
ATTORNEYS AND COUNSELORS



IRS Audits and Appeals

- IRS enforcement efforts over time
- How the process has changed and is changing

 **How to approach an audit and appeal**

Audit Starts: Questions to Ask

- What part(s) of IRS are involved in this audit?
- Why is this audit being conducted?
- Is this audit part of special audit program?
- Does taxpayer have basis for objecting to this audit?
- Where and when will this audit be conducted?
- How long will this audit take?

Audit Starts: Questions to Ask (Cont'd)

- **What problems or issues are expected during this audit?**
- **Where are data, documents, and people needed to support tax return?**
- **What issues or adjustments are likely?**
- **Should taxpayer disclose mistakes to IRS?**
- **Can (should) I represent taxpayer?**

The Audit Process

- **Initial conference and ground rules for audit**
 - ▶ **Identify players and contact person for each side**
 - ▶ **Discuss scope, purpose and timetable for audit**
 - ▶ **Agree to rules for IRS access to facilities, copies, computer data and taxpayer**
 - ▶ **Agree to IDR process and responses**
 - ▶ **Discuss IRS third party contact policies**
 - ▶ **Discuss potential extensions of limitations**
 - ▶ **Address potential refund claims**

The Audit Process *(cont'd)*

- **Responding to IRS requests during audit**
 - ▶ Taxpayer's responsibilities and risks
 - ▶ Practitioner's responsibilities and risks
 - ▶ Dealing with unclear, overbroad, or imprecise IDRs
- **Taxpayer interviews**
 - ▶ Recording interview
 - ▶ Taxpayer's rights at interview
 - ▶ IRS right to bypass representative

The Audit Process *(cont'd)*

- **Third party contacts by IRS**
 - ▶ IRS right to contact third parties
 - ▶ Notice of IRS intent to contact third parties
 - ▶ List of IRS third party contacts
 - ▶ Exceptions to notice and list requirements
 - ▶ **Caution:** Practitioner contacts with third parties

Appeals Function

- **Appeals Mission: To resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer, and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the IRS.**
- **Appeals Independence**

But If It Involves a Tax Shelter?

“For eligible persons that forgo resolving eligible transactions under this settlement initiative and take their issues to Appeals, Appeals will carefully consider both the issue merits and the penalty, but such persons should not expect to receive a better offer in Appeals than that offered under this settlement initiative and may in fact receive a less favorable outcome.”

Announcement 2005-80

Risks of Appeals

- **New issues – Standards for raising**
 - ▶ **Must be “quite certain” IRS will prevail if litigated**
 - ▶ **Necessary facts for new issue are readily available**
 - ▶ **Amount of tax liability in new issue is material in absolute sense**
- **Reference back to Exam**
 - ▶ **New facts or arguments raised by Appeals**
 - ▶ **Likely if taxpayer presents new facts or arguments to Appeals**

Benefits of Appeals

- Possible Tax Court penalty for unreasonable failure to pursue available administrative remedies – § 6673(a)(1)(C)
- Prerequisite to (i) recovery of attorney's fees and costs under § 7430(b)(1), and (ii) shifting burden of proof under § 7491
- Actual participation in or denial of request to participate in Appeals conference required

Appeals Settlement Process

- **Written protest by taxpayer and Exam response**
- **Informal conference(s)**
- **Appeals relationship with Exam**
 - ▶ **Ex parte communications with Exam on substance prohibited**
 - ▶ **Exam (and IRS Counsel) may attend Appeals conference if Appeals consents**
 - ▶ **Appeals may refer case back to Exam if taxpayer presents new evidence**
 - ▶ **Appeals may share new evidence presented by taxpayer with Exam**

Appeals Settlement Process *(cont'd)*

- Appeals rules of practice
 - ▶ Will determine correct amount of tax with “strict impartiality” between taxpayer and IRS
 - ▶ Will settle based on relative merits in light of hazards of litigation – No nuisance settlements
 - ▶ Will inform taxpayer of basis on which Appeals will settle, if taxpayer makes good faith offer to settle
 - ▶ Will offer taxpayer opportunity to meet with reviewer if reviewer disagrees with officer’s recommendation to accept taxpayer’s offer

Words of Wisdom

IRS motto:

**“The unexamined life is not worth living.”
– *Socrates***