

Working with the IRS

Chapter Outline

Organization of the IRS

IRS National Office

Guiding Principles

Strategic Plan Goals

IRS Service Centers

Taxpayer Assistance Orders

Local Taxpayer Advocates

Taxpayer Rights

The Audit Process

Preliminary Review of Returns

Mathematical/Clerical Error Program

Unallowable Items Program

Selection of Returns for Examination

Discriminant Function System

National Research Program

Other Selection Methods

Chances of Audit

Examinations

Correspondence Examinations

Office Examinations

Field Examinations

Dealing with an Auditor

Conclusion of Examination

Thirty-Day Letter

File a Protest or Go Straight to Court?

The Appeals Process

Appeals Conference

Ninety-Day Letter

Entering the Judicial System

Learning Objectives

- Understand the organizational structure of the IRS and administrative procedures relative to the audit and appeals process.
- Advise clients as to audit selection factors and probable litigation success.
- Develop decision guidelines as to audit etiquette, working through the appeals system, and constructing taxpayer defenses.

WE HAVE DISCUSSED VARIOUS aspects of tax practice throughout this text, including both the principles of tax research and the structure of the judicial decision-making process. In this chapter, we will examine in more detail the workings of the **Internal Revenue Service (IRS)** and the **Treasury Department**, with an eye on an overview of the elections and other opportunities and pitfalls that face the practitioner in working with these administrative bodies.

After all, when the researcher has decided that his or her client should prevail with respect to a specified tax issue, a challenge to the IRS must be issued and implemented. In this chapter, we present some of the procedural aspects of this course of action.

ORGANIZATION OF THE IRS

The Department of the Treasury is responsible for administering and enforcing the internal revenue laws of the United States. However, most revenue functions and authority have been delegated by the Secretary of the Treasury to the **Commissioner of Internal Revenue**. The Commissioner is the chief executive officer of the IRS and is appointed by the President of the United States. The Commissioner holds the responsibility for overall planning and for directing, coordinating, and controlling the policies and programs of the IRS.

The IRS is one of about a dozen bureaus within the Department of the Treasury. It was established by Congress on July 1, 1862, to meet the fiscal needs of the Civil War. At that time, the name of the agency was the Bureau of Internal Revenue. In 1953 the name was changed to the IRS.

Since 1962 the agency has undergone a period of steady growth as the means for financing government operations shifted from the levying of import duties on outsiders to one of internal taxation on U.S. citizens and businesses. This expansion increased substantially after 1913 with the ratification of the Sixteenth Amendment, which authorized the modern income tax on noncorporate entities.

Until 1951 the agency was organized on a type-of-tax basis (i.e., with income, alcohol and tobacco, etc., divisions), with jurisdictionally separate departments that were responsible for administering these different revenue sources. Since 1952 the agency has undergone five major reorganizations, including one in 1998 aimed at reengineering the organization. The most important aspects of these structuring exercises have been the reorganization of the IRS along functional lines (i.e., into administration, operations, technical, planning, and inspection divisions), and the abandonment of the system of political appointments to positions other than that of the Commissioner and the Chief Counsel.

The latest restructuring effort was initiated as a response to perceived abuses by the agency. Recognizing that most Commissioners serve only a short tenure and that the Treasury Department carries myriad duties, Congress wants to use third parties to improve the chances for the development of consistent long-term IRS strategies and priorities. Private sector input is provided through the **IRS Oversight Board**, which functions as part of the Treasury Department. The Board has no authority to affect tax policy, to intervene in IRS personnel or procurement matters, or to affect the processing of individual tax cases. Its major duties include the following.¹

- Review and approve IRS mission, strategic plans, and annual planning documents.

¹§7802.

- Review IRS operational functions, including modernization, outsourcing, and training efforts.
- Recommend to the President candidates for Commissioner.
- Review the process of selecting, evaluating, and compensating senior IRS executives.
- Review and approve the IRS annual budget request.
- Ensure the proper treatment of taxpayers.

The Board is designed to function like a corporate board of directors. It is made up of six members of the private sector, appointed to five-year terms by the President, and of the Treasury Secretary, the IRS Commissioner, and a representative of IRS employees.



SPOTLIGHT ON TAXATION

Observation

It is difficult to obtain a proper balance in setting strategic and operational goals for the IRS, given its sometimes conflicting missions of compliance, enforcement, education, and customer service. So many tax returns are filed that a customer-friendly approach seems right; however, since “a little” cheating on returns is allowable under societal norms, a “get tough attitude” might be needed by the IRS.

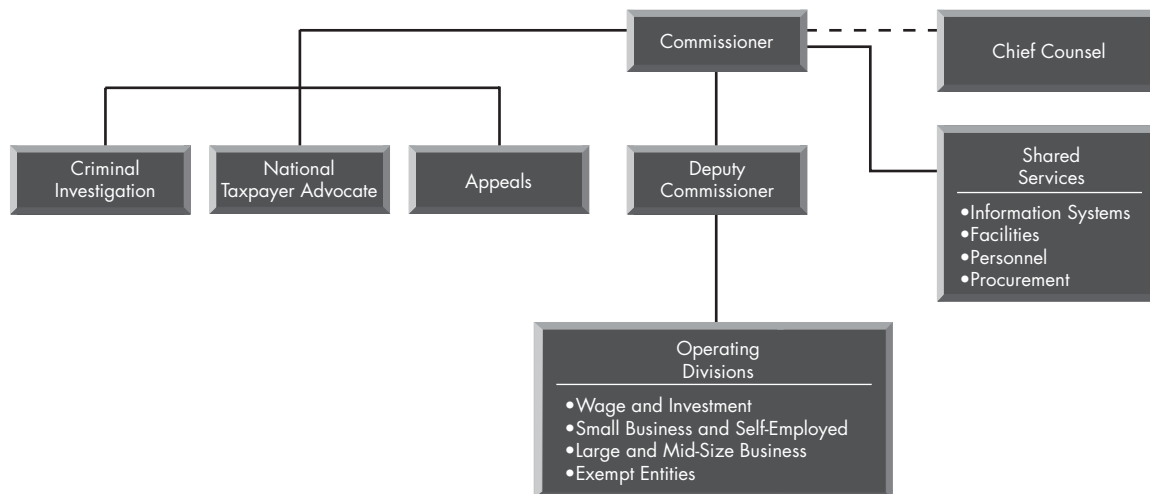
IRS National Office

The IRS processes about 135 million Forms 1040 every year, about 80 million of which are filed electronically. It collects almost \$2.5 trillion in tax revenues and pays refunds to about 110 million taxpayers every year, about 70 percent of which are deposited directly into taxpayer bank accounts. Today, the IRS is an organization of about 90,000 employees. With the exception of the Departments of Defense and Homeland Security, it is the largest agency of the Federal government. It consists of a national office in Washington, D.C., and a large decentralized field organization. Its current mission statement is as follows, reflecting the more aggressive enforcement orientation that the agency now has implemented.

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.

Guiding Principles

- Understand and solve problems from taxpayers' point of view.
- Enable IRS managers to be accountable to taxpayers.
- Use balanced measures of performance to measure taxpayer satisfaction, business results, and our employees' satisfaction.
- Foster open, honest communications.
- Insist on total integrity.

Exhibit 13-1: IRS National Office (Selections)

Strategic Plan Goals

- Improve taxpayer service
- Enhance enforcement of the tax law
- Modernize the IRS through its people, processes, and technology

Exhibit 13-1 illustrates that the IRS is organized to facilitate both the processing of tax returns and the carrying out of its broader goals, using a “shared services” model like that used by most large businesses.

The IRS’s national office is located in the District of Columbia. It is staffed by the office of the Commissioner of Internal Revenue, which includes a Deputy Commissioner and various chief officers and assistants to the Commissioner. The IRS Commissioner is appointed by the President to a renewable five-year term. He or she is the chief executive officer of the agency and is charged to administer, manage, conduct, direct, and supervise the execution of the Federal tax laws.² The Commissioner’s nomination is reviewed by the Senate. He or she advises the President as to the person who should be named Chief Counsel. The Commissioner is the agency’s final authority as to the interpretation of tax law.

The **Chief Counsel** is the agency’s highest ranking legal adviser. He or she is appointed by the President and reports to the Commissioner, relative to the administration and enforcement of the tax laws. In effect, the Chief Counsel is the IRS’s attorney. Rulings and other written determinations are prepared by the Chief Counsel’s office.³ The Chief Counsel represents the agency in Tax Court cases and often assists in preparing proposed legislation, treaties, regulations, and executive orders. Associate Chief Counsels are assigned duties relative to litigation, technical matters, international transactions, and finance and management.

The **National Taxpayer Advocate** administers a taxpayer-intervention system, which is designed to resolve a wide range of tax administration problems that

²§7803(a).

³§7803(b).

Exhibit 13-2: IRS Operating Divisions

Tax Year 2000 estimates	Wage and Investment	Small Business and Self-Employed	Large and Mid-Size Businesses (Assets >\$5 million)	Exempt Entities (Charities, Retirement Plans, Governments)
Type of return filed	1040 with only wage and investment income (no Schedules C, E, F, or Form 2106)	1040 Schedules C and F, Forms 1120, 1120S, and 1065	1040 Schedules C and F, Forms 1120, 1120S, and 1065	Form 990 and 1120, various payroll forms
Number of Filers	90 million, 116 million taxpayers	45 million	210,000	3 million entities, 1.9 million pay tax
Annual Income Tax Liabilities	\$265 billion	\$816 billion	\$466 billion	\$94 billion
Payroll Taxes Withholdings Paid	\$38 billion	\$562 billion	\$712 billion	\$198 billion
Notes	Fewer than half use a paid tax preparer Only 2% earn >\$100,000 per year, 85% earn <\$50,000, 28% earn <\$10,000	Pay in over 40% of all cash received by the IRS 4–60 annual transactions with the IRS	Further organized into industry segments to handle complex filing requirements About 10% are audited every year, some deal with IRS agents year-round	Control about \$10 trillion in assets

are not remedied through the agency's normal operating procedures or administrative channels.⁴ The Advocate reports directly to the Commissioner and works through a system of local Taxpayer Advocates, one of which is located in each state.

The operating divisions of the IRS reflect the major types of tax return that the agency processes. Exhibit 13-2 outlines the workload of each operating division.

The IRS also takes on national-level projects in working with taxpayers. Some of the most important of these recent initiatives include the following.

- Document matching, allowing a lower audit rate because deficiencies or refunds are sent out when data listed on a tax return does not match that on a corresponding source document, like a Form 1099 or W-2.
- Electronic filing, again to reduce error rates and improve compliance with the filing requirements and to enact a modernization of the agency's data processing functions.

⁴§7803(c).

- Extending the reach of the Earned Income Credit to more of the targeted low-income employees.
- Educating cash- and tip-oriented workers to comply fully with their filing requirements.

IRS Service Centers

The first **Internal Revenue Service Center** was established in 1955 in Kansas City on a pilot basis. Additional service centers were established during the 1960s to meet the processing needs of the various geographic regions of the country. A few were redeployed after 2000 to reflect the increase in electronic filing. Today, IRS service centers are located at:

- Andover, MA
- Atlanta, GA
- Fresno, CA
- Kansas City, MO
- Memphis, TN
- Philadelphia, PA

The primary function of the service centers is to process and perform mathematical verifications of the massive volume of Federal tax returns. **Computing Centers**, located in Detroit; Martinsburg, WV; and Memphis, manipulate data collected from tax returns at **Processing Centers** in Austin, Cincinnati, Kansas City, and Ogden. About twenty-five **Customer Service Sites** deal with telephone and electronic contacts from taxpayers, in working with electronic filing of returns, and in answering telephone and online taxpayer inquiries.



SPOTLIGHT ON TAXATION

Observation

More closings and downsizing of IRS processing facilities will be called for in the future, to better manage the agency's cost structure as electronic filing and deposits become the norm. Resisting these redeployments surely will be the personnel unions associated with IRS employees, attempting to slow down technology and protect their jobs, much as did those in print publishing before the document processing revolution was brought about by copy machines, faxes, and computers.

Taxpayer Assistance Orders

The National Taxpayer Advocate can issue a **Taxpayer Assistance Order (TAO)** to suspend, delay, or stop actions where, in the determination of the Advocate, the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the IRS is administering the revenue laws.⁵ "Hardships" refer to any circumstance that includes an immediate threat of adverse action for the taxpayer,

⁵§7811.

his or her irreparable injury, a delay of more than thirty days in settling the taxpayer's account, or the incurring of significant costs (such as professional advisory fees) to handle the dispute.⁶ The IRS action that is the subject of a TAO must be such that it would offend one's sense of fairness, given all the related facts.

Typically, the TAO requires remedial actions, such as a release from the IRS's levy of specific property or the cessation of a collection activity, or it gives the IRS a deadline for action. A TAO is binding on the IRS, short of its rescission by the Advocate, the Commissioner, or a Deputy Commissioner.

A taxpayer applies for a TAO by filing Form 911, Request for Taxpayer Advocate Service Assistance, reproduced as Exhibit 13-3.

Local Taxpayer Advocates

The IRS uses local Taxpayer Advocates in a system designed to help resolve taxpayer problems or complaints that are not being satisfied through regular agency channels. The primary objective of the Advocate system is to provide taxpayers with a representative within the IRS who has access to the pertinent regional, district, or service center official. In addition, the program enables the IRS to identify its own organizational, procedural, and systematic problems and to take corrective action as needed.

The system is not intended to circumvent the existing IRS channels of managerial authority, established administrative procedures, and formal avenues of appeal. Rather, it is designed to ensure that taxpayer problems or complaints that have not been resolved adequately through such normal procedures are referred and controlled within the program. When a case is referred to a member of the National Taxpayer Advocate team, he or she will ensure that the problem is not lost or overlooked, and that it is resolved as promptly and efficiently as is possible. If a case cannot be resolved within five working days after receipt of the statement of the problem or complaint, the taxpayer is contacted by telephone, advised of the status of the case, and given the name and telephone number of the IRS employee who is responsible for the resolution of the problem. Typically, the Advocate system is used to resolve billing, procedural, computer-generated, and other problems that taxpayers cannot correct after one or more contacts with the IRS office that is handling the matter.

The National Taxpayer Advocate works through local team members who are responsible for the work that is conducted within his or her jurisdiction. Local Advocates are independent from IRS examination, collection, and appeals functions. They are responsible only to the National Taxpayer Advocate.

TAXPAYER RIGHTS

Under three incarnations of the so-called *Taxpayer Bill of Rights*, taxpayers are guaranteed various rights to representation before the IRS, a recording of any proceedings, and an IRS explanation of its position relative to the pertinent disagreement. Specifically, the taxpayer has a right to know why the IRS is requesting information, exactly how the IRS will use the information it receives, and what might happen if the taxpayer does not submit the requested information. Accordingly, prior to an initial audit or collection interview, an IRS employee or officer must explain, orally or in written form, the pertinent aspects of the procedures to come.⁷

⁶§7811(a)(2).

⁷§7521(b)(1).

Exhibit 13-3: Application for Hardship Relief—Concluded

OMB No. 1545-1504

Department of the Treasury - Internal Revenue Service

**Request for Taxpayer Advocate Service Assistance
(And Application for Taxpayer Assistance Order)**

Form **911**
(Rev. 6-2007)

Section I – Taxpayer Information (See Pages 3 and 4 for Form 911 Filing Requirements and Instructions for Completing this Form.)

1a. Your name as shown on tax return		2a. Your Social Security Number	
1b. Spouse's name as shown on tax return		2b. Spouse's Social Security Number	
3a. Your current street address (Number, Street, & Apt. Number)			
3b. City		3c. State (or Foreign Country)	3d. ZIP code
4. Fax number (if applicable)	5. E-mail address		
6. Employer Identification Number (EIN) (if applicable)		7. Tax form(s)	8. Tax period(s)
9. Person to contact		10. Daytime phone number <input type="checkbox"/> Check if Cell Phone	11. Best time to call
12. Indicate the special communication needs you require (if applicable) <input type="checkbox"/> TTY/TDD Line <input type="checkbox"/> Interpreter - Specify language other than English (including sign language) _____ <input type="checkbox"/> Other (please specify) _____			
13a. Please describe the tax problem you are experiencing (If more space is needed, attach additional sheets.)			
13b. Please describe the relief/assistance you are requesting (If more space is needed, attach additional sheets.)			

I understand that Taxpayer Advocate Service employees may contact third parties in order to respond to this request and I authorize such contacts to be made. Further, by authorizing the Taxpayer Advocate Service to contact third parties, I understand that I will not receive notice, pursuant to section 7602(c) of the Internal Revenue Code, of third parties contacted in connection with this request.

14a. Signature of Taxpayer or Corporate Officer, and title, if applicable		14b. Date signed
15a. Signature of spouse		15b. Date signed

Section II – Representative Information (Attach Form 2848 if not already on file with the IRS.)

1. Name of authorized representative		2. Centralized Authorization File (CAF) number	
3. Current mailing address		4. Daytime phone number <input type="checkbox"/> Check if Cell Phone	
		5. Fax number	
6. Signature of representative		7. Date signed	

A taxpayer may be represented by an attorney, CPA (certified public accountant), or other person who is permitted to represent a taxpayer before the IRS and who has obtained a properly executed power of attorney. Absent an administrative summons, a taxpayer cannot be required to accompany the representative to an interview.⁸

After meeting a ten-day notice requirement, the taxpayer is allowed to make a tape recording of the IRS interview, using the taxpayer's own equipment. Similarly, if the IRS intends to record an interview with a taxpayer or his or her representative, it must give a ten-day notice to the taxpayer. In addition, upon receiving a request from the taxpayer and a reimbursement for duplication costs, the IRS must make available to the taxpayer a transcript of the interview or a copy of its tape recording.⁹

To protect the rights of so-called innocent spouses on joint returns, the IRS must inform spouses of their joint and several liability for tax deficiencies, and both spouses must receive separately mailed notices as to audit, appeals, and Tax Court proceedings.¹⁰ This may be especially important where the spouses have divorced or separated subsequent to filing the original joint return.

The Service must inform taxpayers of their rights to representation in carrying out a dispute with the agency. The taxpayer can suspend at any time an interview with IRS personnel so as to include a representative.¹¹

With respect to noncriminal tax matters before the IRS or a federal court, the common law privilege of confidentiality exists between a taxpayer and his or her tax practitioner, that is, one who is authorized to practice before the IRS. The privilege exists with respect to tax advice the practitioner has rendered. These provisions extend existing privilege protection previously only applicable between a taxpayer and his or her attorney. The privilege does not exist with respect to dealings with tax shelters (see Chapter 5).

THE AUDIT PROCESS

The U.S. Federal income tax system is based primarily on an assumption of self-assessment. All persons with taxable incomes that exceed a specific amount are required to prepare an accurate statement of annual income (i.e., an income tax return) and to remit in a timely fashion any amount of tax that is due. In a somewhat paternalistic sense, the IRS uses the examination of returns as an enforcement device to promote such voluntary compliance with the internal revenue laws. In a manner that is somewhat similar to the treatment by a parent of a child who is considering some forbidden behavior, the threat of an IRS audit encourages many taxpayers to report accurately their taxable incomes and to pay any tax liability that remains outstanding.

Because only a small number of tax returns can be audited each year, the IRS attempts to select for examination only those returns that will generate additional revenues for the Treasury. It primarily relies on sophisticated statistical models and computer technology to identify those returns that possess the greatest revenue return for the agency's investment of audit resources. However, in addition to this scientific selection process, a number of returns are manually selected for examination at an examiner's discretion.

⁸§7521(c).

⁹§7521(a); Notice 89-51, 1989-1 CB 691.

¹⁰§6103(e)(1)(B).

¹¹§7521(b)(2).

Preliminary Review of Returns

All business and individual tax returns are reviewed routinely by IRS personnel and computers for simple and obvious errors, such as the omission of required signatures and Social Security numbers. After this initial review, income tax returns are processed through the IRS Automatic Data Processing (ADP) program.

One of the most important functions performed by the ADP program is the matching of the information recorded on a return with corresponding data received from third parties, for example, from an employer on Form W-2. This procedure, which is referred to as the Information Document Matching Program (IDMP), has uncovered millions of cases of discrepancies between the amount, say, of income that recipients have reported on tax returns and corresponding deductions or other information that has been transmitted by payors. In addition, the IDMP provides the IRS with a means by which to detect taxpayers who fail to file any return at all. In the typical year, about two million taxpayers are sent such failure-to-file inquiries as a result of the matching program.

ADP also is used to conduct the Service's Mathematical/Clerical Error Program. This process is designed to uncover relatively simple and readily identifiable problems that can be resolved easily through the mail.

Mathematical/Clerical Error Program The Mathematical/Clerical Error Program is one of a number of special programs that are conducted by IRS computers. This program checks every return for mathematical errors, recomputes the tax due after properly applying the numbers that are included in the return, and summarily assesses any additional tax that is due or allows refunds or credits based on (previously) miscalculated deductions or credits. A summary assessment may be made concerning any deficiency that results from a mathematical or clerical error.¹² Consequently, the IRS need not send the taxpayer a formal notice of deficiency (i.e., a ninety-day letter, as discussed subsequently in this chapter) before the additional tax is assessed.

Above 5 percent of all paper filed returns show an error of this type. When a mathematical or clerical error is identified by the service center, the IRS mails the taxpayer a corrected tax computation and requests that he or she pay the additional tax within ten days of the date of the notice, or twenty-one days if the tax underpayment is less than \$100,000. If the deficiency is paid within this period, no interest is charged on the underpayment. However, if the deficiency is not paid in a timely fashion, interest is imposed on the unpaid amount for a period that begins on the date of the notice and demand and ends on the date of payment.

A taxpayer may not petition the U.S. Tax Court with respect to a deficiency that results from a mathematical or clerical error. However, other administrative procedures will allow the taxpayer to contest the summary assessment without first paying the tax.

The IRS must give an explanation of the asserted error to the taxpayer. After receiving this explanation, the taxpayer has sixty days within which to request that the additional tax be abated. If a request for abatement is made, the assessment will be canceled automatically. However, the return is then identified for further examination if the taxpayer cannot justify satisfactorily or substantiate the figures that were included on the original return.

When an error results in a taxpayer overpayment of the tax, the IRS usually sends a corrected computation of the tax, together with a brief explanation of the error and a refund of the excess amount that was paid.

¹²§6213(b)(1).

The IRS does not consider such a contact that it makes with the taxpayer to be an examination. Therefore, a taxpayer who is contacted under the Mathematical/Clerical Error Program is not entitled to the administrative remedies that are available to taxpayers who are involved in a formal examination.

In addition to this testing of mathematical computations, the ADP program is useful for verifying one's compliance with estimated tax payment requirements. As a result of utilizing this system, the IRS has discovered that thousands of taxpayers have not been complying with the statutory estimated tax requirements, and that others collectively have been claiming millions of dollars in payments that actually never were made.

Unallowable Items Program The IRS conducts another program that is similar to the Mathematical/Clerical Error Program called the Unallowable Items Program. Under this program IRS personnel question items that have been included on individual income tax returns that appear to be unallowable by law. These items may be identified manually or on their face by computer, and include such return elements as an overstatement of the standard deduction, a deduction of Social Security taxes paid, the claiming of an incorrect filing status, the deduction of Federal income taxes, or the deduction of lost (but not stolen) assets as a casualty loss.

If a return is identified as including an unallowable item, the IRS computes the seemingly necessary adjustment in taxes, and the taxpayer is notified by mail. Again, the IRS does not consider the contact that it makes with a taxpayer under the Unallowable Items Program to be an examination.¹³ Consequently, it treats an adjustment in this circumstance as a correction of a mathematical or clerical error, and the taxpayer is not sent a formal notice of deficiency.

If the taxpayer is able to explain the questioned item adequately, the assessment is abated. However, the case will be continued as a correspondence or office audit if the taxpayer's response is deemed unsatisfactory.



SPOTLIGHT ON TAXATION

The Future

A new processing system, replacing the antiquated ADP system, is being phased in by the agency. Because the IRS's appropriation for computer improvements is perpetually inadequate given the growth in the number of taxpayers and the sophistication of some of the transactions reported, though, most believe that this system will be obsolete before it is fully implemented.

Selection of Returns for Examination

Each year the IRS determines the approximate number and types of returns that it intends to audit. The national office then prepares an audit plan to allocate its personnel to achieve the desired audit coverage. The primary goal of the IRS in selecting a return for examination is to review only those returns that will result in a satisfactory increase in the tax liability.

Computer and manual methods are used to select returns for examination. Computer programs select certain returns for examination, based on the potential

¹³Rev. Proc. 94-68, 1994-2 CB 803.

that exists for changes in the tax treatment of certain items on the return. Generally, this is done through the use of mathematical models, including correlations and discriminant functions. IRS personnel also manually select returns that they believe warrant special attention. The Service describes in nontechnical terms its selection procedures in its annual Publication 1. Selection criteria for audits are not disclosed by the Treasury.¹⁴

Although most of the initial IRS screening of the returns for audit is performed by computers, a more detailed selection procedure then is employed manually in the Examination Division of the local IRS office, where the classification staff ultimately selects those specific cases that will be examined. The number of returns that finally is selected by the staff is based on the examination resource (and other) capabilities of the respective offices.

Discriminant Function System Once a return has been processed through the Service's ADP program, each return is rated by computer for its audit potential by means of a mathematical model, the **discriminant function formula** (DIF). This formula assigns numeric weights to certain (undisclosed by the IRS) return items, generating a composite score for the return. In this regard, the higher the DIF score, the greater the potential for a favorable-to-the-Treasury change to the return upon audit. Statistics provided by the Commissioner show a high correlation between DIF scores and such tax modifications, but the specifics of the formula are not disclosed.¹⁵

When the computer selects a return that has a high probability for an adjustment, as indicated by a high DIF score, an employee at the service center manually inspects the return to confirm its audit potential. If an acceptable explanation for the DIF score cannot be found after this manual examination of the return and its attachments, including explanatory data that the computer did not consider, the return is forwarded to the Examination Division at the appropriate local IRS office.

National Research Program The National Research Program (NRP) is an initiative that is designed to furnish the IRS with statistics concerning the type and number of errors that are made on a representative sample of individual income tax returns. These statistics are used to develop and update the DIF formulas. Under the annual NRP procedures, perhaps 15,000 individual income tax returns are selected randomly for an extremely thorough examination. These returns then are examined comprehensively to determine the degree of their accuracy as filed.

Unlike the treatment that is given returns that are selected for general audit, the NRP examiner may not exercise any judgment in dealing with an item on the return selected for review. All errors are noted and corrected, regardless of their amount. This procedure is necessary to a determination of the actual error patterns that individual income tax returns exhibit, so that the statistics that underlie the DIF procedure are free from any major bias.

NRP audits integrate IRS data files with some of those from the Social Security Administration and the Census Bureau. Some of the NRP audits are transparent to the taxpayer, that is, all of the work is done with computer models and IRS personnel, and the taxpayer does not even know that the audit is being conducted. Most of the rest of the procedures require correspondence by mail with the taxpayer, with no in-person contact required. Those whose returns are audited and

¹⁴§6103(b)(2); Long v. U.S., 742 F2d 1173 (CA-9, 1984).

¹⁵Feltz v. IRS, 79 AFTR2d 97-747 (DCWVis).

require such in-person contact, though, likely will need professional assistance to meet the IRS data and documentation demands.

Areas of specific concern in the latest rounds of the NRP audits are not publicly known, but the following tax issues likely receive special attention in constructing the DIF scores through this program.

- Determining the basis of capital assets sold, especially for closely held stock and mutual fund shares.
- Transactions involving cash exchanges.
- Taxpayers and their income that is not subject to withholding procedures.
- S corporations, partnerships, LLCs, LLPs, and their owners.
- Self-employed individuals.

Other Selection Methods In addition to the previously discussed computerized methods for identification of returns for IRS examination, returns may be selected manually, for a variety of reasons. An examination may be initiated, for instance, because of information that is provided by an informant or because the selected return is linked to another return that is currently under examination, using the Coordinated Industry Case Program (e.g., a partner's return may be selected as a result of a partnership audit).

Moreover, some returns automatically are reviewed by IRS personnel because the reported taxable income, gross receipts, or total assets exceed a predetermined materiality amount. For instance, individual returns with total positive income of \$50,000 or more, or partnership returns with gross receipts or gross income of \$500,000 or more, can be selected in this manner. Finally, a return may be selected for examination because the taxpayer has filed a claim for refund or otherwise has indicated that an adjustment in the original amount of tax liability is necessary.

“Economic reality” factors can be considered by the IRS in selection of returns for audit, but only where the agency has some other evidence that the taxpayer has underreported taxable income for the year. For instance, manual selection of a return and an economic-reality review might occur when an IRS employee, reviewing data in three-filing-year periods, finds indications that income might be underreported or deductions might be overstated or misclassified. Some of the factors believed to be perused in an economic reality audit include the following.

- Significant increases in interest, dividend, and other investment income.
- Significant decreases in mortgage and other reportable interest paid.
- Significant variance in self-employment or farming income during the period, relative to industry norms.
- Business and other expenditures not seemingly justified by income levels.

Current IRS audit initiatives also include the following.

- Frivolous returns, usually involving tax protestors.
- Tax shelter investors and their advisers.
- Exempt organizations, looking for compliance with disclosure rules and for unrelated business taxable income.
- Large corporations.

- Executive compensation, including options and other noncash transfers.
- Offshore transactions.
- High-income individuals.
- Nonfilers.
- Specific issues related to market segments, often specialized in the local area; for example, software companies on the West Coast.

Chances of Audit Taxpayers often want to know what their overall probability of selection for an audit might be for a given year. In general, the IRS selects about 1 percent of all returns for examination, outside of the mathematical error program. The chances for selection increase, though, if the taxpayer:

- claims tax shelter losses;
- operates a cash-oriented business, such as a restaurant (both as an owner, selling food and drink for cash, and as a waiter, collecting tips) or repair/construction trade;
- claims business deductions that are excessive for the income level;
- has had prior-year returns that were audited and found incorrect; or
- claims itemized deductions that are excessive for the income level.

The probabilities of selection for audit in a recent tax year were as shown in Exhibit 13-4.

EXAMINATIONS

After a return is selected for audit, an IRS agent schedules it for a review in either a correspondence, an office interview, or a field examination. The type of examination to which the taxpayer is subject generally is determined by the audit potential of the return, the nature of the asserted error, and the type of taxpayer.

Correspondence Examinations

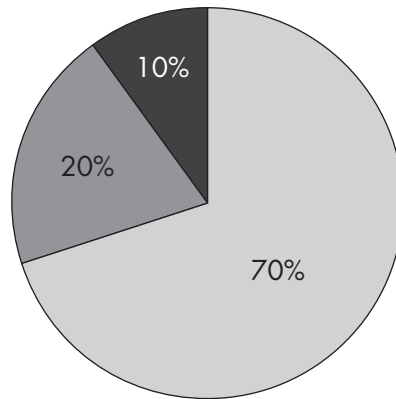
Many times, IRS personnel question only one or two items on a selected return. In these cases, an examination is typically conducted by telephone or mail. The IRS examiner requests that the taxpayer verify the questioned item of income, deduction, or credit by mailing copies of receipts, canceled checks, or other documentation to the district office or service center. If the taxpayer requests an interview, the issues become too complex, or the taxpayer is unable to communicate effectively in writing, the case is referred to the appropriate district office for resolution as an office or field examination.

Local office personnel usually conduct **correspondence examinations**. However, service center staff often conduct such a review if the questioned item is an itemized deduction on an individual taxpayer's income tax return.

A taxpayer who is subject to a correspondence examination is entitled to the same administrative and judicial appeal rights that are allowed to persons who are involved in office or field audits.

Issues that typically are addressed in the correspondence audit setting include itemized deductions for interest, taxes, charitable contributions, medical expenses, and simple miscellaneous deductions such as union dues.

Exhibit 13-4: Various Audit Statistics



Correspondence Audit
 Field Audit
 Office Audit

Individuals' returns filed	135,000,000	
Individuals' returns audited	1,300,000	about 1% of filed returns
Correspondence audits	1,000,000	

Chances of Audit

Individual's Income (\$000)	Nonbusiness Returns	With Schedule C
0-25	1.5%	3.8%
25-100	0.6	2.1
100+	1.3	3.9
C Corporation, assets		
\$0-250K		0.7%
\$250K-5M		1.0
\$5-10M		3.4
\$10M-250M		13.8
\$250M+		35.2
S Corporation		0.4
Partnership		0.4
Gift Tax		0.8
Estate Tax, Gross Estate (\$M)		
0-5		7.8
5+		23.4

Average proposed tax and penalty assessment, individuals' returns

Correspondence audit	\$7,800
Field audit	18,000
"No change" audit report	
Correspondence audit, individuals' return	17%
Field audit, individuals' return	14
C Corporation return	3

Office Examinations

When a return that has been selected for examination involves one or more issues that will require some analysis and the exercise of the IRS personnel's judgment, rather than a mere verification of record-keeping requirements, the audit usually is conducted at the pertinent IRS office. An office interview also will be scheduled if the examiner believes that an office examination is necessary to guarantee that the taxpayer's legal rights are respected.

If the IRS decides to conduct an office examination, the taxpayer is asked to come to the local IRS office for an interview and to bring any records and documents that support the questioned items. Generally, the auditor is given very little time in which to prepare for the session, and the scope of the examination is limited to the items that are listed in the audit notification letter.

Office audits usually are confined to individuals' income tax returns that include no business income. However, in recent years, the IRS has increased the scope of some office audits to include a limited number of small business returns. Issues that typically are examined in an office audit setting include dependency exemptions; income from tips, rents, and royalties; income from partnerships, estates, and trusts; deductions for travel and entertainment; deductions for bad debts; and casualty and theft losses.

A field examination may be conducted in lieu of an office audit if it is difficult for the taxpayer to bring the requested records to the district office or if the taxpayer for some other valid reason requests that the audit be conducted on his or her premises.

Field Examinations

Examinations that present complex issues that require more advanced knowledge of the internal revenue laws and accounting skills usually are conducted on the taxpayer's premises. A **field audit** is more comprehensive than a correspondence or office audit, and it usually is limited to an examination of corporation and individual business returns. In a field examination, the revenue agent reviews completely the entire financial operations of the taxpayer, including the business history of the taxpayer; the nature, amount, and location of taxpayer assets; the nature of the business operations; the extant accounting methods and system of internal control; and other financial attributes of the entity.

While an office audit ordinarily is limited to the items that are specified in the audit notification letter, a field examination may be open-ended. The agent is free to pursue any unusual items that are recorded in the tax return(s) or the records of the taxpayer (i.e., journals, ledgers, and worksheets) and to investigate other areas of which he or she may be suspicious.

The IRS prefers to conduct the field audit on the taxpayer's premises because the taxpayer's books and records may be more accessible and the agent is better able to observe the taxpayer's business facilities and the scope of its operations. However, it is sometimes possible to have the audit conducted at the office of the taxpayer's representative instead. Only one such inspection of taxpayer books and records may be made for a tax year.¹⁶ The Code includes a broad set of restrictions as to access to the taxpayer's physical office by the IRS.¹⁷ Taxpayers refusing to admit IRS personnel are subject to a \$500-per-refusal fine.¹⁸

¹⁶§7605(b).

¹⁷§7606.

¹⁸§7342.

The IRS uses a team approach in its field audits, known as the Coordinated Examination Program, when it examines the returns of large corporate taxpayers. During this type of examination, a large group of IRS agents is used to investigate the operations of the taxpayer. Normally, such an investigation spans more than one IRS district as well.

Dealing with an Auditor

Most practitioners develop over time a list of “dos and don’ts” in negotiating with a government auditor. In the very best case, one will have dealt with the same auditor many times and will have become familiar with the nuances of that particular auditor’s mode of operation. Whether this is the case or not, the following guidelines, dictated as much by common courtesy and decorum as by ethics and hard-core negotiating techniques, are likely to be useful.¹⁹

- Do conduct yourself courteously and professionally, showing that you have prepared yourself for the audit.
- Do review the strengths and weaknesses of your position before the agent arrives.
- Do cooperate with the auditor and promptly respond to all requests.
- Do establish internal timetables and responsibilities for completing the audit.
- Do provide the auditor with adequate work accommodations.
- Don’t impede the audit process.
- Don’t allow the auditor free access to and through the taxpayer’s building.
- Don’t let the agent browse through taxpayer information.
- Don’t volunteer comments or information not requested by the agent.
- Don’t attempt to bully or intimidate the auditor.
- Do assign one person to be the primary on-premises contact with the auditor—he or she cannot interview taxpayer employees on a random basis.
- Do verify the auditor’s credentials before providing any information.
- Do request that all communications be in writing.
- Do keep track of time spent (by taxpayer, practitioner, and auditor) on the audit.
- Do meet at least daily with the auditor to review issues.
- Do agree to disagree on major irreconcilable issues.
- Do conduct a concluding conference to discuss audit recommendations.
- Do obtain copies of all government workpapers affecting the potential assessment.
- Do request clarification on the rest of the appeals process.

¹⁹Some of the material is adapted from a talk by Robert E. Dallman, Milwaukee WI, “The Audit Process.”

Conclusion of Examination

Upon the conclusion of the examination, the IRS auditor or agent must explain to the taxpayer any proposed adjustments to the tax liability. A written **Revenue Agent's Report** (RAR) is prepared by the agent and is given to the taxpayer. The RAR contains a brief explanation of the proposed adjustments and lists the balance due or the overpayment.

The RAR also includes a waiver of the restrictions on assessment, which the taxpayer is asked to sign if he or she agrees with the proposed modifications. This waiver permits the IRS to assess any deficiency in tax immediately, without sending the taxpayer a formal notice of deficiency.

Even though the taxpayer may agree with the proposed adjustments to his or her return and sign the form, thereby indicating acceptance of the proposal, the case technically is not closed until the agent's report is reviewed and accepted by the district office review staff. Therefore, it is possible that an agreement that is worked out with the agent may not be accepted by the IRS.

After the taxpayer agrees to any increase in tax, he or she may either make an advance payment of the deficiency and accrued interest, to eliminate additional interest charges, or wait for a formal request for payment from the service center.

If the taxpayer disagrees with the agent's proposals, the IRS makes an immediate attempt to resolve the disagreement. The taxpayer normally is given an opportunity to discuss the proposed adjustments with the agent's group supervisor or with an appeals officer. If an immediate interview is not possible or if the issues remain unresolved after such an interview, the taxpayer receives a preliminary notice of deficiency, which is also referred to as a "thirty-day letter."

Thirty-Day Letter

When the taxpayer does not agree with the agent's proposed adjustments, a **thirty-day letter** is issued. This correspondence formally notifies the taxpayer of the examiner's findings, requests that the taxpayer agree to the proposed adjustments, and informs the taxpayer of his or her appeal rights. If the taxpayer does not respond to the notice within thirty days, he or she receives a statutory notice of deficiency, also known as a "ninety-day letter," discussed later in this chapter.

The taxpayer has thirty days from the date of the thirty-day letter to request a conference with an appeals officer. This request may be made orally with respect to an office examination or if the total proposed additional tax and penalties total \$2,500 or less. The taxpayer's appeal must be in written form if the total proposed additional tax and penalties exceed \$2,500,²⁰ and a formal protest, setting forth the specific facts and applicable law or other authority in support of the taxpayer's position, is required if the proposed tax and penalties exceed \$10,000.²¹

²⁰Reg. §§601.105(c)(2)(iii) and (d)(2)(iv).

²¹Reg. §§601.105(d)(2) and 601.106(a)(1)(ii).

File a Protest or Go Straight to Court?

In deciding whether to file a protest and request a hearing in the Appeals Office or to allow a ninety-day letter to be issued and skip directly to the courts for satisfaction, the taxpayer and his or her adviser must consider a number of factors.²²

Factors in Favor of the Protest/Appeals Process

- An appeals officer can consider the hazards of litigation. This allows for the possibility of a settlement without the costs of litigation.
- The litigation path remains a possibility even if an appeal is pursued.
- The appeals process allows a further delay in the payment of the disputed tax. This can be an important criterion if (1) funds are not available with which to pay the tax, or (2) the taxpayer can earn more on the funds during the administrative period than is assessed in the form of interest.
- During the appeals process, the taxpayer will discover more of the elements of the government's position. In addition, the taxpayer gains additional time in which to formulate or polish his or her own position.
- Recovery of some court costs and attorney fees is available if the court finds that the government's case was largely unjustified and all administrative remedies were attempted. Thus, working through the appeals process is required if any costs are to be recovered.

Factors in Favor of Bypassing Appeals

- The likelihood of the government finding and raising new issues during the appeal is eliminated.
- The government receives a psychological message that the taxpayer is firmly convinced of his or her position, and negotiating advantages for the taxpayer may result.
- The conclusion of the dispute, whether for or against the taxpayer, is expedited.

THE APPEALS PROCESS

To minimize the costs of litigation in both time and money, the IRS encourages the resolution of tax disputes through an administrative appeals process. If a case cannot be resolved at the examination level, the taxpayer is allowed to appeal to a separate division of the IRS, known as the **Appeals Office**.

The Appeals Office has the exclusive and final authority to settle cases that originate in a district that is located within its jurisdiction. This division is under the supervision of the Commissioner of the IRS, with input from the Chief Counsel. The appeals function provides the taxpayer with a final opportunity to resolve tax disputes with the IRS without incurring litigation. Its objective is to resolve tax controversies without litigation on a basis that is fair and impartial to both the government and the taxpayer.

²²Saltzman, *IRS Practice and Procedure*, Warren, Gorham & Lamont; ¶ 9.05(1).

Appeals Conference

The conference with the appeals officer is an informal proceeding. Although the appeals office may require allegations to be submitted in the form of affidavits or declarations under the penalty of perjury, testimony typically is not taken under oath.²³ The taxpayer, or his or her representative, meets with the appeals officer and discusses the dispute informally. According to the IRS's conference and practice rules, the appeals officer is to maintain a standard of strict impartiality toward the taxpayer and the government.

The appeals officer has the authority to settle all factual and legal questions that are raised in the examiner's report. He or she also can settle a tax dispute on the basis of the hazards of litigation. However, no settlement can be made that is based on the nuisance value of the case to the government.

The appeals officer may use a considerable amount of personal judgment in deciding how to handle the disputed issues of a case. He or she can split or trade issues where substantial uncertainties exist as to the law or the facts. On the other hand, the appeals officer may defer action on, or refuse to settle, a case or an issue to achieve greater uniformity concerning the application of the revenue laws and to improve the overall voluntary compliance with the tax laws.

Ninety-Day Letter

If the taxpayer and the IRS cannot agree on the proposed adjustments after an appeals conference, the regional director of appeals will issue a **statutory notice of deficiency**.²⁴ The statutory notice also is issued if the taxpayer does not request an appeals conference.

A statutory notice of deficiency, commonly referred to as a **ninety-day letter**, must be sent to the taxpayer's last known address by certified or registered mail before the IRS can assess the additional taxes that it believes are due.²⁵ Once a formal assessment has been made, the IRS is entitled to collect and retain the tax. However, a statutory notice is not required relative to deficiencies that result from mathematical errors or from the overstatement of taxes that were withheld or paid as estimated taxes.

After the statutory notice of deficiency is mailed, the taxpayer has 90 days (150 days if the letter is addressed to a taxpayer who is outside the United States) to file a petition with the U.S. Tax Court for a redetermination of the deficiency. If such a petition is not filed in a timely fashion, the deficiency is assessed and the taxpayer receives a notice and demand for payment of the tax.²⁶ Once this ninety-day period expires, the taxpayer cannot contest the assessment without first paying the tax, filing a claim for refund, and, if the claim is denied by the IRS, instituting a refund suit in a district court or the U.S. Court of Federal Claims.

Generally, no assessment or collection effort may be made during the ninety-day period, or, if a Tax Court petition is filed, until after the decision becomes final.

A mailing of the statutory notice to the taxpayer's last known address is sufficient to commence the running of the ninety-day period, unless the Commissioner has been notified formally of a change of address.²⁷ The statute does not require that the taxpayer receive actual notice; therefore, a notice that is sent by certified or

²³Reg. §601.106(c).

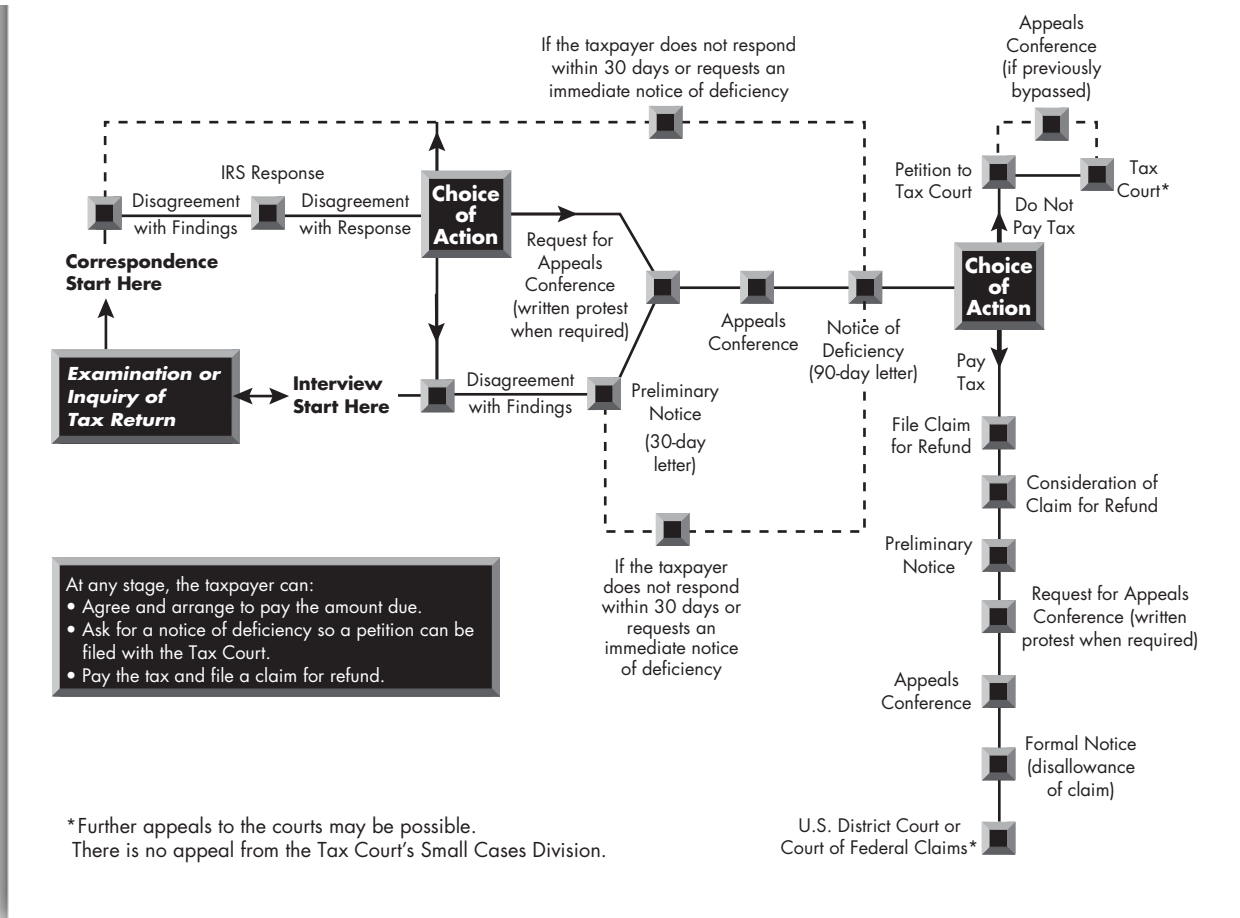
²⁴§7522.

²⁵§§6212(a) and 6212(b)(1).

²⁶§6213(c).

²⁷§6212(b); *McIntosh v. U.S.*, 85 AFTR2d 98-6501 (SDOh).

Exhibit 13-5: Income Tax Appeal Procedure



registered mail to the proper address is effective, even though it is never received by the taxpayer him- or herself.²⁸

After a case has been scheduled (*docketed*) for review in the Tax Court, the taxpayer is invited to attend a pretrial settlement conference with an appeals officer and an IRS attorney. However, this conference typically is offered only if the case was not considered previously by the appeals office and if no related criminal prosecution is pending. If the taxpayer and the IRS agree to settle the dispute at this stage, they will enter into a written agreement stipulating the amount of any deficiency or overpayment. This stipulation is filed with the Tax Court, which will enter a decision in accordance with the agreement. The Tax Court can levy a penalty of up to \$25,000 if it determines that the taxpayer did not pursue the available administrative remedies prior to approaching the court.²⁹

Possibilities for appeal after completing the trial-level suit have been discussed in Chapters 2, 3, and 5. Exhibit 13-5 illustrates the appeals procedures, from the initial IRS examination to the hearing before the trial-level court. Exhibit 13-6 offers sample thirty- and ninety-day letters for the reader's perusal.

²⁸§6212(a); *Lifter*, 59 T.C. 818 (1973), and *U.S. v. Abrens*, 530 F.2d 781 (CA-8, 1976).

²⁹§6673(a)(1)(c).

Exhibit 13-6: Sample Thirty- and Ninety-Day Letters

Notice of Adjustment—Thirty-Day Letter

Internal Revenue Service Department of the Treasury

Date:

Social Security or Employee Identification Number:

Tax Year Ended:

Person to Contact:

Contact Telephone Number:

Contact Address:

Dear

Enclosed are two copies of our report explaining why we believe adjustments should be made in the amount of your tax. Please look this report over and let us know whether you agree with our findings.

If you accept our findings, please sign the consent to assessment and collection portion at the bottom of the report and mail one copy to this office within thirty days from the date of this letter. If additional tax is due, you may want to pay it now and limit the interest charge; otherwise, we will bill you. (See the enclosed Publication 5 for payment details.)

If you do not accept our findings, you have thirty days from the date of this letter to do one of the following:

1. Mail us any additional evidence or information you would like us to consider.
2. Request a discussion of our findings with the examiner who conducted the examination. At that time you may submit any additional evidence or information you would like us to consider. If you plan to come in for a discussion, please phone or write us in advance so that we can arrange a convenient time and place.
3. Discuss your position with the group manager or a senior examiner (designated by the group manager), if an examination has been held and you have been unable to reach an agreement with the examiner.

If you do not accept our findings and do not want to take any of the above actions, you may write us at the address shown above or call us at the telephone number shown above within thirty days from the date of this letter to request a conference with an Appeals Officer. You must provide all pertinent documentation and facts concerning disputed issues to the examiner before your case is forwarded to the Appeals Office. If your examination was conducted entirely by mail, we would appreciate your first discussing our findings with one of our examiners.

The Appeals Office is independent of the District Director. The Appeals Officer, who had not examined your return previously, will take a fresh look at your case. Most disputes considered by Appeals are resolved informally and promptly. By going to Appeals, you may avoid court costs (such as the U.S. Tax Court filing fee), clear up this matter sooner, and prevent interest from mounting. An Appeals Officer will promptly telephone you and, if necessary, arrange an appointment. If you decide to bypass Appeals and petition the Tax Court, your case will normally be assigned for settlement to an Appeals Office before the Tax Court hears the case.

Under Internal Revenue Code Section 6673, the Tax Court is authorized to award damages of up to \$25,000 to the United States when a taxpayer unreasonably fails to pursue available administrative remedies. Damages could be awarded under this provision, for example, if the court concludes that it was unreasonable for a taxpayer to bypass Appeals and then file a

continued

Exhibit 13-6: (continued)

petition in the Tax Court. The Tax Court will make that determination based upon the facts and circumstances of each case. Generally, the Service will not ask the court to award damages under this provision if you make a good faith effort to meet with Appeals and to settle your case before petitioning the Tax Court.

The enclosed Publication 5 explains your appeal rights.

If we do not hear from you within thirty days, we will have to process your case on the basis of the adjustments shown in the examination report. If you write us about your case, please write to the person whose name and address are shown in the heading of this letter and refer to the symbols in the upper right corner of the enclosed report. An envelope is enclosed for your convenience. Please include your telephone number, area code, and the most convenient time for us to call, in case we find it necessary to contact you for further information.

If you prefer, you may call the person at the telephone number shown in the heading of this letter. This person will be able to answer any questions you may have. Thank you for your cooperation.

Sincerely yours,
IRS Examinations
Enclosures:
Examination Report (2)
Publication 5
Envelope

Notice of Deficiency—Ninety-Day Letter

Internal Revenue Service Department of the Treasury

Date:

Social Security or Employer Identification Number:

Tax Year Ended and Deficiency:

Person to Contact:

Contact Telephone Number:

Dear

We have determined that there is a deficiency (increase) in your income tax as shown above. This letter is a NOTICE OF DEFICIENCY sent to you as required by law. The enclosed statement shows how we figured the deficiency.

If you want to contest this deficiency in court before making any payment, you have 90 days from the above mailing date of this letter (150 days if addressed to you outside of the United States) to file a petition with the U.S. Tax Court for a redetermination of the deficiency. To secure the petition form, write to U.S. Tax Court, 400 Second Street, NW, Washington, D.C. 20217. The completed petition form, together with a copy of this letter must be returned to the same address and received within 90 days from the above mailing date (150 days if addressed to you outside of the United States).

The time in which you must file a petition with the court (90 or 150 days as the case may be) is fixed by law and the court cannot consider your case if your petition is filed late. If this letter is addressed to both a husband and wife, and both want to petition the Tax Court, both must sign the petition or each must file a separate, signed petition.

If you dispute not more than \$50,000 for any one tax year, a simplified procedure is provided by the Tax Court for small tax cases. You can get information about this procedure, as well as a petition form you can use, by writing to the Clerk of the Tax Court at 400 Second Street, NW, Washington, D.C. 20217. You should do this promptly if you intend to file a petition with the Tax Court.

You may represent yourself before the Tax Court, or you may be represented by anyone admitted to practice before the court. If you decide not to file a petition with the Tax Court, we would appreciate it if you would sign and return the enclosed waiver form. This will permit us to assess the deficiency quickly and will limit the accumulation of interest. The enclosed envelope is for your convenience. If you decide not to sign and return the statement and you do not timely petition the Tax Court, the law requires us to assess and bill you for the deficiency after 90 days from the above mailing date of this letter (150 days if this letter is addressed to you outside the United States).

If you have questions about this letter, please write to the person whose name and address are shown on this letter. If you write, please attach this letter to help identify your account. Keep the copy for your records. Also, please include your telephone number and the most convenient time for us to call, so we can contact you if we need additional information.

If you prefer, you may call the IRS contact person at the telephone number shown above. If this number is outside your local calling area, there will be a long distance charge to you.

You may call the IRS telephone number listed in your local directory. An IRS employee there may be able to help you, but the contact person at the address shown on this letter is most familiar with your case.

Thank you for your cooperation.

Sincerely yours,

Commissioner

By

Enclosures:

Copy of this letter

Statement

Envelope

Entering the Judicial System

If a taxpayer cannot resolve his or her dispute with the IRS administratively, he or she may seek judicial relief. As we have discussed throughout this text, the taxpayer can choose from among the U.S. Tax Court, the pertinent district court, and the U.S. Court of Federal Claims to initiate the lawsuit against the government.

The Tax Court will review the taxpayer's case, provided that he or she files a petition with the court within ninety days of the date of his or her statutory notice of deficiency. The district courts and the Court of Federal Claims cannot hear the taxpayer's case unless he or she is suing for a refund. Consequently, the taxpayer first must pay the disputed tax, and then file an (unsuccessful) claim for refund to obtain a judicial review in either of these latter two forums.



SPOTLIGHT ON TAXATION

Deciding to Litigate

One should not consider tax litigation lightly. The additional costs to the taxpayer for attorney and accountant fees, in addition to filing and processing fees and the cost and time involved in gathering supporting documentation for the taxpayer's position, finding and coaching expert and other witnesses, and providing for one's own travel to the site of the hearing, make litigation a costly prospect. Given the right combination of facts and law, though, a suit might be the taxpayer's only chance to achieve an equitable solution.

Remember, nonetheless, that the IRS tends to litigate only cases that (1) it expects to win and (2) it expects will make good precedent to discourage other taxpayers. Moreover, because many taxpayers represent themselves before the Tax Court, procedural errors occur, usually to the detriment of the taxpayer. Thus, it is not surprising that the deck appears to be stacked against the taxpayer once he or she enters the judicial system, especially outside the Tax Court. The information in Exhibit 13-7 illustrates this situation.

Exhibit 13-7: Taxpayer and Government Victories in Tax Litigation

Forum	Percent of Partial Taxpayer Victories	Percent of Total Taxpayer Victories	Percent of Total Government Victories
U.S. Tax Court, Small Cases Division	49.0	5.0	46.0
U.S. Tax Court, all other	64.0	3.0	33.0
U.S. District Court	11.6	23.2	65.2
U.S. Court of Federal Claims	12.2	14.3	73.5

SUMMARY

In counseling clients, the tax professional must be aware of the organization and inner workings of the IRS. Strategic and tactical decisions as to how and when to appeal within the administrative system of the Service, assessing the strengths and weaknesses of the client's case, and determining available re-

medies can be made only with a thorough understanding of the agency and its operating style. Some of the most valuable advice that a client receives can be in the context of an audit selection letter or the handling of settlement alternatives thereafter.

TAX TUTOR

Reinforce the tax research information covered in this chapter by completing the online tutorials located at the *Federal Tax Research* web site: <http://academic.cengage.com/taxation/raabe>

KEY WORDS

By the time you complete this chapter, you should be comfortable discussing each of the following terms. If you need additional review of any of these items, return to the appropriate material in the chapter or consult the glossary to this text.

Appeals Office	IRS Oversight Board
Chief Counsel	National Taxpayer Advocate
Commissioner of Internal Revenue	Ninety-day letter
Computing Centers	Office audits
Correspondence examinations	Processing Centers
Customer Service Sites	Revenue Agent's Report
Discriminant function formula	Statutory notice of deficiency
Field audit	Taxpayer Assistance Order
Internal Revenue Service	Thirty-day letter
Internal Revenue Service Center	Treasury Department

DISCUSSION QUESTIONS

1. Why must the tax professional be cognizant of how tax law administration works?
2. What are the major functions of the national office of the IRS?
3. What are the chief responsibilities of
 - a. The IRS Commissioner
 - b. The IRS Chief Counsel
 - c. The National Taxpayer Advocate
 - d. Local Taxpayer Advocates
4. List three of the items included in one of the Taxpayer Bills of Rights.
5. Distinguish between the Math/Clerical Error program and the Unallowable Items program.
6. What are the chances of having a tax return audited this year?
7. What techniques other than the random selection of returns for audit does the IRS use in its enforcement function?
8. Why might it be desirable to settle with an agent, rather than to continue by appealing to a higher level within the IRS?
9. Relate some of the “audit etiquette” tactics that you have heard taxpayers or tax professionals discuss.
10. Which of the following methods is used to select tax returns for audit? More than one answer may be correct.
 - a. DIF procedures
 - b. Random samples
 - c. Amount of gross income
 - d. Type of income, for example, business or wages

11. Which type of audit is used most often to substantiate the reported items of income or deduction for individuals who have only wages?
 - a. Field
 - b. Office
 - c. Correspondence
 - d. Home
12. A revenue agent may do which of the following in an attempt to negotiate a settlement after the completion of an audit? More than one answer may be correct.
 - a. Attempt to settle an unresolved issue based on the hazards of litigation.
 - b. Settle a question of fact.
 - c. Reach an agreement that will be accepted unconditionally by the IRS.
 - d. Turn the case over to the Appeals Office.
13. When an agreement cannot be reached with a Revenue Agent, a letter is transmitted stating that the taxpayer has thirty days to do which of the following?
 - a. File a suit in the U.S. Tax Court.
 - b. Request an administrative appeal.
 - c. Pay the tax.
 - d. Find additional facts to support his or her position.
14. A statutory notice of deficiency gives the taxpayer ninety days to do which of the following?
 - a. Pay the tax.
 - b. Request an administrative appeal.
 - c. File a suit in the U.S. Tax Court.
 - d. File a protest.
15. Distinguish among the various means by which the IRS selects a tax return for examination. For this purpose, examine the criteria of:
 - a. scope of review
 - b. probability of selection
 - c. preservation of taxpayer constitutional rights
16. Add two items to the “dos and don’ts” list included in the discussion of audit etiquette.
17. Suggest other information documents that the IRS computers could add to the IDMP.
18. Identify several items that you believe are included in the prevailing DIF model.
19. Carol takes some very aggressive positions on her tax return. She maintains, “With the downsizing of the government, my chances of getting caught are virtually zero.” Is Carol’s approach correct?
20. Should the IRS audit more or fewer returns every year? What issues would you consider in this regard if you were a politician? A wealthy individual?
21. What are the most important activities that the IRS currently is carrying out in its data collection and audit efforts?

EXERCISES

22. Make a chart that distinguishes among the various types of examinations that the IRS conducts relative to individual income tax returns, namely, office, correspondence, field, and NRP audits. For this purpose, examine the criteria of:
 - a. scope of review
 - b. type of documentation that typically is required of the taxpayer
 - c. use of IRS personnel time and other resources
 - d. opportunity for agent to use professional judgment in resolving issues
23. Respond to a client's comment: "We have a better than even chance of winning in the Tax Court, according to an article I read. Let's sue the government!"
24. With respect to the Small Cases Division of the U.S. Tax Court, which statement is true?
 - a. The taxpayer (but not the IRS) can appeal a contrary judgment.
 - b. The IRS (but not the taxpayer) can appeal a contrary judgment.
 - c. Either the IRS or the taxpayer can appeal a contrary judgment.
 - d. Neither the IRS nor the taxpayer can appeal a contrary judgment.
25. How should the tax professional advise a client whose charitable contributions are double that of the U.S. norm for his or her income level?

PROBLEMS

26. The President of the United States has hired you to assist in a trim-the-fat program with respect to the Federal government. The President has asked you to recommend specific steps to downsize the bureaucracy of the IRS, from the national office through the district headquarters, by 15 percent. Draft a memo to the President summarizing your recommendations. Augment your memo with diagrams supporting your proposals.
27. The IRS has issued a summons for the tax file held by CPA Ann Whitman for her clients the Harberts. The file consists of paper and electronic spreadsheets in which Whitman detailed some tax computations using assumptions that the IRS would find to be "too aggressive." In addition, the file includes notes from meetings with the Harberts, income and balance sheet data as to their personal assets, and other technical correspondence, including e-mail messages. In a memo to the tax research file, summarize the current status of the law as to whether the privilege of confidentiality protects these documents from the government.

RESEARCH CASES

28. Your supervisor says that the U.S. Constitution forces the IRS to reveal the make-up of the DIF formula that it uses to select tax returns for audit. Prepare a file memo assessing the supervisor's assertion.

29. Max and Annie are roommates sharing an apartment. Although they know each other well, they have respect for each other's privacy. Thus, when Max's 2003 Form 1040 was audited by the IRS, he made no mention of the audit to Annie. When Annie was clearing the answering machine that they shared, she heard the following message: "Max, this is Richard, the IRS auditor. My figures show that you owe the government \$10,000 in taxes and another \$4,500 in penalties and interest."

When Annie brought up the message during dinner conversation that night, Max was furious. How could the IRS be so careless as to broadcast this news to a stranger? Didn't he have any privacy and confidentiality rights? Max calls you to determine whether he might have a case against the IRS or Richard, the agent. Prepare a file memo assessing Max's position.

30. You have just rendered service for a taxpayer as an expert witness in a case heard by the U.S. Tax Court. The taxpayer is requesting reimbursement for your fees and for those amounts paid to her attorney in presenting the case. Your billing rate for this type of engagement is \$500 per hour, the market rate for such services in your city, plus out-of-pocket expenses (e.g., auto mileage, computer charges). How much of your fee will the taxpayer recover?
31. Examine some tax journal articles and treatises to put together a checklist, "How to Prepare for a Tax Audit."
32. Examine some tax journal articles and treatises to put together a checklist, "How to Prepare for an Appeals Conference."
33. Prepare a graph illustrating the trends in IRS audit activity over the past decade. First decide whether you are measuring audited returns, tax dollars recovered by audit, or budget resources dedicated to audit activities. Next decide which types of taxpayers and returns you will be graphing. Then find your data at <http://www.irs.gov>.