

How to Survive a Tax Audit

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Discover some of the criteria the IRS uses to select a return for inspection, learn how to protect yourself in advance, and (if necessary) face your auditor with confidence. Or, take two aspirin and call Monica Haven, E.A. in the morning.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

A. Selection of the Tax Return

1. Probability of Selection

Audits of Income Tax Returns Filed by Individuals

Fiscal Year	Rate per 1,000 Returns	
	All Examinations	Rate Excluding Correspondence Exams
1992	10.6	6.6
1993	9.2	6.6
1994	10.8	7.2
1995	16.2	7.0
1996	16.7	6.6
1997	12.8	6.1
1998	9.9	4.6
1999	9.0	3.1
2000	4.9	2.0
2001	5.8	1.6
2002	5.7	1.6
2003	6.5	1.6
2004	7.7	1.5
2005	9.3	1.8
2006	9.8	2.2

2. Discriminant Function (DIF) scores—75% of all audits selected based on a secret formula assigned to various return characteristics

Process:

- a. 50,000 returns randomly selected for TCMP audits are used to develop DIF scores
- b. All returns are scored—*the higher the score*, the greater the potential for additional tax
- c. The audit *selection process begins in June* when computer-selected returns are categorized by the amount of income reported

Return Type/Income Class	Percent of Returns Audited		
	Fiscal Year		
	2006	2001	1996
All 1040/1040A Returns	0.22	0.16	0.66
1040A < \$25,000	0.02	0.08	0.41
Non-1040A < \$25,000	0.08	0.11	0.61
\$25,000 < \$50,000	0.14	0.11	0.51
\$50,000 < \$100,000	0.23	0.13	0.59
> \$100,000	0.44	0.38	1.70
Sch C: < \$25,000 Gross Receipts	0.58	0.59	2.36
Sch C: \$25,000 - \$100,000	0.88	0.57	1.95
Sch C: > \$100,000	2.36	0.92	3.15

- d. The Service Center pulls those returns with high DIF cutoff scores and sends them to the Districts which are required to shuffle returns throughout the year so that *all tax returns, regardless of their filing date, have an equal chance of being audited*
- e. Selected returns are then *manually screened by a classifier* who must rely upon his experience and instincts to find returns with the greatest likelihood of error since the items that resulted in the high DIF score are not identified.
- f. Subjective factors frequently enter into the selection process, such as sloppiness or round numbers. Other *DIF score raisers* include:
 - Missing schedules or Form 8283 (Non-Cash Contributions) or Form 6251 (AMT)
 - Casualty losses
 - Foreign bank accounts (reported on Schedule B)
HINT: File Form TDF 90-22.1 with Department of Treasury if balance > \$10K
[IRS has used shells to open accounts so that they would receive bank mailings—even in unmarked envelopes]
 - Certain tax credits (Earned Income or Child Tax)
 - High itemized deductions relative to total income or disproportionate to the geographical area
 - Multi-year Schedule C losses or those with a particular business code
 - Certain occupations
 - Related party transactions
 - Self-prepared returns

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3. Other Selection Criteria & Programs

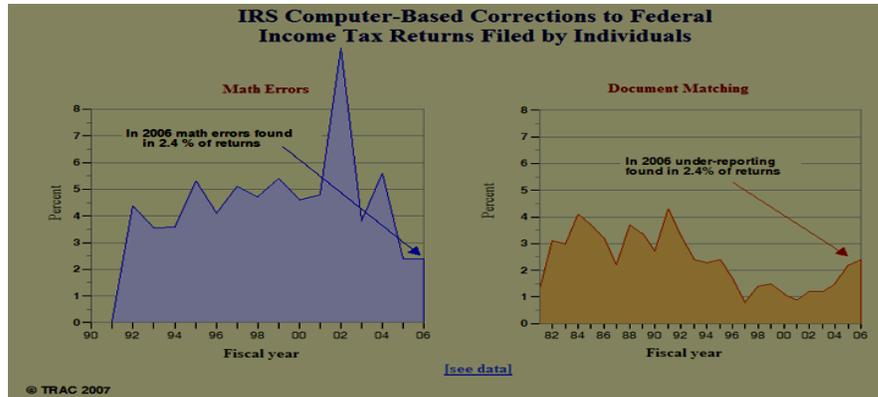
a. Market Segment Specialization Program (MSSP)

b. Document Matching—1099s, W-2s, K-1s, Real Estate Transactions (1099-S), Gambling Winnings (W-2Gs)

HINT: Request corrected 1099s from Payers

HINT: Issue 1099s for Nominee Interest

HINT: Request IRS transcripts at (800) 829-1040 or use Form 4506 to request copy of previously-filed tax return



c. Special Programs, incl. Non-filers, Abusive Trusts, Passive Activities

d. Life-style matches (random)

e. Economic Cycle & Government Deficits

f. Informants

- Maximum Rewards: 10% of first \$75K collected; 5% of next \$25K; 1% thereafter, capped at \$10 million. The average reward in 2003 was 2.74%.
- Tipster claims are rejected if the information is of no value or already known to the IRS—for example, only \$4 million paid to 190 of 4,765 informants in 2003.

Table 1: Rewards Paid to Informants and Taxes, Fines, Penalties, and Interest Recovered From Informants' Information - Fiscal Years (FY) 2001 Through 2005

	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	TOTALS
Rewards Paid to Informants	\$3,337,035	\$7,707,402	\$4,057,476	\$4,585,143	\$7,602,685	\$27,289,741
Taxes, Fines, & Penalties Recovered	\$30,774,539	\$56,583,517	\$48,379,562	\$45,644,890	\$68,126,671	\$249,509,179
Interest Recovered on Amount Above	\$13,249,794	\$10,357,002	\$13,176,613	\$28,485,904	\$25,550,935	\$90,820,248

Source: IRS annual reports to Congress.

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Figure 3: SB/SE Division – Comparison of Recommended Adjustment Dollars and No-Change Rates for Informant Examinations and DIF Returns - FYs 2003 Through 2005

FYs 2003 - 2005	ADJUSTMENT DOLLARS/HOUR			NO-CHANGE RETURNS		
	Total Recommended Adjustments	Total Hours	Dollars per Hour	Total Returns	No-Change Returns	No-Change %
Informants' Program (SB/SE Division examinations)	\$26,233,554	38,139	\$688	727	152	21%
DIF (SB/SE Division Revenue Agent Individual & Corporate)	422,356,790	1,105,890	\$382	15,832	4,435	28%

Source: Treasury Inspector General for Tax Administration analysis of IRS data.

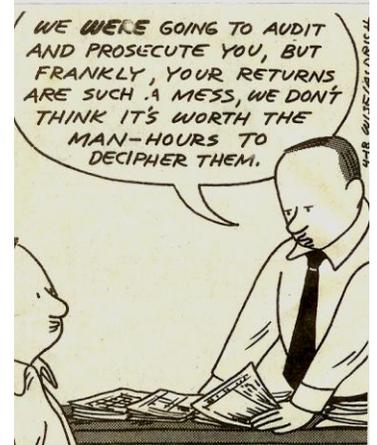
g. Another's Return (Partnership Audits, Spousal Alimony, Return Preparers)

"Worried about an IRS audit? Avoid what's called a red flag. That's something the IRS always looks for. For example, say you have some money left in your bank account after paying taxes. That's a red flag."

– Jay Leno

h. Red flags

- Missing Social Security Numbers For Dependents & Caregivers
- HOH Status (in California)
- Self-Employment; Home-In-Office; Business Auto → audit rate quadruples!
- Treating Employees as Independent Contractors
- Bad Debt Deductions
- Passive Activities
[e.g. Taxpayer's restaurant charges incurred for 150 days negated claim that that the property was used as a rental rather than for vacation purposes.]
- Early IRA Distributions
- Barter Income
- Refunds In Excess of \$200,000
- **Round Numbers (!)**



4. Statute of Limitations

- 3 years from filing (unless failure to file or fraud)—4 years in CA
- 2 years from payment
- Use Form 4810 to shorten SOL to 18 months

5. Amended Returns—do not increase the chance of an audit

- If 1040X filed *before* return is audited, changes become effective upon filing
- If 1040X is filed *during* or *after* an audit, changes will affect the earliest open year

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When called to an IRS audit, the taxpayer was concerned about what he should wear to the appointment. His accountant advised, "Wear your worst clothing and an old pair of shoes—let them think you are a pauper." But his lawyer recommended, "Wear your best suit and most expensive tie—don't let them intimidate you."

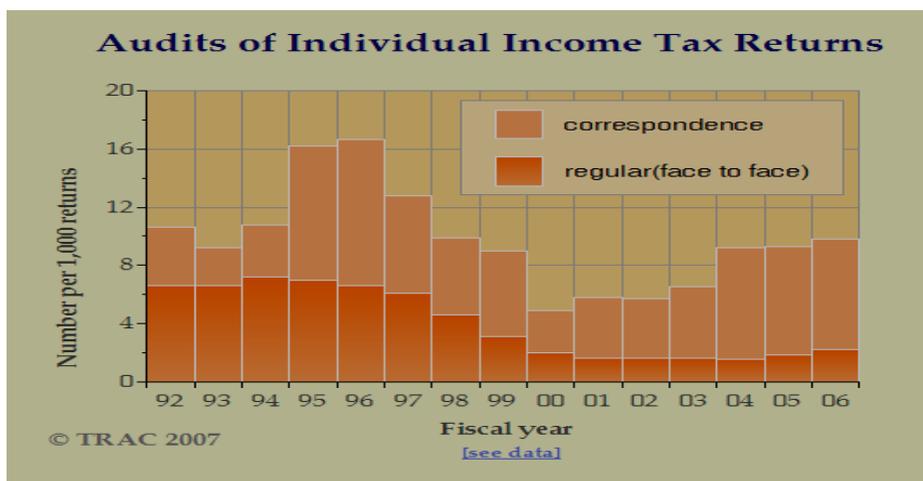
Confused, the man went to his Rabbi and told him of the conflicting advice he had received. "Let me tell you a story," replied the Rabbi. "A woman, about to be married, asked her mother what to wear on her wedding night. Her mother suggested that she wear a heavy, long, flannel nightgown and wool socks. The woman's best friend, on the other hand, advised her to wear a sexy negligee with a V-neck cut down to her navel."

The taxpayer did not understand the point of the Rabbi's tale. "What does all this have to do with my problem with the IRS?"

The Rabbi explained, "It doesn't matter what you wear—you're going to get screwed."

B. Types of Audits

- Correction Letter—usually a math error or mismatch
- Correspondence Audit—used to request additional information or clarification



- Office Interview—used to verify specific issues (unless the scope is expanded)
- Field Audit—usually to verify business records [**HINT:** Never agree to a *home* audit!]
- TCMP Audit (life-style audit)—last done in 1995 (153K audits performed)
- Criminal Investigation—penalties may involve fines and/or incarceration

D. Courses of Action

- **THEORY:** Request an extension & file after April 15th
- **THEORY:** File 1040X just before Yr 3 SOL expiration to prevent opening of *entire* tax return
- NEVER ignore IRS correspondence—respond promptly & succinctly
- Follow-up aggressively
- Verify information contained in notice (45% are incorrect!)
- Use Form 8822 to report change of address
- Provide only requested information & records
- Get a receipt for any paperwork provided to the IRS
- Ask that all additional requests for information are put into writing to limit scope of the audit
- Maintain written record of all proceedings and communications with IRS
- Be polite and avoid adversarial confrontations



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- **BETTER YET:** Hire someone to represent you & cease *all* personal communications with IRS. Reasons to hire a professional include his ability to find the requested information more quickly and obtaining a faster, more favorable result.

"Somehow the IRS auditor knew that it was my first audit", the accountant told me. "How?" I wondered. "Because the auditor explained that "for this kind of examination, you don't have to undress."

E. Defenses

Recordkeeping & Documentation

1. Burden of proof is on taxpayer
2. Make a good faith effort—do not make up documentation
3. Keep all long-term records (residence, capital assets, K-1s, IRAs)
4. Cohan rule allows estimation of expenses except travel & entertainment
5. Use alternative methods of proof, if necessary
 - Cost basis computed from sales price less CPI increases
 - Cost basis of comparable items in newspaper ads
 - Cost of improvements via photos and building permits
 - Casualty losses via statements from friends
6. File Form 4506 to request Copy of Tax Return (\$39)



Other Measures

1. Neatness counts!
2. Maintain consistency from year to year, but avoid taking identical deductions as in the past
3. Avoid round numbers
4. Detail expenses in excess of \$500 or subdivide into multiple categories

HINT: Request Audit Reconsideration after receiving Notice of Examination Changes

F. Refunds

- Automated status verification at (800) 829-1954
- *Never* cash a check which is not yours or to which you are not entitled

G. Penalties (140 civil penalties!)—PLUS interest

1. Amounts
 - Failure to File (by due date): 5% per month of tax due (25% max.)
 - Failure to Pay (by due date): 0.5% per month of unpaid tax (25% max.)
 - Frivolous Return (unsubstantiated position or inadequate disclosure): \$500
 - Accuracy-related (negligence): 20% of underpayment
 - Substantial Underpayment (if >10% of correct amount or >\$5K): 20% of underpymt.
 - Substantial Over-valuation of FMV (i.e. char. contributions): 20-40% of underpymt.
 - Fraud: 15% per month of underpayment (75% max.)
 - Trust Fund Recovery: 100% of liability
 - Failure to File Information Returns: \$15-50/each
 - Missing TIN: \$50/each
 - Bad Check: 2% of check amount (\$15 minimum)
 - Preparer Penalties

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2. Waivers & Abatement due to Reasonable Cause—use Form 843 to request abatement
 - a. Reasons could include: Death, Disability, Casualty, or Natural Disaster
 - b. Good phrases to use: “prior history of compliance”, “no deliberate intent to avoid taxes”, “will inflict hardship upon spouse & family”

Excuses that have worked...

A taxpayer was misdiagnosed with Legionnaire's Disease and told that he had less than a year to live. So he quit his job, divorced his wife, and took off for the Caribbean without ever filing another tax return. When he was still alive 11 (!) years later, he provided a copy of the medical diagnosis to the IRS auditor who dropped all penalties for failure to file and pay.

The taxpayer, a married man, stopped at his girlfriend's house on his way to mail his tax return. They quarreled and he forgot all about the envelope that contained a check for \$800,000. Two months later, he made up with his mistress and discovered the forgotten tax return at her apartment. When his accountant explained the situation to the IRS and provided bank records proving that the taxpayer had in fact transferred funds to cover the check he had intended to send, the auditor waived the late payment penalty.

A married couple failed to file tax returns in a timely manner, failed to report substantial income, failed to maintain adequate records, failed to pay taxes for 3 years, and had even been convicted of tax fraud in earlier years. However, no penalties were assessed this time around when the judge accepted their excuse: The couple said that they hated all lawyers and accountants, whom they held responsible for their previous problems.

The taxpayer, a traveling salesman, turned up at his IRS audit apologizing profusely. He had carefully organized his records on his desk, then left town on a business trip. When he came back a few days later, he found that his cat had used the paperwork as a litter box. The taxpayer collected the remaining, limp and moist scraps, and brought them to the auditor in sealed baggies. The audit was over immediately!

H. IRS Procedures

30-Day Letter → 90-Day Letter → 10-Day Notice & Demand → 30-Day Notice of Intent to Seize
 (a.) (b.) (c.) (d.)

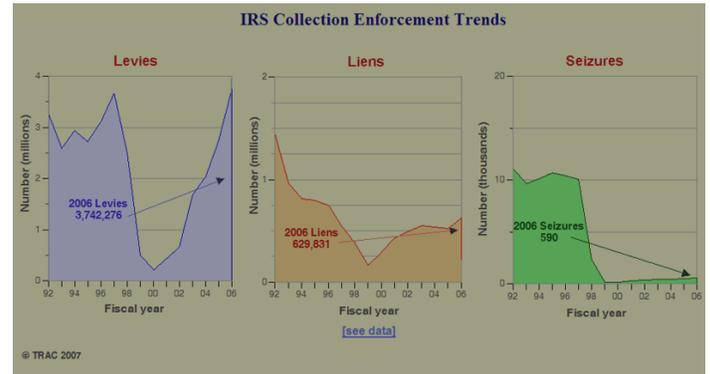
- a. Auditor's Report & Taxpayer's Waiver of Restrictions Against Assessment—can be challenged in Appeals within 30 days
- b. Notice of Deficiency = gives reason for assessment and total penalties and interest
 - If taxpayer responds within the time limit, he may sue the Commissioner in Tax Court without paying the liability
 - Alternatively, the taxpayer may pay the assessment and then sue for a refund in the US District Court or Court of Claims—the IRS has 4 months to settle all claims before proceeding to court

HINT: File 1040X start the SOL clock, then pay most (but not all) of the tax due to avoid accrual of penalties & interest

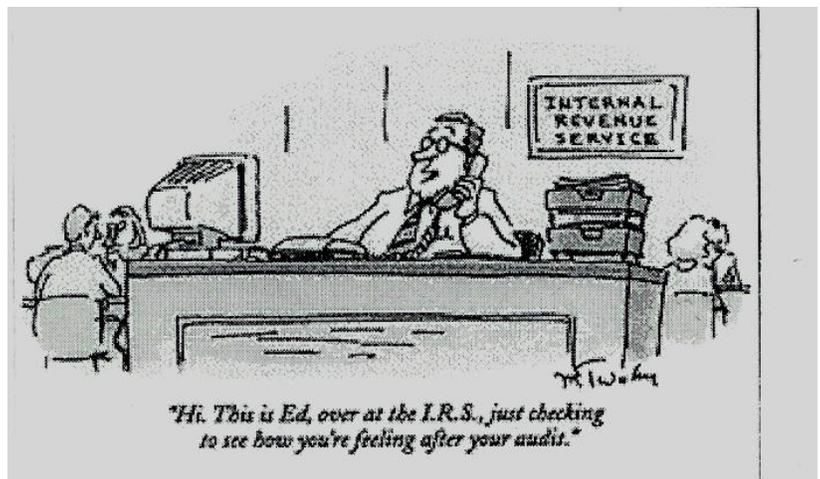
Venue	Procedure	IRS Wins
Claims Court	pay first, then file for refund located in DC only BURDEN: must prove that you are right	90%
District Court	pay first, then file for refund circuit judges come to you jury trial optional BURDEN: must prove that you are right	80%
Tax Court	fight now, pay later circuit judges (19) come to you simpler & cheaper (avg. case lasts 14 months) may represent self oral testimony is allowable BURDEN: must prove that IRS is wrong	35% 45% split decisions 89% of appeals are upheld

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- c. Notice of Demand—if liability uncollected after 10 days, the case is referred to Collections
- d. Notice of Intent to Seize—used to levy real or personal property (including wages)
- IRS may file a Tax Lien with the County Clerk indicating a debt is owed to the government and is usually followed by seizure, levy, and wage garnishment.
 - Wage Garnishment—an employer must deduct a specified amount from the employee's paycheck and submit it directly to the IRS until the amount owed is fully paid or the garnishment is released. The IRS may garnish up to 80% of net take-home pay; the FTB up to 25%.
 - Levy—the taking of money by a Revenue Agent who is empowered to cash-in all balances in your savings and checking accounts.
 - Seizure (used as a last resort) removes ownership rights and allows the government to dispose the seized assets in order to recover the money owed.



- I. Offers in Compromise
- Based on doubt as to tax liability &/or collectibility
 - Provide financial information on Form 433-A
 - File Form 656 to make offer based on Total Assets - Liabilities + Projected Net Income over next 5 years
 - Collection efforts are stayed & SOL is suspended while OIC is considered
 - “A settlement is good if each party comes away angry.” (James King, EA)
- J. Taxpayer Bill of Rights
- Right to representation
 - T/P need not be present unless served with an administrative summons
 - May request change of venue to a location within reasonable distance of work or home
 - Right to tape-record meetings or receive transcript of IRS recording
 - No penalties if you relied on *written* advice from IRS
 - Taxpayer Assistance Orders issued by taxpayer advocate can stay collection activity (Form 911)
 - Bank account is frozen (but not attached) for 21 days pending levy action—FTB has 10 days
 - Some personal property is exempt from levy
 - Interest-free period has been



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- extended to 21 days after payment notice is given
- IRS must prove its position was substantially justified or pay attorney's fees if taxpayer prevails

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