Review

Considerations in addressing an internal revenue service audit of an individual taxpayer in the United States

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This paper presents a discussion of certain procedural issues that confront an individual taxpayer in the United States when dealing with a civil tax audit conducted by the Internal Revenue Service (“IRS”). Given the nature of the topic, the paper cannot address every such issue because the topic is vast and each individual situation is unique. It is, however, the author’s hope that the reader will come away with a deeper understanding of the IRS’ civil tax audit and protest process, along with an appreciation for certain procedural issues related to the resolution of conflicts with the IRS. It is the author’s further hope that this paper will inspire students of accounting and taxation to develop a deeper appreciation for the tactics and techniques used during the civil tax audit and defense process and that these students can utilize this information in their professional careers. Issues pertaining to IRS criminal tax investigations and prosecutions under the Internal Revenue Code of the United States or other related laws are beyond the scope of this paper.

Key words: Internal revenue service, IRS, tax, audit.

INTRODUCTION

If cultural stereotypes are to be believed (and from the author’s experience they can be), few things upset the average citizen of the United States more than an unsolicited contact from the Internal Revenue Service (“IRS” or the “Service”). After such a contact occurred, the author would often receive a phone call from the recipient of the IRS’ attention. Although now employed as an Assistant Professor of Business and Managerial Science, teaching in the fields of Accounting, Federal Taxation in the United States (“US”) and Law, the author is also an Attorney, Certified Public Accountant (“CPA”) and former IRS Trial Attorney. While in private practice, he worked as a Tax Attorney with a practice emphasis in, among other things, representing individual clients with federal tax problems and was often retained to assist by dealing with the IRS on the affected taxpayer’s behalf.

From the collection of the author’s experiences and research, common reasons exist for a contact from the IRS. In the best-case scenario, a taxpayer may receive a notice or check indicating that he/she is unexpectedly entitled to money.

In the worst-case scenario, a taxpayer may have filed
his/her tax return with the IRS, but failed to pay the tax due. Maybe the taxpayer has not filed a tax return at all for a particular year, or sometimes many years, and the IRS is aware of his/her income from reports made to them by employers, customers, banks or other persons who have paid income to the taxpayer. Even though some taxpayers both file and pay the tax due on a return, the IRS may select their return for what is commonly referred to as a tax audit. Additionally, a business may fail to file payroll returns, or other required information returns, or neglect to remit withholding taxes to the IRS, thereby prompting a contact. These are only a few examples of reasons why the IRS may contact a taxpayer, but whatever the reason, it is vital that a taxpayer, or his/her authorized representative, understand how to take the necessary steps to deal with the possible problem that may have unmasked itself by the contact received from the IRS. The foregoing examples address a wide array of tax issues and pertain to matters related to the filing or non-filing of a tax return and/or the payment or non-payment of a tax due or proposed to be due. It must be noted that this paper focuses primarily on certain procedural issues that confront an individual taxpayer when dealing with a civil tax audit conducted by IRS of a previously filed income tax return. As such, many of these scenarios are beyond the scope of this paper, but presented by way of foundational information.

Preliminary considerations

As a first and critical step after contact from the IRS, a taxpayer must always ascertain the office within the Service that has initiated the contact with him or her. This information will greatly affect the potential response. As a preliminary matter, the tax world makes a demarcation between two types of IRS problems: those that are civil and those that are criminal. As to a criminal matter, a taxpayer may be contacted by an employee of the IRS operating division known as Criminal Investigation (“CI”) concerning an ongoing or contemplated investigation of a possible criminal violation of the Title 26 of the United States Code, generally referred to as the Internal Revenue Code (“IRC” or the “Code”), or other related Federal criminal statutes. This paper is not intended to discuss how to deal with this type of situation, but it must be noted that if CI contacts a taxpayer, he/she should act with an abundance of caution and seek legal counsel before speaking with the contacting agent. The IRS’ rules generally require that an agent from CI, known as a Special Agent, must, among other things, indicate that he/she is employed as such when contacting the subject of an investigation. Moreover, a Special Agent is required to advise the subject of the investigation of his/her constitutional rights before conducting an interview, specifically the subject’s right against self-incrimination under the Fifth Amendment to the U.S. Constitution. For a more thorough discussion of issues pertaining to representing a client who is involved in a criminal tax investigation, please review the American Institute of Certified Public Accountants (“AICPA”) Tax Division’s publication entitled, Client Criminal Matters and the CPA: Practice Guide (2011) that can be found at www.aicpa.org. Finally, it should be noted a Special Agent generally carries a badge and a gun, a distinguishing feature between other forms of IRS employees.

With the foregoing being said, the vast majority of contacts from the IRS involve matters of a civil, not criminal, nature. A contact in civil matter will generally originate as the result of one of a few other matters under consideration by the IRS; namely, the audit and/or examination of a filed tax return, the collection of an unpaid tax or the procurement of an un-filed tax return. Each of these contacts may originate from different groups within the Service.

In order to understand who is contacting you from the IRS, it is first important to understand how the organization is structured. The current configuration of the IRS’ organizational structure results from massive changes made after the passage of the The Internal Revenue Service Restructuring and Reform Act of 1998 (“IRS Restructuring Act”). Prior to that legislation, the IRS was organized along functional lines and consisted primarily of three large divisions, namely: 1) Examination (commonly referred to as Audit), 2) Collection (primary function to collect delinquent tax liabilities and/or secure past due tax returns) and 3) Criminal Investigation. Each division was organized based on geographic regions that were divided into districts and all reported to the Commissioner of Internal Revenue, located in a National Office housed in Washington, DC.

Before the IRS Restructuring Act, the function of the Examination Division was, among other things, to examine (commonly referred to as audit) tax returns filed by taxpayers to verify accuracy in hopes of promoting voluntary compliance by the taxing public as a whole, while the main job of the Collection Division was to take the steps necessary to collect unpaid taxes.

Following the IRS Restructuring Act and the related reorganization, the Commissioner continues to head the IRS as the chief executive officer and remains housed in Washington, DC. However, the IRS is now divided into three Commissioner-level organizations: Office of Commissioner (again, in charge of the entire organization) along with the Deputy Commissioner for Service and Enforcement (“DCSE”) and the Deputy Commissioner of Operations and Support (“DCOS”). Both Deputies report to the Commissioner. DCOS focuses on support functions with limited taxpayer contact. DCSE consists of four primary operating divisions and these divisions are responsible for dealing with the taxpaying public. Each is based on the nature of the taxpayers serviced and consists of the following: (1)
Wage and Investment (W&I), (2) Large Business and International Division (LB&I), (3) Small Business/Self-Employed (SB/SE) and (4) Tax Exempt and Government Entities (TE/GE). 5

Both W&I and SB/SE deal primarily with individual taxpayers. The mission of W&I is to help taxpayers understand and comply with the US tax laws and to protect the public by applying these laws with integrity and fairness. The profile of the typical taxpayer served by W&I is a wage earner who pays his/her tax liability through employer collected tax withholdings. 10 As to SB/SE, its mission is to help small business and self-employed taxpayers understand and meet their tax obligations, while applying the tax law with integrity and fairness. The profile of the typical taxpayer served by SB/SE is one involved in the operation of a business, including rental activities and farming, through a sole proprietorship, corporation, or partnership holding total assets of less than $10,000,000. 11 Given the nature of the taxpayers serviced in both LB&I (business with assets in excess of $10,000,000) and TE/GE (governmental bodies and non-profit groups) neither deals extensively with individual taxpayers. 12

Despite this functional reorganization following the IRS Restructuring Act, the work of the former Examination Division (typically, verifying the accuracy of a filed tax return through the audit process) and Collection Division (obtaining payment on past due taxes or returns) with regard to individual taxpayers is still accomplished. Now, however, each of these functions separately exists within W&I and SB/SE. Within W&I, both these functions fall under the Office of Compliance. Within SB/SE, a separate organization exits to perform each function. It also should be noted that CI still exists as an operating division within DCSE.

The foregoing is discussed in order to help the reader identify the office within the Service that has initiated division within DCSE. In light of the foregoing, it should be noted that, often times, confusion exists between many of the basic terms used in this self-assessment system. These include the terms: tax return, tax liability and tax refund. A tax return, typically from the IRS Form 1040 series for individual taxpayers, is the actual form and related schedules that are filed with the IRS to report the tax due and to satisfy a taxpayer's obligation to make an annual tax filing, if certain income limits are met. 17 Remember that the item subject to tax on a return is a taxpayer's income and it is this income along with any accompanying deductions, credits and payments that are reported on this tax return.

In its very basic form and in an effort to try to oversimplify a complex topic, the term tax liability means the amount of tax as calculated on the return after the rules of the IRC are applied to this income in order to calculate the amount that a taxpayer is required to pay. Such rules typically allow a taxpayer to subtract for income certain allowable tax deductions in order to calculate what is referred to a taxpayer's taxable income. After applying a tax rate percentage to this taxable income, the amount of the tax is determined. One would think that the calculation should stop there, but it does not. Certain other miscellaneous additions and subtractions may be made to this amount in order to finally determine the tax liability. This amount is currently reflected on line 61 of the IRS Form 1040 and is indicated by the phrase “Total Tax”. 18

Most taxpayers make payments over the course of a and meet their tax responsibilities and enforce the law with integrity and fairness to all.” 14 The IRS appears to have tried to achieve the goal noted by many pundits: become kinder and gentler.

THE IRS AUDIT PROCESS FOR INDIVIDUAL INCOME TAX RETURNS

Although the following may sound ironic given the power of the IRS, the United States utilizes a self-assessment system of income taxation. Every taxpayer liable for a tax imposed by the IRC is required to complete and file a form prescribed by the IRS, calculating and reporting his or her income tax liability to the government on an annual basis. The primary purpose for filing the form, also known as an income tax return, is to report what a taxpayer believes to be his or her annual income tax liability. In making this required report to the government, a taxpayer agrees to allow the IRS to reflect in its records that the taxpayer is liable for the tax indicated on the filed tax return. The act of noting the amount of a taxpayer's liability in the IRS' records is also known as “assessing” the tax. Therefore, because a taxpayer files his or her own tax return, as compared to the IRS preparing it for him or her, in order to assess the tax due, the US operates under what is termed a self-assessment tax system. 16

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year against their anticipated tax liability. These payments take the form of quarterly estimated amounts sent by a taxpayer directly to the IRS or funds sent to the IRS on the taxpayer’s behalf through items such as payroll or other withholdings. The Code also provides for certain credits that can be treated as payments against a taxpayer’s liability and in some cases, any excess of these credits over a taxpayer’s liability can be given to the taxpayer. As such, when payments and credits reported on a tax return are more than the tax liability reflected on it, the taxpayer may be entitled to a refund of this overpayment, such being commonly called a tax refund.

There are occasions when the payments and credits for a given year are insufficient to satisfy the entire tax liability and then the income tax returns reflects a balance due or amount owed that must be paid, oftentimes with interest and even penalties.

Obviously, by filing the required form with the IRS, a taxpayer provides the basic information upon which his/her tax liability can be determined. A taxpayer, however, is not typically required to file with a tax return all his/her tax liability can be determined. A taxpayer, how-

The IRS utilizes many tools to select an individual income tax return for examination. First of all, the IRS utilizes a classification system to determine which returns should be considered for examined. After filing, tax returns are classified and selected for possible examina-

Because the IRS is responsible for the administration and enforcement of the tax laws, it has been granted broad powers in the Code to carry out its duties. One of these powers consists of the authority to examine any books, papers, records, or other information that may be relevant to determining the correctness of a filed tax return, or the tax liability of any person. Many laymen and professional alike commonly refer to this process as an audit. The IRS also refers to this process as an examination. This, of course, begs the question of how or why is a tax return selected for an audit or examination.

It should be understood that tax returns filed with the IRS, either by mail or e filing, are initially processed at various facilities located throughout the country. After computational and other information checks are performed on a filed return at the campus location, an initial determination is made as to whether any further examination of the return is required. In most cases, the IRS accepts the taxpayer’s self-assessed tax liability reported on the filed individual income tax return without any further question. According to a report published by the IRS entitled Enforcement and Service Results ("ESR Report"), 1.1% of all filed individual income tax returns were selected for examination during fiscal year 2011. This percentage, referred to as the Coverage Rate, has ranged from a low of 0.58% in the fiscal year 2001 to a high of 1.1% for both the 2010 and 2011 fiscal years.

It should also be noted that this over all Coverage Rate statistic is deceiving. The rate is further broken down in the ESR Report by income category. For individual income tax returns reporting income of under $200,000, the Coverage Rate for fiscal year 2011 is 1.02%. However, for returns with income of over $200,000 for that same year, the Coverage Rate is 3.93% and once over $1,000,000 in income, the rate grows to 12.48% in fiscal 2011. Accordingly, the chance of an individual income tax audit rises substantially as a taxpayer’s income rises.

Another reason why the IRS computer programs may designate a return for audit results from studies of past examinations or issues identified by compliance projects. The most common of these studies is the Discriminant Function ("DIF") system. Under the DIF system, mathematical formulas were developed as a basis for computer programs whereby weights are assigned to certain basic return characteristics. The weights are then added together to produce a score for each return processed. Returns are then ranked in numerical sequence based on their score (highest to lowest). Generally, the higher the score, the greater the likelihood of a significant tax change on examination and the greater the likelihood of an audit.

The IRS has periodically used these types of compliance studies to formulate the basis for its audit selection formulas. The most extensive of these compliance research programs was done in 1988 and was called the Taxpayer Compliance Measurement Program ("TCMP"). Participants in the TCMP initiative were selected at random for a complete audit of all items on a tax return and the information derived was used to make a statistical sample used in the DIF program. TCMP has been discontinued but in fiscal year 2000, the IRS began another ongoing compliance study entitled the National Research Program ("NRP"). Under the NRP, the IRS
initially selected for examination about 46,000 individual income tax returns filed shortly after the program began. The purpose of these audits was, in part, to develop statistics to measure the overall reporting compliance of the US voluntary tax system. Another approximately 13,200 individual income tax returns were selected for examination annually under the NRP for tax years 2006, 2007 and 2008. The NRP is an ongoing Service initiative and therefore, another reason that a tax return may be selected for examination. In addition to utilizing information from the NRP to update the DIF system, the Service has used the data collected from the program to measure the difference between the taxes that taxpayers as a whole should pay and the amount paid voluntarily and on time by all taxpayers. This difference is known as the Tax Gap and is currently a matter of great concern to the Service.

Another reason a return may be selected for audit results from the IRS reliance on information from outside sources, including newspapers, public records, and individuals. Finally, a return may also be selected to address both the questionable treatment of an item on the return or to study the behavior of similarly situated taxpayers and develop data on them. The Service refers to such a group of taxpayers as a market segment.

Once a return is selected for audit, an examination is conducted of the specific items designated for consideration. An employee in the Examination Division of the IRS handles the audit. The taxpayer, or his/her representative as designated in an IRS Form 2848, is asked to address these specific items and provide factual or legal substantiation for the position taken on the tax return. This process can take place either by mail or in person, depending on the size and nature of the audit.

If the examination is conducted by mail, the taxpayer will receive a letter asking for information about certain items of income, deduction, credit or payment shown on the filed tax return. If the IRS determines that the tax liability shown on the return is correct, the examination is terminated, and the return is accepted as filed. If the Service makes an initial determination that the taxpayer has not correctly reported his or her tax liability and that additional tax is due, the IRS will issue a report to the taxpayer outlining its findings.

There are also occasions when the examination is not conducted by mail, but instead, in person. Oftentimes, the taxpayer is asked to visit a local office of the IRS to meet with a tax auditor for purposes of what is usually termed an office audit. It is during this meeting that the tax auditor discusses with the taxpayer the items on the tax return that are being reviewed and asked for information pertaining to these items. Depending on the needs of the parties, this meeting can also be held at a taxpayer’s home, place of business, location of business records or the office of the CPA, Attorney or enrolled agent (typically a non-CPA or Attorney who has taken and passed a test administered by the IRS to allow him/her to practice before the IRS) representing the taxpayer. Business returns and individual returns with complex or financial or business activities may be assigned to a more experienced revenue agent for examination rather than a less experienced tax auditor.

If the IRS believes, as a result of the audit, that a taxpayer owes additional tax above that shown on the tax return (known as a “deficiency” under the Code) such determination becomes final if the taxpayer agrees with, or chooses not to contest, the IRS findings. The typical manner is which the taxpayer agrees with the IRS findings under these circumstances is by signing and agreeing to the report generated by the auditor.

As part of the audit process, practitioners should take note of IRC §6103 that provides that tax returns and tax return information are confidential and may not be disclosed by the IRS, subject to a number of exceptions. One such exception can be found in IRC §6103(c) wherein disclosure is authorized to a taxpayer’s designee. In light of this provision, practitioners are required to obtain and file with the IRS a Form 2848 in order to represent the taxpayer during the audit process.

PROTESTING AUDIT DETERMINATIONS AND PROPOSED AUDIT ASSESSMENTS

A civil audit by the IRS of a taxpayer’s return may result in an initial determination that a tax deficiency exists. In such a case, the IRS issues the taxpayer a notice of proposed deficiency (commonly known as a “30-day letter”), which details the nature and amount of the proposed adjustments to his/her tax return. If the taxpayer disagrees with the initial determination made by the IRS in the 30-day letter, he or she is entitled to an informal conference with a manager in the examination division in hopes of resolving the dispute. If the matter is not then resolved, the taxpayer may, but is not required to, pursue a formal protest process.

The 30-day letter outlines the taxpayer’s right to protest the proposed audit adjustments. Generally, the protest process to the findings in the 30-day letter commences with the submission of a written request by the taxpayer outlining the reasons that he/she disagrees with those finding. Once submitted, the administrative appeal to the proposed examination finding is handled by the Service’s Appeals unit (“Appeals”), a separate division that reports to the Commissioner with the mission of resolving tax disputes without litigation.

Appeal is given authority to resolve the case on behalf of the IRS and will informally meet, via phone or in person, with the taxpayer and/or his or her representative in an attempt resolve all or a portion of the disputes between the Service and the taxpayer resulting from the examination. If a complete resolution is reached through the appeals process, the examination is completed and both parties agree to abide by the result.
If the taxpayer does not timely avail himself or herself of the right to seek Appeals consideration upon receipt of the 30-day letter, or a resolution cannot be found in Appeals, a statutory notice of deficiency (commonly known as a “90-day Letter”) is issued to the taxpayer. The 90-day Letter informs the taxpayer that he or she has 90 days (150 days if the notice is addressed to a person outside the United States) in which to file a petition with the Tax Court to contest the proposed deficiency. The 90-day letter provides the taxpayer with the ability to contest the deficiency in the Tax Court without having to prepay the tax and provides the Tax Court jurisdiction to resolve the dispute over the proposed assessment. The notice of deficiency must be sent by certified or registered mail to the taxpayer at his/her last known address. This term is defined as the address that appears on the taxpayer's most recently filed and properly processed federal tax return, unless the IRS is given clear and concise notification of a different address. There is no statutorily prescribed format for the notice of deficiency. While the IRC provides that the notice of deficiency shall describe the basis for, and identify the amount of tax due, along with interest and penalties, it also expressly states that an inadequate description does not invalidate such notice. Additionally, the IRS is required to include in each notice of deficiency the date determined by the IRS as the last day on which the taxpayer may file a petition with the Tax Court. The IRS also provides that a petition filed with the Tax Court by the specified date will be treated as timely filed.

As a general rule, a notice of deficiency must be issued, if at all, by the IRS within the applicable statute of limitation for the assessment of tax. Under IRC §6501, the statute of limitations is generally three years after the taxpayer filed his or her return, regardless of whether or not the return was filed on or after the prescribed due date. The period of limitations on assessment is extended to six years, however, if the taxpayer has omitted in excess of 25% of the amount of gross income stated on his or her return. Further, if the taxpayer has not filed a return, or if the taxpayer has filed a false or fraudulent return, a deficiency may be assessed at any time. The filing of an amended return after the filing of a fraudulent return does not start the period of limitations. If the taxpayer does not timely file a petition with the Tax Court, the tax and penalties as set forth in the notice of deficiency are then assessed against him/her and the case will proceed to the collection function.

When a taxpayer timely files a petition for review with the Tax Court for a redetermination of a proposed deficiency, the Court has jurisdiction to determine the correct amount of the deficiency for the taxable year, even if such determination results in a greater deficiency than that originally asserted by the IRS. During the pendency of the Tax Court case, the IRS is prevented from taking collection action against the taxpayer.

Also, once a notice of deficiency has been mailed to the taxpayer and the taxpayer files a petition with the Tax Court within the prescribed time, no additional deficiency may be determined for the same taxable year. The requirement to issue a notice of deficiency applies to income, estate, gift, and certain excise taxes. The deficiency procedures outlined in this paper do not apply to employment taxes or tax penalties and interest unless those additions are based on the taxes subject to the deficiency procedures.

If a taxpayer fails to seek Appeals consideration from the 30-day letter and the Service issues a 90-day letter with the taxpayer filing a petition with the Tax Court, Appeals may consider settlement of the case for a limited period of time, provided it has not previously considered the case. If a taxpayer reaches an agreement with Appeals while the matter is pending before the Tax Court, the settlement is affected by a stipulation of agreed deficiency or overpayment filed with the Tax Court and ordered by the court. If the taxpayer is unable to reach a settlement with Appeals during the time allowed, Appeals consideration will stop and the Tax Court case will proceed.

Conflict of Interests

The author has not declared any conflict of interests.

Conclusion

It is critical that all professionals in the tax and accounting field, along with those people working in business, have an understanding of the operations of the IRS and its civil tax audit and protest process. Many of them will be called upon in the deal with the IRS on this type of issue. Moreover, any citizen, regardless of employment or profession, may be asked to address a conflict with the IRS. As such, knowledge about the IRS is critical to resolving disputes with it. It is the author’s hope that this paper assists professionals, students and citizens alike to develop this understanding.

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50 IRM §8.2