Chapter 25

Tax Administration and Practice

Eugene Willis, William H. Hoffman, Jr., David M. Maloney and William A. Raabe

Tax Administration (slide 1 of 3)

- The IRS is responsible for administration and enforcement of the tax laws
  - Provides info to taxpayers through publications and forms with instructions so taxpayers can comply with the tax law
  - Identifies delinquent tax payments
  - Carries out assessment and collection procedures

Tax Administration (slide 2 of 3)

- In meeting its responsibilities, the IRS conducts audits of selected tax returns
  - Only about 0.5% of all individual tax returns are audited each year
  - Certain tax returns, such as those for high income individuals or cash-oriented business, have a much higher audit rate

Tax Administration (slide 3 of 3)

- To enhance its enforcement efforts, the IRS has focused much effort on:
  - Developing requirements for information reporting and document matching
  - Increasing pressure on tax advisers
- The IRS has recently undertaken a major reorganization and adopted new operational strategies aimed at improving its efficiency while enhancing its interaction with taxpayers

Letter Rulings (slide 1 of 3)

- When a tax issue is controversial or involves significant tax dollars, a taxpayer may request a letter ruling from the IRS
  - The ruling describes how the IRS will treat the transaction

Letter Rulings (slide 2 of 3)

- The ruling can only be relied upon by the party requesting the ruling
  - Other taxpayers may use the ruling as an indication of the IRS' position on the matter
- Letter rulings are generally followed by the IRS for the taxpayer who requested the ruling as long as all material facts of the transaction were accurately disclosed in the ruling request

Letter Rulings (slide 3 of 3)

- Letter rulings may be declared obsolete by the IRS for other taxpayers
- A fee is charged by the IRS for processing a ruling request

IRS Procedures-Other Issuances

(slide 1 of 2)

- Determination letters - provide guidance regarding a completed transaction when the issue involved is covered by judicial or statutory authority, regulations, or rulings
- Technical advice memorandum - may be requested by taxpayer when an issue in dispute is not treated by the law or precedent and/or published rulings or regulations

IRS Procedures-Other Issuances

(slide 2 of 2)

- Technical expedited advice memorandum (TEAM)
  - New written determination approach being tested by IRS
  - Used during office or field audits
  - Designed to reflect the position of the IRS in a shorter time than the TAM currently requires

IRS Administrative Powers

(slide 1 of 3)

- Examination of records
  - The IRS can examine a taxpayer's records to determine the correct tax due
  - If taxpayer meets the record keeping requirement and substantiates income and deductions properly, the IRS bears the burden of proof in establishing a tax deficiency during litigation.

IRS Administrative Powers

(slide 2 of 3)

- Assessment and demand
  - The IRS can assess a tax deficiency and demand payment of a tax.
  - The assessment cannot be made until 90 days after a “statutory notice of deficiency” is issued to the taxpayer
    - During the “90 day letter” period, taxpayer may file a petition with the U.S. Tax court, which prevents the IRS from collecting the amount until after the Tax Court case is resolved
    - After assessment, the IRS demands payment within 30 days

IRS Administrative Powers
(slide 3 of 3)

- IRS collection procedures
  - If the taxpayer does not pay an assessed tax, the IRS can seize property belonging to the taxpayer

IRS Audit Selection
(slide 1 of 3)

- The IRS does not disclose its audit selection process
- Utilizes mathematical formulas to select returns:
  - Likely to contain errors and
  - Yield a substantial amount of additional tax revenue

IRS Audit Selection
(slide 2 of 3)

- Examples of audit selection
  - Many large corporations are audited every year
  - Certain taxpayers are more likely to be audited such as:
    - Individuals with gross income > $100,000
    - Self-employed individuals with substantial business income and deductions
    - Cash businesses where potential for evasion is high

IRS Audit Selection
(slide 3 of 3)

- Most audits of individual tax returns are started about two years following the date the return is filed
  - Non-fraudulent returns cannot generally be audited more than three years after filing

Types of IRS Audits
(slide 1 of 3)

- Correspondence audits
  - The return is checked for mathematical accuracy or clearly erroneous deductions, etc. soon after the return is filed
  - In addition, several months after filing, all 1099s and W-2s and other matching information is verified
  - If a discrepancy is found in either of these cases, the IRS simply sends the taxpayer an explanatory letter and a bill or a refund

Types of IRS Audits
(slide 2 of 3)

- Office audits
  - These audits are frequently limited in scope, and can be conducted in the IRS office or by mail
  - The taxpayer is generally asked to substantiate the items requested (i.e., present invoices, canceled checks, etc.)

Types of IRS Audits
(slide 3 of 3)

- Field audits
  - Commonly used for corporate returns and for returns of individuals engaged in business or professional activities
  - These audits are generally conducted at a taxpayer’s home or business

Audit Procedures (slide 1 of 4)

- The taxpayer’s CPA, attorney or enrolled agent may represent the taxpayer in any type of audit
- A “power of attorney” (POA) (signed by the taxpayer and the representative) must be provided authorizing the CPA, etc. to perform certain activities (e.g., discuss certain transactions, provide documents, etc.) on the taxpayer’s behalf

Audit Procedures (slide 2 of 4)

- The IRS must grant permission to make an audio recording of any interview, if so requested in advance in writing
- On completion of the examination, the IRS agent will file a revenue agent's report (RAR) outlining recommended changes to the return (if any)

Audit Procedures (slide 3 of 4)

- The RAR is reviewed internally before the IRS assesses an additional tax
- The taxpayer may accept the RAR or appeal within the IRS
- Appeal within the IRS must be accompanied by a written protest unless:
  - The amount of tax does not exceed $10,000 for any tax year
  - The adjustment resulted from a correspondence or office audit

Audit Procedures (slide 4 of 4)

- Settlement with an IRS agent is based solely on the merits of the case, given IRS policy
- Settlement at the IRS appeals level can be based on the "hazards of litigation" - i.e., the likelihood that the courts would agree with the IRS position

Offers In Compromise And Closing Agreements (slide 1 of 2)

- Offers in compromise
  - IRS can negotiate a compromise if taxpayer's ability to pay the tax is doubtful
    - May result in IRS accepting less than full amount of tax due
    - Final payment of taxes may be allowed through installment payments

Offers In Compromise And Closing Agreements (slide 2 of 2)

- Closing agreements
  - May be used:
    - When disputed issues carry over to future years
    - To dispose of a dispute involving a specific issue in a prior year or a proposed transaction involving future years
  - Binding on taxpayer and IRS

Interest (slide 1 of 3)

- Congress sets interest rates applicable to underpayments and overpayments of tax
  - Rate is determined quarterly
  - Based on federal short-term rates

Interest (slide 2 of 3)

- IRS deficiency assessments
  - Interest accrues from unextended due date of return until 30 days after taxpayer agrees to the deficiency
  - If amount due is not paid within 30 days, interest again accrues on the deficiency

Interest (slide 3 of 3)

- Refund of taxpayer's overpayments
  - If refunded within 45 days after return is filed or is due, no interest is allowed
  - If taxpayer files an amended return or a claim for a refund of a prior year's tax, interest is accrued from the original due date of the return through the date the amended return is filed

Taxpayer Penalties (slide 1 of 9)

- A comprehensive array of penalties are used to promote compliance with the tax law
- Failure to file a tax return
  - Penalty is 5% per month (up to 25%) on amount of tax due
    - Minimum penalty is $100
  - If failure is due to fraud, rate is 15% per month (up to 75%)

Taxpayer Penalties (slide 2 of 9)

- Failure to pay tax due
  - Penalty is 1/2% per month (up to 25%) on amount of tax due
  - Penalty is doubled if taxpayer fails to pay tax after receiving a deficiency assessment
- Both above penalties can be eliminated if "reasonable cause" exists for failure to file or pay
  - Failure to file penalty is reduced by any failure to pay penalty for the same month

Taxpayer Penalties (slide 3 of 9)

- Accuracy-related penalties
  - 20% of portion of tax underpayment due to:
    - Negligence or intentional disregard of law,
    - Substantial understatement of tax liability
    - Substantial valuation overstatement
    - Substantial valuation understatement
  - Penalty applies only if taxpayer fails to show a reasonable basis for the position taken on the tax return

Taxpayer Penalties (slide 4 of 9)

- Negligence includes any failure to make a reasonable attempt to comply with the tax law
  - Penalty also applies to any disregard of rules and regulations whether careless, reckless, or intentional
  - Penalty applies to all taxes except when fraud is involved
- Penalty can be avoided upon showing reasonable cause

Taxpayer Penalties (slide 5 of 9)

- Substantial understatement of tax liability
  - Occurs when tax understatement exceeds the larger of 10% of amount due or $5,000 ($10,000 for a C corporation)
- This penalty applies unless:
  - The taxpayer has “substantial authority” for the tax treatment
  - Relevant facts are disclosed in the tax return
  - The taxpayer has reasonable basis for taking the disputed position

Taxpayer Penalties (slide 6 of 9)

- Substantial over- or under-valuation of an asset
  - Penalty is 20% of additional tax that would have been due if correct valuation had been used
  - These penalties apply if the valuation is:
    - At least 200%or more of the correct valuation for over valuation or
    - 50% or less than the correct amount for under valuation
  - Only applies if tax underpayment > $5,000 ($10,000 for a C corporation)

Taxpayer Penalties (slide 7 of 9)

- Civil fraud penalty
  - 75% penalty on any underpayment resulting from fraud by the taxpayer
  - For this penalty, burden of proving taxpayer civil fraud "by a preponderance of evidence" is on the IRS

Taxpayer Penalties (slide 8 of 9)

- Criminal penalties
  - Various monetary fines and/or imprisonment may be assessed
  - Burden of proof is on IRS to show guilt "beyond the shadow of any reasonable doubt"

Taxpayer Penalties (slide 9 of 9)

- Failure to pay estimated taxes
  - Applies to individuals, corporations, trusts, and certain estates
  - Penalty is not imposed if tax due < $500 for corporations, $1,000 for all others

Statutes Of Limitations (slide 1 of 2)

- In general, any tax imposed must be assessed within three years of filing the return (or, if later, the due date of the return)
  - Exceptions to the three year rule include:
    - If no return is filed or a fraudulent return is filed, there is no statute of limitations
    - If taxpayer omits gross income > 25% of gross income stated on the return, statute of limitations is extended to six years

Statutes Of Limitations (slide 2 of 2)

- Refund claims
  - Must be filed within three years of filing the tax return or within two years following payment of the tax, if later
  - A seven year period applies to claims relating to bad debts and worthless securities

Circular 230 (slide 1 of 3)

- Prescribes rules governing practice before the IRS
  - Includes prohibitions against:
    - Taking a position on a tax return unless there is a *realistic possibility* of it being sustained
    - Taking frivolous tax return positions

Circular 230 (slide 2 of 3)

- Also contains requirements to:
  - Disclose nonfrivolous tax return positions that fail the realistic possibility standard
  - Inform clients of penalties likely to apply and ways they can be avoided
  - Make known to clients any error or omission the client may have made
  - Submit records lawfully requested by the IRS

Circular 230 (slide 3 of 3)

– Also contains requirements to:(cont'd)
  - Exercise due diligence in preparing and filing tax returns accurately
  - Not unreasonably delay disposition of matters before the IRS
  - Not charge an "unconscionable fee" for representing a client before the IRS
  - Not represent clients with conflicting interests

Preparer Penalties (slide 1 of 3)

- $250 for understatement of tax from taking unrealistic position on tax return
  - Can be waived if “reasonable cause”
- $1,000 for willful attempt to understate tax or reckless disregard of tax rules
  - Can be waived if position is adequately disclosed in tax return

Preparer Penalties (slide 2 of 3)

- $1,000 for aiding in preparation of return which preparer knows (or has reason to believe) will result in a tax understatement of another person
  - If this penalty applies, neither the unrealistic position nor the willful and reckless penalty is assessed

Preparer Penalties (slide 3 of 3)

- $50 for failure to sign return or failure to provide copy of return to taxpayer
- $500 if preparer negotiates refund check payable to taxpayer

Privileged Communications

- Communications between attorney and client are protected from disclosure to other parties (such as the IRS and the tax courts)
  - Similar privilege of confidentiality extends to tax advice between a taxpayer and tax practitioner
  - Not available for matters involving:
    - Criminal charges
    - Promoting or participating in tax shelters

AICPA Standards For Tax Services

- Key provisions include:
  - Do not take questionable position on client’s tax return in hope of it not being audited
  - Client’s estimates may be used if reasonable
  - Try to answer every question on the tax return (even if disadvantageous to client)
  - Upon discovery of an error in prior year tax return, advise client to correct

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

Dr. Donald R. Trippeer, CPA

donald.trippeer@colostate-pueblo.edu

Colorado State University-Pueblo