SO, YOU'VE BEEN AUDITED...

NOW WHAT?

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This pamphlet describes what happens to your tax return and your tax liability from the filing of your return, through an audit, all the way to getting a decision from the Tax Court determining your tax liability. Knowing the audit process can make it less scary, and can give you insight into how to protect your own interests.

I'm very familiar with this process, having spent ten years of my career defending audits in Tax Court as an attorney in the IRS's Office of Chief Counsel. So in the next few pages I'll explain what kind of organization the IRS has, and the functions of the various people involved in handling your return and the audit.

I hope you'll find this information helpful.

-John D. Faucher, Esq.

How Filing May Lead to an Audit

There are two ways to file your tax return. First option: you can print and file a copy of your return and sign it. This requires what the IRS calls a "wet signature," meaning that your original signature is on the return. Alternatively, you can file your return electronically and send it straight to the IRS. This requires a personal identification number, provided through your tax preparer or tax preparation software.

When you file a return physically, it goes to an IRS service center. There are ten of these centers across the country; in California, the tax returns generally go to the service center in Fresno. The IRS service center is a warehouse about 10 acres large. It has all kinds of offices in it; it is well-secured and surrounded by barbed wire. To enter, employees must use key cards. It is a place that stores a huge number of physical tax returns. The center looks like a Costco warehouse with floor to ceiling tax returns. The service centers actually only hold about six months' worth of returns and after a certain time, they get packed up and shipped off to a larger document service center in Iron Mountain, Colorado. While the tax returns are in their original service centers, various IRS personnel take them off the shelves, look at them, type in relevant data, and return them to the shelves.

When the return is electronically filed, all your relevant tax data goes straight into the IRS computers.

The IRS computers, however, are somewhat outdated,hailing from about the 1980s. They don't have the capacity, for instance, to recognize or distinguish text in upper and lower cases and therefore only use upper case letters. Furthermore, the computers use bizarre strings of numbers and three digit transaction codes that tie to a larger computer system. However, e-filing is more accurate than paper filing: the IRS reports a 21 percent error rate in entering paper returns to its computer system, compared with an error rate of 0.5 percent for electronically-filed returns.

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Overall, the IRS uses a very antiquated system compared to the technology used in the private sector today. However, it is a powerful system because of the immense amount of tax returns registered on it which allows employees to cross reference documents and see patterns. This is a common step at which the IRS decides whether to audit a taxpayer.

Selection for an Audit

There are a variety of reasons and ways the IRS can select a taxpayer for audit. If some enemy chose to turn you into the IRS by reporting you, the IRS may or may not audit you. This is somewhat rare because the IRS doesn't usually take this bait unless it can find some independent probable cause. The Informant's tip must have a solid basis and conform to the IRS's initial investigation before it opens an audit. IRS agents sometimes open audits because they become suspicious and question whether a taxpayer should be audited (for example, seeing a flashy car). This agent is able to then look into a taxpayer's affairs through the agency's computers and databases to determine whether further examination is warranted. Or you might be audited because you were chosen entirely at random by the National Research Program, which set a baseline for what an average taxpayer does. Unfortunately, this audit process is very unpleasant because it lasts about four to five days and you must turn in every scrap of paper that records a financial dealing. Finally, the most common reason to be audited is that the IRS computers recognized some sort of factor in a return. For example, if computers determine that a deduction is too high or there are suspicious links between deductions,the IRS will investigate further. The IRS has many programs and methods for auditing, but a taxpayer will rarely find out that he or she has been audited for one of these reasons. Although it is sometimes obvious why the IRS is conducting an audit, it is more often kept secret and not announced.

The IRS will start an audit by sending you correspondence. It won't send an email, or call you.

I've often asked revenue agents why a particular taxpayer has been chosen. "Honestly, I can't tell you, because I don't know myself," is the usual answer. On the other hand, patterns sometimes show themselves: all the clients of a particular accountant may get audited for a specific year if the computers see similar implausible deductions among his tax returns. Generally, the criteria that trigger an audit are closely-held secrets, known only to a few persons in the IRS, and certainly not to auditors themselves.

Like breaking the speed limit, the reason you were audited does not matter. If you are selected for audit and the IRS determines that you owe more tax, your defense cannot be that "I should not have been audited in the first place." The IRS can often extend or continue an audit if it decides to do so, and no court can review that decision. For example, if there is a problem with the return for 2018 and 2019 tax years,

the IRS can expand that audit to the 2020 tax year and look at the same issues. The only time the IRS cannot continue to expand an audit is when agents have already examined an issue for multiple consecutive years and found no change; it cannot reopen that issue again for several years.

The IRS will start an audit by sending you correspondence. It won't send an email, or call you. In fact, if you ever get an email from the IRS from someone you've not met, it is a fake.

The auditor is a federal employee with civil service protection. She may be a member of the National Treasury Employees Union. She will probably have a college degree and several dozen credit hours of accounting classes. She can be straight out of college or at the end of her career. There is a wide variety of talent and ambition among the auditors: some pride themselves on their interactions with taxpayers, others on their investigative abilities or their accounting acumen. Some seem not to pride themselves on anything at all except showing up and leaving the office at the beginning and end of their "tour of duty," or workday. The auditor is usually about six or seven layers of management removed from the Secretary of the Treasury, to whom she ultimately reports. She has a procedure for auditing your case, and you can look it up yourself: the IRS procedures are all published in the Internal Revenue Manual, available online.

The correspondence will invite you to attend an appointment at the IRS office. In rare cases, the IRS will start by asking for a site visit. How you respond to this invitation will determine the tenor, although not necessarily the outcome, of the audit experience. If you show up or call to say that you need a different time, the auditors will generally accommodate you at this stage. If you don't show, the auditor will make a few more efforts to reach you, including possibly calling you. After a few attempts, the auditor will close the cases unagreed: this means that the auditor will determine that you have not substantiated any of the issues she raised, and that you owe as much tax as is possible to assess against you. Because the taxpayer has all the documentation and the IRS starts with none, the taxpayer always has the burden of providing deductions: guilty until proven innocent.

If you show up at the audit, or host the auditor at your business, the auditor will talk to you to find out some of your story: who you are, how much education you have, your work, your business. She'll also ask you to provide documentation for the expenses you've claimed, and sometimes will present you with her reports that seem to show that you had more income than you reported during the tax year. She'll set a deadline for providing the documentation. Usually, failure to meet the first one or two deadlines will not hurt you; the auditor usually has time to keep the audit open.

How an Audit Proceeds

So once an audit is open, how much time does the IRS have to audit you? The IRS has a three-year limitation period on assessment from the time of the return's filing. That means that if three years past from the time you, the taxpayer, filed your return, the IRS can no longer increase your tax debt for that year. So the IRS wants to complete its audit in time to issue its final report well ahead of the three-year deadline. Generally, the IRS will try to complete things six months before the deadline date.

There are some relatively uncommon exceptions to the three-year assessment rule. The IRS gets six years to audit you if it can show a large understatement of income. And if it can show that your return is fraudulent, it can open the audit and assess at any time; there is no statute of limitations on fraudulent returns. Sounds simple, right? But when did you actually "file the return?" Let's take a return for the 2011 tax year. If you filed it before April 15, 2012, the law says that the return was filed on April 15. If you had an extension until October 15 and filed the return on September 1, the limitation period starts on October 15.

If you filed the return late, the law says that it was filed on the day the IRS received it. Obviously, the laws strongly favor the taxing authorities: our legislatures want to make sure that people do not get out of their rightful tax liabilities by skillful procedural moves.

These assessment clocks can be tolled, or extended (and often are) by agreement between the taxpayer and the taxing authority. In such a case, the auditor will ask the taxpayer or his attorney to sign a Form 872, Waiver of Limitation Period. Sometimes this is a good idea, especially if the taxpayer just needs a bit more time to gather records to show to the auditor. Sometimes it's a bad idea, if the tax authority's case is not very strong. If the taxpayer doesn't sign the Form 872, the IRS will issue a Statutory Notice of Deficiency.

The Statutory Notice of Deficiency, sometimes known as a 90-day letter, changes the relationship between the IRS and the taxpayer. Up until that letter is issued, the IRS is just proposing a change to your tax return; you as a taxpayer don't have to agree with it. The Statutory Notice tells you that the IRS is done trying to reach an agreement with you: it has decided how much you owe, and is willing to back that up in court. If the taxpayer doesn't agree with

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the IRS decision (technically called a "determination"), the taxpayer must file a petition with the Tax Court within 90 days of the issuance of the letter.

The statutory notice expresses the determination as a "deficiency," that is, the difference between what was shown on the tax return and what the tax return should have shown. In addition to the deficiency, the notice will also show any penalties owed (including failure-to-pay, failure-to-file, negligence, and fraud). The petition must be filed within 90 days or the Tax Court won't hear the case. "Filed" means put in the mail or delivery service (FedEx, UPS) by midnight of the 90th day. There is a wealth of case law on when petitions were actually "filed" under the timely mailing rule. If you think there will be any problem with the filing, it is best to send the petition by registered mail with a return receipt requested.

The taxpayer chooses whether to file the case as a "small" case or a regular case. A small case for a deficiency of less than $50,000, and cannot be appealed. The advantage is that the case may be heard quicker, and because it cannot be appealed nor used as precedent, the judge may bend the law in the taxpayer's favor.

Back to the audit process. Once the taxpayer brings the requested documentation back to the auditor, she will look it over and determine what is allowable. I advise clients to make this step as easy as possible for the auditor: collect receipts and list them in a spreadsheet. The more legible, the better. Provide explanations for why particular items are included. For meal receipts, include the names of the participants and the nature of the business conducted. For mileage logs, refer the mileage notations to objective evidence showing that the car actually drove this far (such as repair bills). The more documentation, the better: the IRS agent starts with the assumption that you are entitled to no expense deduction until you can prove that you actually incurred the expense. Logic only works against the taxpayer at this stage: you can argue that it is impossible to conduct your business without driving at least 10,000 miles a year, and the agent may even agree with you on an abstract level, but unless she sees some objective evidence rather than deduction that you actually drove something, she will allow nothing. The taxpayer has to prove all his deductions.

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Income is another story, because the IRS has the burden of proof. The IRS usually finds unreported income by doing a bank deposits analysis. It takes all of a taxpayer's bank statements

from the audit year, adds up all the bank deposits on those statements, and tries to subtract all the non taxable deposits (loan proceeds, gifts, transfers between the taxpayer's accounts). That number is total income; it compares this figure to the income reported on the return. It sounds simple, but the results can be amazingly confusing. Another method of finding unreported income is by third-party reports: payers issue forms 1099 to a taxpayer, and the IRS may compare these reports to the income reported on the taxpayer's return.

If there is a discrepancy, the IRS may go so far as to issue a Statutory Notice of Deficiency based on the unreported income; however, it cannot win on this issue in court without further evidence, usually by calling a witness from the payors to say that yes, the payor actually paid the amount shown on the Form 1099.

At the end of the audit, the agent will issue a report, and send it to the taxpayer. The report (Form 4549) will include some sketchy explanations and computations. It will also include a consent form, because the government wants to make it easy to agree with its findings. If the taxpayer disagrees, then it's usually worth it to call up the auditor to go over the findings and talk about disagreements.

If I teach anything about the IRS, it is that it is worth it to pursue genuine good-faith disagreements. If the taxpayer refuses to agree with the IRS determination, he will enter a bureaucratic process in which a succession of ever-more-powerful actors consider his argument. The auditor is at the bottom of the IRS hierarchy, and has little discretion. Procedures and documentation are most important to her, and she probably will not and cannot allow any items without documentation. If she hasn't seen the issue before and it is very unusual, the auditor is likely to disallow the expenses on the theory that she cannot know the right result herself, but the bureaucratic process after her will reach the right result.

Let's assume a real issue I saw while at the IRS: the taxpayer, an attorney, had a Schedule C business (thus all income and expense for the business was taken on the taxpayer's Form 1040 individual return). The business was in training phone sales people. The taxpayer had to fly to seminars up to 1500 miles away, so the taxpayer purchased an airplane, used it in his business, rented it to other people, and claimed the airplane operating losses on Schedule C. The auditor said no, the airplane activity is a passive activity under IRC 469, and so the expenses can only be claimed against the airplane rental income. I'll refer to this issue throughout this pamphlet.

Appealing an Auditor's Decision

The bureaucratic process continues with the auditor's chain of command. The auditor has a group manager. The group manager got there by being a good and loyal revenue agent; all promotion at the IRS is from within. This group manager has more discretion than the revenue agent, and will probably meet with a taxpayer who politely but firmly articulates a disagreement with the auditor. The manager on the airplane rental activity also punted: the passive activity rules are incredibly complex, she didn't know the right answer, she didn't trust the attorney-taxpayer's reading of the law, she disallowed it.

If you, as a taxpayer, don't like the results after meeting with the auditor and her manager, the next step is to take your disagreement to an appeals officer. The IRS Office of Appeals is a separate function from the audit function: appeals officers are experienced in their area (audit or collections), and have no prior involvement with the particular taxpayer.

A taxpayer can get appeals consideration either before or after filing a Tax Court petition. Appeals Officers have even more discretion than audit managers to resolve issues. But they cannot reach a result that violates the law. For the airplane leasing activity, the appeals officer also decided to go along with the audit result. Notice that the auditor's report becomes the government's default position: the taxpayer must convince the successive decision makers (group manager, appeals officer, and so on) that the audit report is wrong. But each successive decision maker can make the case go away: if the taxpayer succeeds in convincing a single decision maker that the report is wrong, he gets the result he wants. Filing a Tax Court petition puts the audit issue in front of the Office of Chief Counsel of the IRS. Chief Counsel attorneys tend to be relatively pleasant and intelligent people; many taxpayers told me and my colleagues that we were the nicest people they had met at the IRS. The attorneys come from ABA-accredited law schools, and as best as I could tell, the main quality sought is collegiality.

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Attorneys have even more discretion than appeals officers. As a matter of course, the Chief Counsel attorney will send the Tax Court case to an appeals officer for resolution before considering it. If Appeals cannot settle the case, the Chief Counsel attorney will almost always offer at least one meeting with a taxpayer before trial.

In fact, the Tax Court rules require the parties to meet, confer, and prepare a stipulation outlining the facts on which they agree and disagree prior to the cases trial.

In the airplane rental case,the Chief Counsel attorney did not settle the case. Her analysis said that the training and the airplane rental were separate activities; the taxpayer said they were an economic unit. Because they could not agree,the case went to trial. At any time before trial, the airplane-rental taxpayer had the option of agreeing with the IRS determination and ending the process. For the IRS to concede a case, however, the Chief Counsel attorney must write a memo to her group manager convincing him that the audit result is wrong. The group manager is another attorney who did well as a line attorney.

Trial puts the taxpayer in front of the decision maker with the most discretion of all: the Tax Court Judge. These judges are appointed by the President under Article I of the Constitution (the Executive Branch). Unlike Article III judges, Tax Court judges do not serve for their lifetime, and can suffer pay cuts; they have a 15-year term. The Tax Court sits in Washington, D.C., and the judges "ride circuit," that is, they hear cases all over the country. Large cities such as Los Angeles get 10-15 visits from Tax Court judges per year, each visit for one to two weeks. Smaller cities (Fargo, ND, for instance) will get one two-day visit a year. Judges come most often from private firms, sometimes from the IRS or from the Department of Justice.

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Federal Rules of Evidence and specialized procedural rules apply in a Tax Court case. And yet the procedures are loose enough that an individual lay taxpayer can effectively conduct a case against the IRS: the judges seek to let the taxpayers tell their story. The feeling is more formal than a traffic court, and less friendly to the government than that forum. If you need to go before the Tax Court, you may not need an attorney to prevail. Talk to one anyway.

After trial, the judge will ask for the parties to submit briefs. Depending on the issues in the case,the IRS attorney may need to send her brief to the National Office for review (the airplane-rental case required national office review because it was an alleged passive activity). After receiving briefs, the judge will take the case "under advisement," and issue a written decision after due consideration. In one case I tried while at the IRS, the judge issued his opinion and decision six and a half years after the briefs were submitted.
The opinion is the published rationale for the decision. The decision states solely how much of a deficiency is

determined against the taxpayer.

Either the IRS or the taxpayer may appeal the Tax Court's Decision. The appeal goes to federal Court of Appeals for the circuit where the taxpayer lives (in California, that is the 9th Circuit). Appeals can only allege that the judge applied the law wrongly; the appeals court does not want to hear the facts again, and assumes that the trial judge knew the facts better than the circuit court ever will.

If the case is an S case (small case) the case cannot be appealed, and the judge is not bound by the Rules of Evidence. I have seen Tax Court judges bending the law to favor taxpayers in S cases, reaching results that they never would if the case were reported as precedent. In one case, the judge awarded the taxpayer deductions for clothing and meals although clearly not allowable under settled law; he was just very impressed by the taxpayer's professional demeanor and her honesty in other matters.

On that particular case, I cannot say I won as the government's attorney: the judge found against my position. Did I care? No. I was a government employee with no skin in the game beyond that of a regular citizen. And that illuminates another point: your adversaries at the IRS don't take the audit personally. They are doing a job. Your audit will not make or break their career. Make their job easy for them, and you are more likely to get the result you want.

Once you have agreed to an amount you owe, or the Tax Court decides how much you owe, the IRS assesses the tax. The decision is final, and the IRS gets to start its collection process. And that is a subject worth a whole other pamphlet.