



Welcome to TaxMama's Place Home of the



Representing Your Client at a 1040 Audit



Table of Contents

- **Meet Your Instructors**
- **Resources**
- **Evaluations and Thanks!**



Who is Eva Rosenberg MBA, EA



Eva Rosenberg, EA, Your TaxMama® has been teaching Enrolled Agents Exam review courses off and on since developing the program for UCLA Extension over 15 years ago. These days, she's teaching her own course online at www.irsexams.com

Eva has a BA in Accounting and an MBA in International business. Your TaxMama® is a TaxWatch columnist for Dow Jones' www.MarketWatch.com and author of the ever-popular book, Small Business Taxes Made Easy, published by McGraw-Hill – new edition – just released!

As a speaker, TaxMama® is popular with both tax professionals and taxpayers.

You can find her at www.TaxMama.com and subscribe to her free daily podcast at www.TaxQuips.com



Who is Tom Buck, CPA



Tom Buck, CPA is a published author, tax coach, teacher And mentor. He has been a licensed CPA since 1971 and has been in private practice since 1982.

Tom was chairman of the Nevada Society of CPAs Taxation Committee. Tom has been representing taxpayers and solving IRS problems ever since the landmark Casino employee cases in 1982.

The approach Tom takes and that he would like to pass on to you is this: the “science” of the work is the law and how it should be applied. The “art” is being able to counter any and all IRS measures which are not supported by law. Does the IRS always follow the rules? Of course not, so part of the “art” is really in forcing the IRS to obey the law. Of course, having the tenacity of a bulldog is often the critical ingredient. In the final analysis, once you determine what the outcome should be, then you must be ready to take any detours necessary to get your client to the finish line.

Tom is a willing and helpful teacher and looks forward to sharing his hard-gained knowledge.



AUDITS ARE FUN!



AUDITS ARE FUN!

This is my totally favorite part of being an enrolled agent.

I love the investigative part of this, building the case, doing the research to prove my position if a tax law or procedure might be in doubt. I love being able to find replacement deductions for the errors on the tax returns that have been brought to me.

Most of all, even when everything's wrong, I thoroughly relish being able to find a win-win solution that enables IRS to win, without my client really losing.



**Fun, Even
When you Lose**



For instance, many years ago, I gave the Appeals Officer copies of my in depth research on an alimony deduction taken by a man whose divorce agreement specifically spelled out that there was no alimony, building a case for his payments to actually BE alimony.

Do you think I won the case?



The Divorce on Appeal



Well....sort of.

The Appeals Officer **wrote** in his decision that he would never even have considered this ridiculous matter at all, except that the representative presented such a good case, that he was compelled to waive all the penalties.

This saved the client over \$5,000 worth of penalties, plus all the related interest.

THIS is the benefit the research skills you're going to learn. Use those skills and resources as the foundation for what you are about to learn about IRS audits.



What's if you don't know how to Research?



NAEA research service - \$35-\$75 per question for members, \$100+ for non-members

<http://www.naea.org/MemberPortal/Research/>

NATP research service – 1 question free for members, then \$28. \$58 for non-members

<http://www.natptax.com/TAXKNOWLEDGECENTER/RESEARCH/Pages/NATPResearch.aspx>

NSA member – first 5 questions are free to members, then \$25 -\$40

<http://www.nsacct.org/MembersOnly2/NSATaxHelpDesk/tabid/7014/Default.aspx>

AICPA technical hotline – free to members. Other resources on this page.

<http://www.aicpa.org/Research/TechnicalHotline/Pages/AATechnicalHotline.aspx>

Learn Tax Research at CPE Link

Live- June 28 , Conducting Tax Research with Increased Confidence by Annette Nellen

<http://www.cpelink.com/product/detail.php?p=2401>

Self-Study - Doing Tax Research Online for Free by Eva Rosenberg, EA

<http://www.cpelink.com/product/detail.php?p=2283>

Self-Study - Conducting Tax Research with Increased Confidence by Annette Nellen

<http://www.cpelink.com/product/detail.php?p=1166>



Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

This mission statement describes our role and the public's expectation about how we should perform that role.

- In the United States, the Congress passes tax laws and requires taxpayers to comply.
- The taxpayer's role is to understand and meet his or her tax obligations.
- The IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.

<http://www.irs.gov/irs/article/0,,id=98141,00.html>



IRS Office Audits



Stats for Audits from 1996 – 2002 (latest numbers)

<http://www.irs.gov/pub/irs-soi/02rtctab5d.xls>

Schedule C and Schedule F audits in 2002 - 20,741 down from 54,662 in 1996

Return Type/Examination Class	1996	1997	1998	1999	2000	2001	2002
Total Sum of Returns Below	352,054	333,606	236,553	158,746	91,785	71,339	70,511
Individual income tax returns, total	343,846	322,131	229,523	153,981	87,741	68,006	67,586
Nonbusiness returns:							
Forms 1040A with TPI under \$25,000 [1]	71,150	58,249	40,828	25,808	14,731	10,515	6,150
All other returns by size of TPI:							
Under \$25,000	39,707	33,382	20,938	13,395	7,360	5,023	3,795
\$25,000 under \$50,000	85,454	75,170	53,632	33,048	18,697	15,073	11,778
\$50,000 under \$100,000	63,437	60,668	44,979	30,878	15,876	11,688	13,771
\$100,000 or more	29,436	25,858	18,553	14,764	9,475	8,447	11,351
Business returns:							
Schedule C returns by size of TGR:							
Under \$25,000	19,486	22,521	16,866	11,450	6,905	5,830	5,662
\$25,000 under \$100,000	24,032	32,289	22,192	16,421	10,043	7,913	9,855
\$100,000 or more	8,531	11,392	9,929	7,273	4,191	3,198	4,687
Schedule F returns by size of TGR:							
Under \$100,000	1,807	1,977	1,247	722	326	235	411
\$100,000 or more	806	625	359	222	137	84	126



Examination of Returns



IRS Publication **556** Examination of Returns, Appeal Rights, and Claims for Refund

<http://www.irs.gov/publications/p556/index.html>

Your return may be examined for a variety of reasons, and the examination may take place in any one of several ways. After the examination, if any changes to your tax are proposed, you can either agree with those changes and pay any additional tax you may owe, or you can disagree with the changes and appeal the decision.

The three main reasons your returns can be selected for audit are:

- 1) DIF Scores
- 2) Third Party Documents, like W-2s, 1099s, etc.
- 3) Third Party Sources reporting non-compliance



Selected by DIF Scores



Examination selection criteria. Your return may be selected for examination on the basis of computer scoring. A computer program called the **Discriminant Inventory Function System (DIF)** assigns a numeric score to each individual and some corporate tax returns after they have been processed. If your return is selected because of a high score under the DIF system, the potential is high that an examination of your return will result in a change to your income tax liability.



Third-Party Documentation and Data



Your return may also be selected for examination on the basis of information received from third-party documentation, such as Forms 1099 and W-2, that does not match the information reported on your return. Or, your return may be selected to address both the questionable treatment of an item and to study the behavior of similar taxpayers (a market segment) in handling a tax issue.

Note: Routine omissions will just trigger a CP-2000 notice. Those can usually be handled with one written response. More later.

Third-Party Reports – Turned in by former friends, spouses, lovers, or current neighbors, employers, co-workers, etc.

Form 3949a is an Information Referral form -

<http://www.irs.gov/pub/irs-pdf/f3949a.pdf>

Form 211 provides for a reward. <http://www.irs.gov/pub/irs-pdf/f211.pdf>

More common Third-Party sources – Facebook, newspaper stories, radio or TV news or reports featuring your client.



- Correspondence
- Office audit – held in the IRS office (or by correspondence)
- Field audit – best if held in the tax accountant’s office rather than client’s business
- Lottery audit (has been called TCMP and NRP)
- Special projects and informant tips (much more lucrative now)
- Payroll tax audits – be aware of independent contractor projects again



It all starts with audit invitation letter, which contains the IDR (Information Document Request)

- Auditor will request face-to-face with taxpayer, don't give into this request (cite IRC 7____) you are the client if you have a POA on file
- IDR will explain all issues that you will need to deal with
- Usually will show a time and place for taxpayer to show up with requested records



Response to the IDR



- You will need POA to represent taxpayer
- Contact the auditor, in writing, send POA and request additional time to respond (request change of venue if needed)
- Be cautious not to even appear to be delaying the audit, IRS could get past your POA in some cases)
- If you need to represent you client from afar – IRS may balk and require your physical presence. Simply provide everything requested via email or fax. If IRS closes “unagreed” you have full Appeals rights



Change of Venue



Transfers to another area. Generally, the return is examined in the area where the client lives. But if the return can be examined more quickly and conveniently in another area, such as where the books and records are located, you can ask to have the case transferred to that area.

i.e. Have the client send you all the books and records before requesting the change of venue to your location.



Canceling an Audit before it Starts



Repeat examinations. The IRS tries to avoid repeat examinations of the same items, but sometimes this happens. If your tax return was examined for the same items in either of the 2 previous years and no change was proposed to your tax liability, please contact the IRS as soon as possible to see if the examination should be discontinued.

If the audit must go forward....be informed.



Before the Audit – Know What IRS Knows



- 1) Get all information on client in IRS records –
 - 1) either ask examiner for all third-party records,
 - 2) or call Practitioner Priority Service 866-860-4259
 - 3) Or log into e-services with your POA
- 2) Look up IRS Audit Technique Guides and MSSP guides for your client's business <http://www.irs.gov/businesses/small/article/0,,id=108149,00.html>
- 3) Look up industry standards for expenses - <http://www.irs.gov/businesses/small/industries/index.html>
Biz Miner – look up sample P&L by Industry
<http://www.bizminer.com/products/analysis/industry/micro/profit-loss>



Recordings. You can make an audio recording of the examination interview. Your request to record the interview should be made in writing.

You must notify the examiner 10 days in advance and bring your own recording equipment. The IRS also can record an interview.

If the IRS initiates the recording, you must be notified 10 days in advance and you can get a copy of the recording at your expense.

So, if IRS wants to record the session when you get there, what do you tell them?

Should you record the audit?



Confidentiality Privilege



Before submitting your POA and scheduling the appointment – get as many details as possible from the client to determine if you want to handle the audit.

Generally, the same confidentiality protection that you have with an attorney also applies to certain communications that you have with federally authorized practitioners.

Confidential communications are those that:

- Advise you on tax matters within the scope of the practitioner's authority to practice before the IRS,
- Would be confidential between an attorney and you, and
- Relate to noncriminal tax matters before the IRS, or
- Relate to noncriminal tax proceedings brought in federal court by or against the United States.

What do you do if criminal issues crop up?



Hire Attorney



That's right.

Have the client hire an attorney.

Let the attorney hire you.

Now you are operating under the attorney's privilege,
which is a broader umbrella.

Be SURE to keep the attorney in the loop.

Be SURE you get paid by the attorney – not the client.



Let's Get Ready to Work on the Audit



Forms for IRS in a 1040 audit



Most likely forms for IRS to audit in a 1040 audit

- Schedule A
- Schedule C and F
- Schedule E - Rentals



Schedule A – Itemized deductions



1. Contributions
 - a) Contemporaneous receipts required
 - b) Non-cash, especially cars, etc.
2. Medical expenses – DIF scores used here
3. Mortgage interest, especially if not supported by form 1098, received by IRS
4. 2106 issues (largely similar to Schedule C expenses in scope)
5. Casualty losses, especially based on new Ponzi scheme rules



Schedules C and F



Schedules C and F (taken together because audit approach is similar) This is where IRS thinks much of the “tax gap” resides. We’re going to expand on these issues:

- Bank Statements (unreported income)
- Substantiating Expenses
- Office in Home
- Hobby Loss



- Bank statements re: unreported income
- 100% of business income S/B deposited
- Proof of Cash will eliminate non-income deposits
- Make sure you don't show a negative Gross Profit (Cost of Goods problem)



Proof of Cash



DATE	DEPOSITS	INCOME	TFR	Pension	W2	Misc	Desc
1/2/2007	138.71	-	-	138.71	-	-	
1/30/2007	166.67	-	-	-	166.67	-	
1/31/2007	1,663.50	1,663.50	-	-	-	-	
2/1/2007	139.93	-	-	139.93	-	-	
2/6/2007	102.95	-	-	-	102.95	-	
2/26/2007	166.67	-	-	-	166.67	-	
3/1/2007	139.93	-	-	139.93	-	-	
3/8/2007	900.94	-	-	-	-	900.94	Wire Tfr Deposit
3/19/2007	150.00	-	-	-	-	150.00	OLB Tfr
4/2/2007	139.93	-	-	139.93	-	-	
4/19/2007	166.67	-	-	-	166.67	-	
4/23/2007	280.00	280.00	-	-	-	-	
5/1/2007	144.13	-	-	144.13	-	-	
5/2/2007	22,875.00	22,875.00	-	-	-	-	
6/1/2007	144.13	-	-	144.13	-	-	
6/14/2007	2,000.00	-	2,000.00	-	-	-	Tfr fr Pension a/c
6/14/2007	1,500.00	-	-	-	-	1,500.00	was Reversed
6/29/2007	2,500.00	-	2,500.00	-	-	-	Tfr fr Pension a/c
7/13/2007	500.00	-	500.00	-	-	-	Tfr fr Pension a/c
7/24/2007	500.00	-	-	-	-	500.00	Tfr from?
7/2/2007	144.13	-	-	144.13	-	-	
8/15/2007	1,100.00	1,100.00	-	-	-	-	
8/17/2007	166.67	-	-	-	166.67	-	
8/27/2007	400.00	-	-	-	-	400.00	Tfr from?
8/1/2007	144.13	-	-	144.13	-	-	
8/21/2007	500.00	-	-	-	-	500.00	Tfr from?
8/31/2007	144.13	-	-	144.13	-	-	
10/25/2007	4,650.00	4,650.00	-	-	-	-	
10/1/2007	144.13	-	-	144.13	-	-	
11/13/2007	1,900.00	2,000.00	-	-	-	(100.00)	
11/1/2007	144.13	-	-	144.13	-	-	
11/19/2007	6,000.00	6,000.00	-	-	-	-	
11/29/2007	144.13	-	-	144.13	-	-	
	<u>49,900.61</u>	<u>38,568.50</u>	<u>5,000.00</u>	<u>1,711.54</u>	<u>769.63</u>	<u>3,850.94</u>	



Any and all expenses take could be challenged – these are the most common

- Car and truck expenses (logs, etc.)
- Depreciation
- Employee benefits (need to have employees – IRC sec 105)
- Interest expense
- Office Expenses or Supplies (possibly hiding asset purchases or loan payments)
- Professional fees (possibly hiding personal expenses)
- Rental expenses AND Office in Home – beware!



Travel and entertainment expenses

- Travel meals - only out of town overnight
- Meals or entertainment with a business associate (only 50%) or incident to business activity
- \$75.00 rule
- Meals served in your office, home or client venue sometimes 100% deductible
- Special rule for DOT drivers – now 85%



Red flag or routine business?

- Accurate square footage measurements
- Remember ALL places you use for business
- Repairs or improvements
- Exclusive and regular use
- Exterior maintenance only if people visit for business purposes



Make sure you can show a profit motive.

If not?

- Business Plan showing when profit is expected
- Demonstrate business-like operation of business
- No profits due to disasters or unexpected events

Note: Eleven consecutive years of losses has been accepted by US Tax Court – why?



Schedule E - Rentals



- Any expense taken is subject to question
- Special attention to repair vs. improvement
 - Rental income (loss) is passive
 - Review personal use days vs rented days
 - Up to \$25,000 loss (rental real estate only) phases out between AGI \$100K and \$150K in which case the losses are suspended until property becomes profitable or is sold
 - Must be actively involved – making management decisions



Exception for Real Estate Professionals



Real Estate Professionals, may take 100% of losses, regardless of income, if qualified

- Material participation qualifiers
 - At least 750 hours activity on properties in which owner materially participates – spouses activities count
 - More than 50% of personal services performed during year must be in R/E as item I above
- May aggregate activities on all properties in order to qualify, but must make the election. Can now make election up to six months after timely filing
- Material Participation vs Active Participation



Fundamentals of Audits



- a. Provide lead schedules for each item and offer to provide any detailed backup requested by the auditor
- b. Don't spend a lot of time on issues that you really can't defend
- c. Try to start off discussing items you have excellent records on. (Great mileage log may truncate audit while sloppy records could cause it to become more in depth.
- d. Use affidavits when you can't provide third party records to prove deductions.
- e. Always be on the lookout for expenses the taxpayer forgot to report or didn't know he was entitled to
- f. IRS is now more likely to audit flow-through entities more than in recent past ("tax gap" issues)



Practice Tip



PRACTICE TIP: Before going to the audit, discuss with your client how much they are willing to pay, based on your assessment of the correctness of their return, and the additional, replacement expenses or losses you've found.

Have them sign a letter or document to confirm that they agree to let you sign off on their audit if the balance due is that amount or less. (For your protection.)

During the audit, if you end up with a balance due within those parameters - or 'No change' - sign the audit report on the spot.

Yes, auditors can spew it out of their computer if you sit quietly and patiently for about 10 minutes. Bring something to read. Do NOT sit there and text or work on a keyboard. Be QUIET.



You Do Not Agree



If you do not agree with the proposed changes, the examiner will explain your appeal rights. If your examination takes place in an IRS office, you can request an immediate meeting with the examiner's supervisor to explain your position. If an agreement is reached, your case will be closed.

If you cannot reach an agreement with the supervisor at this meeting, or if the examination took place outside of an IRS office, the examiner will write up your case explaining your position and the IRS' position. The examiner will forward your case for processing.



The LETTERS



30-day letter

Within a few weeks after your closing conference with the examiner and/or supervisor, you will receive a package with:

A letter, known as a 30-day letter, or a Notice of Proposed Income Tax Deficiency notifying you of your right to appeal the proposed changes within 30 days,

- **A copy of the examination report explaining the examiner's proposed changes,**
- **An agreement or waiver form, and**
- **A copy of Publication 5.**

You generally have 30 days from the date of the 30-day letter to tell the IRS whether you will accept or appeal the proposed changes. The letter will explain what steps you should take, depending on which action you choose. Be sure to follow the instructions carefully. *Appeal Rights* are explained later.



90-Day



***90-day letter.* - The Statutory Notice of Deficiency -**

If you do not respond to the 30-day letter, or if you later do not reach an agreement with an Appeals Officer, the IRS will send you a 90-day letter, which is also known as a notice of deficiency.

You will have 90 days (150 days if it is addressed to you outside the United States) from the date of this notice to file a petition with the Tax Court.

The notice will show the 90th (and 150th) day by which you must file your petition with the Tax Court.



Summary



- Interview your client in depth before accepting the audit engagement.
- Schedule the appointment far enough in advance to prepare properly.
- Gather all the information the client has – and that IRS has.
- Prepare solid, clear workpapers – and give the examiners a copy for their files.
- Know what deductions you will lose, or what extra income has cropped up.
- Have replacement deductions ready.
- Advise your client of projected audit results – especially if they are going to have a substantial balance due – due to their own omissions or record-keeping. (Have them sign it.)
- Have a strategy prepared to fight the audit, if you expect to lose, once you've meet the examiner.



Resources



IRS Examination Correspondence http://www.irs.gov/irm/part4/irm_04-004-007.html

Practitioner Priority Service 866-860-4259

IRS National Research Program – random audits - <http://www.irs.gov/newsroom/article/0,,id=171023,00.html>

IRS Comparison of TCMP and NRP results 1988-2001 <http://www.irs.gov/pub/irs-soi/08resconcomparty88.pdf>

Small Business Taxes Made Easy – Chapter 13 <http://taxmama.com/small-business-taxes-made-easy/>

IRS Audit stats for 1996 – 2002 <http://www.irs.gov/pub/irs-soi/02rtctab5d.xls>

IRS Form 211 – Reward for being the first one to turn someone in
<http://www.irs.gov/pub/irs-pdf/f211.pdf>

IRS Audit Technique Guides <http://www.irs.gov/businesses/small/article/0,,id=108149,00.html>

IRS industry information - <http://www.irs.gov/businesses/small/industries/index.html>

Biz Miner – look up sample P&L by Industry <http://www.bizminer.com/products/analysis/industry/micro/profit-loss-income-statement.php>



Thanks for coming.

Remember to give CPE Link your evaluations.

Drop by to sign up for other TaxMama classes –

<http://www.cpelink.com/teamtaxmama>

The next class in the series is – Curing the Addicted Tax Delinquent – a 12-Step Program

Series are available as Self-Study or Resources:

- The Tax Practice Series - Taxpayer representation – Collections, Offers In Compromise, other payment alternatives
- TaxMama's Courses