The Nuts and Bolts of an IRS Audit and the Collection Process

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The IRS audit process is rife with procedural rules to ensure taxpayers are notified before action is taken against them and they have me to respond. However, these procedures also introduce added complexity for tax professionals who may face multiple pressures—they may lack expertise in handling audit and collection matters and/or their clients may have delayed in getting them involved in the matter and deadlines are looming. This overview is intended to guide tax professionals in handling these matters effectively.

I. Selection of Returns for Audit

The IRS uses several methods to identify returns for audit. It uses a process called Discriminant Function Scoring to assign scores to returns based on items or amounts that deviate from national norms, as well as other factors that IRS studies have found to be indicators of possible noncompliance. Tax returns may also be selected for audit through information document matching from forms such as W-2s and 1099s by comparing them to filed tax returns. Additionally, the IRS may select returns for audit based on related examinations or informant claims.

Once returns have been identified, a significant amount of groundwork is conducted before the auditor contacts a taxpayer. For example, auditors typically conduct internet research on the taxpayer, review reports from asset locator services, and compare information from third-party reporters to that reported on the return. The examiner will prepare a cash analysis to determine if the taxpayer has sufficient income to meet his or her expenses. The examiner will review returns to identify large or unusual items. A three-year comparative analysis of the taxpayer's returns will also be prepared.

Importantly, the examiner will consider the taxpayer's current financial situation and collectability in determining audit scope. Based on this analysis, the auditor may choose to "survey" the return as not warranting further examination. At this state, prior to the taxpayer being contacted, the final determination is made by a manager. The examiner may also choose to survey a return if an examination is deemed unlikely to result in a material change. Extraordinary circumstances, such as death,

terminal illness, or bankruptcy, may also warrant survey of the return.

II. The Audit Process

There are three main types of audits: correspondence examinations, service center (or office) examinations, and field examinations, each with its own procedures and forms for notification. One specific type of correspondence examination is a CP2000 Notice based on the automated under- reporter program. A taxpayer will receive a CP2000 Notice if his or her income and/or payment information on file from third parties doesn't match the information reported on his or her tax return. The Notice will show amounts reported on the return compared to the amounts reported to the IRS along with the proposed adjustments. Most correspondence examina ons are commenced with a Letter 566, which lists the issues in question and requests information and documents. A correspondence examination report is issued by Le er 915 showing the proposed changes. If a taxpayer disagrees, they have 30 days from the notice date to appeal. However, if the statute of limitations is within six months of expiration, the IRS may just issue a statutory notice.

Examiners make first contact via telephone or letter. If a taxpayer fails to respond to an initial contact letter (and it was not returned as undeliverable) or does not appear for an initial appointment, the examiner must make follow up attempts to contact the taxpayer—by certified mail with return receipt. The IRS must wait 10 calendar days from the date the certified mail was delivered for the taxpayer to call.

If no contact is made, in an office audit, the IRS will issue a report disallowing the expenses under exam if income is not at issue. If income is at issue, the Tax Compliance Officer must follow the procedures in IRM 4.10.4. In a field audit, the examiner must continue with normal audit procedures including minimum income probes, summons, and third-party contacts. Form 4564 is used to document all information and documents need to support items under audit, including specific requests for records, information, and documents needed at the initial interview. The requests should include the particular activity and time period. In an office exam, Form 4564 is mailed to the taxpayer with the initial contact letter. In a field exam, Form 4564 will be sent with the appointment confirmation letter.

In office exams, the initial appointment should be scheduled within 28 to 35 days of the initial contact. Rescheduling the initial appointment beyond 45 days from initial contact requires a group manager's approval. Office exams are conducted in the IRS office closest to the taxpayer's residence, usually lasting two to four hours.

In field exams, the initial appointment should be scheduled within 14 to 21 days of the initial contact. Field examiners have the responsibility to determine the most reasonable place to conduct the exam. Requests to change the location are considered on a case by case basis. Examiners will visit the taxpayer's place of business to establish facts such as inventory and assets. Representatives should participate, as taxpayers conducting the tour alone may inadvertently make unnecessary disclosures. The tour should not disrupt business operations. Tours are usually conducted after the initial interview but early in the exam. Compliance Officers are required to issue a report and Letter 915 at the conclusion of each meeting. Protest may be filed within 30 days of Letter 915. Taxpayers must protest even if the exam is not yet concluded.

Generally, the examiner issues a report at the conclusion of the initial appointment even if the taxpayer indicates that there is additional relevant information. However, the report may be revised based upon same. The parties can decide on a mutually agreeable date by which the additional information will be submitted. The submittal can be by either mail or fax. If the examiner does not issue a report, the parties should agree to a mutually agreeable date by which the taxpayer will submit additional information. Whether or not a report was issued, an information document request (IDR) should be issued to request the additional information. A closing conference is generally not required in cases where the parties reach an agreement. In unagreed cases, a closing conference will be held. In agreed cases, the report is issued when agreement is reached on the last of the disputed issues.

Generally, for individual returns the IRS attempts to complete audits within 26 months of filing. For business returns, the period is within 27 months of filing.

After the audit is concluded, a Form 915 will be sent to the taxpayer. The 30-day response me starts on the date of the le er, not the date it is received. A Notice of Deficiency is issued when there is a proposed tax deficiency to which the taxpayer does not agree and the statute of limitations is about to expire and no extension can be granted, or the taxpayer does not properly

respond to the 30-day letter, or the taxpayer requests the issuance of the notice in order to file a petition in the U.S. Tax Court. A petition to the U.S. Tax Court must be filed within 90 days of the issuance of the statutory Notice of Deficiency.

There are several steps that practitioners can take to mitigate audit risk. They should obtain and review the taxpayer's wage and income transcripts prior to completing a return. This will help avoid CP2000 audits. Returns should also be compared to those for the preceding year to ensure that all carryforwards are correct and to identify any missing schedules or forms. This will also ensure the accuracy of depreciation schedules and identify any unreported income. A practitioner should have his or her client complete and sign a tax organizer prior to preparing the tax return. Finally, a practitioner should advise clients of the importance of maintaining records including me records, mileage logs, etc.

III. Statute of Limitations

Internal Revenue Code §6501 provides a statute of limitations on assessments of three years from the original due date of the return or the date of filing, whichever is later. This can be extended to six years if a taxpayer has understated his or her gross income by more than 25%. The statute can also be extended by mutual agreement with Form 872. There is no statute of limita ons on assessments involving false or fraudulent returns, willful a empts to evade tax or if no return has been filed. The statute of limitations for collections is ten years from the date of assessment. This can be tolled by events such as bankruptcy, a pending Offer in Compromise, or a Collection Due Process Hearing. The statute of limitations on a refund claim is three years from the filing of the return or two years from the payment of the tax, whichever is later.

IV. The Collection Process

Before the IRS can begin taking collection actions it must provide notice to the taxpayer. The initial notices inform the taxpayer of the balance owed for a tax period as well as any additional interest and penalties due.

Subsequent to those relatively polite notices, the IRS will issue more aggressive sounding notices, such as the CP504 Notice of Intent to Levy. However, the IRS can only do some soft collection actions at that me, such as keeping the taxpayer's NYS tax refunds. It isn't until the IRS issues a Final Notice of Intent to Levy that it takes the final step towards enforcement and collection.

To issue a bank levy, the IRS sends a Form 668-A, which obliges the institution to hold any funds for 21 days before sending them to the IRS. The IRS can also levy a taxpayer's wages by sending Form 668-W, No ce of Levy on Wages to the taxpayer's employer.

If a tax isn't paid after a formal request, the IRC grants the IRS an automatic or "silent" lien against all of a taxpayer's property and rights thereto.

In general, taxpayers are afforded an opportunity to request a Collection Due Process hearing when they receive one of the following notices: No ce of Federal Tax Lien Filing, Le er 3172 (I.R.C. § 6320); Final Notice - Notice of Intent to Levy and Notice of Your Right to a Hearing, Letter 1058 (I.R.C. § 6331(d)); Notice of Jeopardy Levy and Right of Appeal, Letter 2439; Notice of Levy on Your State Tax Refund - Notice of Your Right to a Hearing, CP 92; or a Final Notice Before Levy on Social Security Benefits, CP 298.

If the taxpayer receives a levy notice, they have 30 days from the date of the notice to request for a Collection Due Process ("CDP") hearing. However, for a lien notice, the 30-day period begins five days after the notice is filed. The letter usually provides the deadline; however, if in doubt, use the date on the letter.

The CDP hearing is requested by filing Form 12153 and sending it to the address provided on the levy or lien notice; or, if no specific address is provided, to the return address.

Hearings are conducted by a neutral Settlement Officer with no previous involvement in the case. The taxpayer may request that the officer consider whether the IRS's collection decision (lien, levy) was appropriate. The officer has the responsibility of first verifying that procedures relating to creating the federal tax lien or proposed levy have been duly satisfied. In addition, the officer works toward striking a balance between the need for efficient tax collection with intrusiveness.

Significantly, taxpayers may not challenge the existence or amount of the underlying tax liability, except in cases where they did not receive a statutory Notice of Deficiency or otherwise have not been provided opportunity to contest the underlying

liability. Unless the taxpayer contests the appropriateness of the lien or levy, the CDP hearing will likely focus on what collection alternatives are available. Importantly, while the hearing is pending, the IRS will suspend collection efforts. However, a CDP request will also toll the ten-year statute of limitations on collections.

The results of the hearing are provided in a Notice of Determination prepared by the Officer. This notice must confirm that all procedural requirements were met and decide the merits of any issues raised by the taxpayer during the hearing. If the parties reach an agreement regarding any relief or other action, the Notice of Determination will set forth the terms and conditions of same. Generally, if a taxpayer receives an adverse ruling, they have 30 days to petition the Tax Court.

Where the taxpayer fails to file a CDP hearing request within the required 30-day me limit, the taxpayer has the right to an Equivalent Hearing ("EH"). While the same issues may be considered as in a CDP hearing, the request for an EH does not halt the proposed levy or collection action or toll the statute of limitations on collections. However, IRS policy is to place a hold on collection for all periods included in the pending EH. As a matter of strategy, it may be more prudent not to file a CDP request if the statute of limitations ("SOL") is about to expire.

Upon completion of the hearing, Appeals issues a "Decision Letter," which generally contains the same information as a Notice of Determination. In general, there is no statutory provision for judicial review. Therefore, a taxpayer generally cannot challenge his or her EH Decision Letter in court, unless a special circumstance applies.

If the taxpayer receives a lien notice, he or she has one year and five business days from the filing date of the Federal Tax Lien to request the hearing. Alternatively, where the taxpayer receives a levy notice, he or she has one year from the date of the notice to request the hearing.

In addition to CDP and EH rights, a taxpayer may request consideration pursuant to the IRS's Collection Appeals Program ("CAP"). CAP rights are available in the following situations: before or after the IRS files a Notice of Federal Tax Lien; before or after the IRS levies or seizes property; upon termination of an Installment Agreement; or upon rejection of an Installment Agreement.

Prior to invoking appeal rights under CAP, the taxpayer must first discuss the issue with the Revenue Officer's manager and be prepared to suggest a reasonable alternative to the protested action. If an agreement cannot be reached with the manager, the taxpayer can then file a Form 9423, "Collection Appeal Request." Thereafter, collection action will usually be suspended, but only if Form 9423 is filed within two days of the manager conference.

CAP is distinguishable from CDP rights in that the taxpayer can request this consideration before the IRS takes harmful collection action. CAP is also generally quicker (Officers are expected to close their cases within five business days) and available for a broader range of collection actions. Decisions under CAP are binding and cannot be appealed in court. It is important to note that issues raised under CAP cannot be asserted again in a later CDP hearing with respect to the same tax liability. This could affect the taxpayer's right to be heard in Tax Court.

If a taxpayer cannot afford to pay the liability in a lump sum, he or she may qualify for an installment agreement. A financial disclosure and direct debit may be required for some installment agreements. If the taxpayer can't afford to pay the full amount of outstanding liabilities, even in installments, he or she may submit an Offer in Compromise ("OIC"). An OIC is a binding agreement wherein the IRS agrees to accept less than the full amount due of tax, interest, and penal es. In evaluating an OIC, the IRS calculates the reasonable collection potential which consists of the taxpayer's net equity in assets and future excess income.

The IRS may accept an OIC based on three grounds: doubt as to liability; doubt as to collectability; and effective tax administration (based on the taxpayer's economic hardship or other circumstances).

If an OIC is rejected, the taxpayer will receive a letter, IRS Form 11271, and a report listing the basic reasons why it wasn't accepted. Taxpayers have 30 days to request an appeal of a rejected offer.

Notably, a taxpayer's passport may be revoked if he or she is "seriously delinquent," meaning he or she owes the IRS $52,000 or more (including penalties and interest). The Commissioner of Internal Revenue notifies the Secretary of State, who is then permitted to deny the issuance or renewal of a passport or revoke the passports of that individual. The IRS must contemporaneously give notice to the individual involved. If the individual is outside the United States, the Secretary of State may also limit a previously issued passport for return travel to the United States or issue a limited passport that only permits

return travel to the United States. Some tax debt will not be included in determining if a taxpayer is seriously delinquent, including if the taxpayer and the IRS have entered into an installment agreement or OIC, the debt has been suspended under the innocent spouse rules, the taxpayer is bankrupt, or other specified circumstances.

How tax professionals respond to audit and collection notices can make a significant difference to a taxpayer's case. Untimely or inadequate responses can jeopardize the taxpayer's opportunity to resolve the matter favorably. Tax professionals who are not accustomed to handling audit and collection matters should consider consulting an experienced tax attorney for guidance.

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