IRS CIVIL EXAMINATIONS: END-GAME ALTERNATIVES AND STRATEGIES

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I. INTRODUCTION

A. Types of Examinations

The three types of examinations we normally see are:

1. "correspondence" audits,
2. "office" audits, and
3. "field" audits.

Correspondence audits are conducted entirely by mail. "Office" audits are done in the nearest IRS facility and are also known as "TCO" audits.[1] Field audits (conducted by revenue agents) are subdivided into either SBSE[2] audits (for smaller cases) or LB&I[3] audits (for larger cases). Field audits also include specialty examinations such as:

1. Estate/gift tax,
2. Employment tax, and
3. Exempt organizations.

B. Basic Choices at Conclusion of Examination

At the conclusion of an IRS examination, however it may be conducted, the taxpayer or his representative has only three threshold choices:

1. Agree,
2. Partially agree, or
3. Disagree completely.

If it is an agreed case the taxpayer usually signs an agreement form such as an 870 or a 4549 form. This form waives restrictions on assessments and also waives the taxpayer's right to go to Tax Court to contest the tax deficiency. It does not, however, waive a taxpayer's right to file a claim and subsequent refund suit in Federal District Court. As a practical matter, signing these waivers ordinarily means that the case is over as far as the government is concerned. A representative holding a valid power of attorney can sign these waivers on behalf of his client. Usually within 60-90 days of signing the waiver, the taxpayer receives his first billing from the IRS for the deficiency, including interest and applicable penalties.

C. "Office" Audit Issues

In "office" or correspondence audits, the examination process is relatively quick and perfunctory. At the conclusion of an office examination, the auditor (TCO) will generally issue a preliminary report if there are any outstanding unsubstantiated items

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[1] TCO's are tax compliance officers, formerly known as office auditors.
[2] Small business, self-employed.
[3] Large business and international, for entities with more than $10 million in total assets.

that were questioned. They will offer to revise the report if documentation is submitted within a short period of time. In the event of a disagreement with the auditor's determination, an oral statement that an appeal is desired will suffice. There is no requirement for a written protest of any kind.[4]

II. STATUTE OF LIMITATIONS ISSUES

A. Window of Audit Opportunity

By statute, the IRS has a 3-year window within which to conduct an audit of a tax return.[5] But as a practical matter, it is more like an 18 month period. The reason for that is that by the time a tax return enters the audit stream, an entire year has elapsed since the filing date of the return. And normally a return will not be selected for examination if there are fewer than six months left on the assessment statute of limitations.

B. Extensions of the Statute of Limitations

Examiners tend to get nervous if they have not finished the audit by the time a statute expiration is looming on the horizon. Whenever this happens, an agent will routinely ask the taxpayer to execute an extension of the assessment statute.[6] Form 872 is usually prescribed for this purpose.[7] See Exhibit A attached.

Whether to extend the statute to a date certain, indefinitely, or not at all, is an important decision for a practitioner. A statute extension can also be limited to a particular issue or issues. Representatives often routinely extend the statute upon request by the government in an effort to appear "cooperative." However, that may not be good strategy. Note that in estate tax examinations, the statute cannot legally be extended.[8]

The advantage to extending the statute is that often the case can be resolved administratively without having to file a Tax Court petition or otherwise litigate the case. The disadvantage to extending the statute is that it allows the examiner extra time to properly develop his case – always to the detriment of the taxpayer. Agents often erroneously advise the taxpayer that failure to extend the statute will result in

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[4] Treas. Reg. § 601.105(d)(2).

[5] This assumes that there is not a greater than 25% omission of income. See I.R.C. § 6501(e).

[6] See I.R.C. § 6501(c)(4) for statute extension procedures.

[7] Other types of extension forms are also used, depending on the type of examination or the particular circumstances in which the extension is desired.

[8] I.R.C. § 6501(c)(4)(A).

forfeiture of administrative appeal rights. But that is simply not true. Even in cases docketed before the Tax Court, a petitioner always has the right to an administrative settlement conference with an Appeals Officer.

What happens if the taxpayer refuses to extend the statute? IRS audits may be interrupted by the imminent expiration of the statutory period of limitations for assessment of the tax. To protect the government's interests in such a case, the IRS may be required to dispatch a statutory notice of deficiency even though the case may be in examination status. Therefore, in these situations, practitioners should advise their client to expect a certified letter known as a Notice of Deficiency. And representatives need to be prepared to file a Tax Court petition in response.

III. THE "30-DAY LETTER"

A. General Rule

At the conclusion of an IRS examination (audit)[9], the taxpayer will commonly receive what is known as a "30-day letter." This letter gives the taxpayer 30 days within which to notify the Service of his intent to appeal and within which to prepare a written protest (if one is required). If there is less than six months remaining in the [I.R.C. § 6501] statute of limitations, often the IRS will simply skip the 30-day letter and, instead, issue the 90-day letter (notice of deficiency).

B. Review

In unagreed cases, and before the 30-day letter is issued, cases are sent to IRS' Quality Review function for appropriate review. After this review process is complete, IRS will mail the taxpayer a copy of the examination report under cover of a transmittal (30-day) letter providing a detailed explanation of available alternatives.[10]

C. Extensions of the 30 Days

A 30-day letter imposes a tight timetable. There is no provision for granting an extension of time to prepare a protest after receiving the 30-day letter, although as a practical matter, the agent in charge of the case may do so upon request.

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[9] For purposes of this paper the terms "examination" and "audit" are used interchangeably, although the former is the more common way that IRS personnel now refer to audits.

[10] Treas. Reg. 601.105(c)(2).

IV. PROTESTS

A. Publication 5

IRS Publication 5 contains an explanation of appeal rights and instructions on how to prepare a protest if you do not agree with an audit determination. Note that there is no filing fee required to obtain an administrative appeal.

B. Essential Elements of a Protest

Publication 5 contains the minimum requirements for a protest. There are eight essential elements:

1. Taxpayer name, address, and daytime telephone number,
2. A statement that the taxpayer wants to appeal the IRS findings to the [nearest local] Appeals Office,
3. A copy of the 30-day letter,
4. The tax periods or years involved,
5. A list of the disputed changes,
6. The facts supporting the taxpayer's position(s),
7. The law or authority, if any, on which the taxpayer is relying, and
8. The taxpayer (or representative) signature, signed under penalties of perjury.

C. Techniques for Preparing a Successful Written Protest[11]

Recommendations:

- Prepare a planning roadmap and remember that presentation matters.
- Focus on relevant facts.
- Develop logical and convincing arguments.
- Critique the report of the examining agent, but don't attack him/her personally.
- Revise, revise again, and revise one more time. It has been said that there is no such thing as good writing; there is only good rewriting.

After the issues have been identified and listed, the remainder of the protest should be organized by issue. Within each issue category, the following should be the organization:

1. Issue identification,
2. Proposed adjustment,
3. Facts,
4. Analysis of relevant law,

[11] *See* William P. Wiggins, *The Art of Preparing a Successful Written Protest*, Journal of Tax Practice & Procedure, (April-May 2008).

5. The IRS examiner's position,
6. Argument, and
7. Conclusion.

The facts section should tell an interesting story, but not be too wordy. Be sure to reference documentary evidence in the facts section and attach necessary exhibits. Consider obtaining an affidavit from the taxpayer (or third parties) in the absence of written evidence. Remember that a taxpayer's oral or written statement is just as probative as a written document. Also remember that one should not cite any authority that has little or no bearing on the argument. Examiners will often cite authorities without actually reading them; don't be guilty of that sin.

D. Under What Circumstances are Protests Required?

Protests are not required following a correspondence or office audit.[12]

In a field audit, no protest is required if the deficiency does not exceed $2,500 for any period. An oral request for an appeal will suffice in such cases. But a brief written statement of disputed issues is required if the deficiency is greater than $2,500 but less than $10,000.[13]

A formal written protest is required in the following circumstances:

1. Where the deficiency is greater than $10,000 in a field examination case,
2. In all employee plan and exempt organization cases, and
3. In all partnership and S Corporation cases.

If the tax deficiency is between $10,000 and $25,000, there is a streamlined procedure for preparing a protest. A REQUEST FOR APPEALS REVIEW, Form 12203 (one page), is available for this purpose. See Exhibit B. Also see Exhibits C, D, and E for various types of protest templates.

E. Rebuttal

Protests are submitted to the examination group having jurisdiction of the audit. After receiving the protest, an agent generally has an option of preparing a rebuttal. It is a recommended practice for a taxpayer to ask for a copy of that rebuttal before he appears for a settlement conference with an Appeal Officer. This request can be put in the transmittal letter accompanying the protest.

[12] Treas. Reg. § 601.105(c)(1)(ii). This is often a hotly contested point. Practitioners frequently have to force TCO's to review this regulation.

[13] Treas. Reg. § 601.105(c)(2)(ii).

V. IRS APPEALS

A. Appeals' Independence

Cases that are not agreed usually end up in the administrative appeals section of the IRS. In Houston, that office is at 8701 S. Gessner, Suite 750. This office consists of IRS employees who are experienced either in examination or collection matters and are theoretically independent of the field functions. It is not the purpose of this paper to examine the inner workings of the Appeals Office. Note that there is an "ex parte" rule that prohibits Appeals employees from communicating with field personnel.[14]

B. Timetable

Once you have submitted a written protest, you will usually hear from the IRS Appeals Office within 90 days. If more than 90 days have passed, you should contact the office where you sent the protest to find out when the case was forwarded to Appeals. Once your protest is received in Appeals, it generally takes anywhere from 90 days to a year to resolve the dispute, depending on the complexity of the case and the current Appeals workload.[15]

C. Advantages of Utilizing Administrative Appeals

One of the reasons one would want to take advantage of the administrative appeals function rather than go straight to the deficiency notice is I.R.C. § 7430. In order to be awarded administrative or litigation costs, it is necessary first to exhaust administrative remedies. Failure to respond to a 30-day letter may result in a determination of failure to exhaust administrative remedies.[16]

Another advantage of going to Appeals is that Appeals Officers can consider the "hazards" of litigation in making a settlement. Examiners are unable to do that; instead, examiners tend to make decisions that "protect the revenue." Litigating hazards can include the uncertainty of litigation outcome because of conflicting or nonexistent case law or evidentiary weakness on the part of the party having the burden of proof.

D. Disadvantages of Utilizing Administrative Appeals

Some practitioners will skip the administrative appeals process altogether. This often occurs if there is the possibility of Appeals raising a new issue that the examiner may

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[14] *See* 1998 IRS Restructuring and Reform Act.

[16] I.R.C. § 7430(b)(1); Burke v. Commissioner, 73 T.C.M. (CCH) 2291 (1997).

have missed. Even though the Appeals Manual discourages this practice, there are circumstances when it is appropriate. If the Appeals process is bypassed, the case will necessarily have to be filed in Tax Court, District Court , or the Court of Federal Claims. And raising new issues in docketed cases is a much more restrictive and cumbersome process than in Appeals.

VI. MISCELLANEOUS TOPICS

A. Closing Conferences

At the conclusion of a field examination, the taxpayer or his representative is entitled to a "closing conference." During this conference the examiner is required to explain his proposed adjustments and give the taxpayer an opportunity to either agree or disagree. Many times, examiners are unable to articulate their positions with confidence. If their report cites court cases, they probably have not read them. Don't expect them to understand the nuances of case law or what constitutes probative evidence. In estate and gift tax examinations, however, a higher level of understanding can be expected, as those audits are done by government attorneys.

B. The 90-Day Letter

If a taxpayer refuses to request an administrative appeal, IRS will issue a so-called "90-day" letter, officially known as a "Notice of Deficiency."[17] This statutory notice is also sometimes referred to as a "stat" notice. In such cases, it will be necessary to file a petition with the U.S. Tax Court within 90 days unless the taxpayer wises to pay the deficiency and file a refund suit in another forum. Only admitted practitioners may prepare and sign such petitions unless the taxpayer wishes to do his own petition on a "*pro se*" basis.

C. Use of Experts

If the government has retained an expert during the examination process, either an IRS employee/specialist or an outside consultant, the taxpayer should also consider hiring an expert to rebut the government's opinion. This can be done during the examination itself, during the administrative appeals process, or during litigation. The preferable practice is to retain the expert as early in the process as possible. This will tend to accelerate the settlement process.

[17] I.R.C. § 6212.

D. Fast-Track Procedures

There are two alternative procedures available during the examination to resolve disputed issues. These are the fast-track mediation process and the fast-track settlement process. These relatively new procedures are further described in IRS Publications 3605 and 4539 attached as Exhibits F and G respectively. The author of this paper does not believe that such procedures are particularly useful during the examination process. This is because they tend to prolong the audit and give the examiner further opportunity to develop his case. The better strategy is to get the examiner out of the picture at the earliest possible moment. If the agent is off the case, he can do no more damage to your client.

E. Closing Agreements

Closing agreements are rarely used at the conclusion of an IRS examination. They are used much more frequently at the end of the administrative appeals process where there is a desire to achieve absolute finality and prevent further claims by the taxpayer or deficiencies by the government.[18] Further discussion of this topic is beyond the scope of this paper.

F. Technical Advice

During the examination process, it occasionally happens that there is a lack of uniformity on the disposition of a particular issue or that the issue is unusual or complex. In such cases, either the government or the taxpayer may request technical advice from the IRS' National Office on how the issue should be disposed of.[19]

G. No-Change Letters

On those rare occasions when a return is accepted as filed, with no recommended adjustments, the taxpayer is notified by an appropriate "no-change" letter.[20]

H. Claim Cases

When claims for refund or credit are examined by IRS, substantially the same procedure is followed (including appeal rights afforded to taxpayers) as when taxpayers' returns are originally examined.[21]

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[18] *See generally*, I.R.C. § 7121.
[19] See the procedures outlined in Treas. Reg. § 601.105(b)(5).
[20] Treas. Reg. § 601.105(d)(1).
[21] Treas. Reg. § 601.105(e)(2).

I. FOIA Requests

In large or complex cases it is often a good idea to obtain copies of everything in the revenue agent's file after the audit is complete. The best time to file a Freedom of Information Act (FOIA) request[22] is after the case has left the examination group. The reason for this is that after the case has left the examiner's hands, he has no more opportunity to "sanitize" his file and remove embarrassing material. A FOIA requester can obtain all internal memos, emails, and the examiner's activity record. This is often quite helpful in defending unagreed cases.

J. Manager Involvement

In SBSE cases, the group managers have very little "hands on" involvement with an audit. In LB&I cases, however, they are much more active. At the conclusion of the examination, taxpayers have a right to a conference with the agent's manager, who will usually support the agent's conclusion(s). Therefore, those conferences are not generally worthwhile.

K. Agent Misconduct

Representatives should be alert to situations where an agent may have crossed over the ethical line or engaged in "rogue" behavior. Such situations may include:

- Unauthorized disclosure,[23]
- Ignoring the Code or Regulations,[24]
- Using penalties as a bargaining chip,[25] or
- Bypassing or ignoring a valid power of attorney.[26]

In such situations, a representative should not hesitate to notify the Treasury Inspector General for Tax Administration (TIGTA) office and request an investigation.[27]

L. Verbal IRS Statements

Don't ever rely or act on verbal statements made by an IRS employee. IRS is not bound by oral statements made by its employees. It is preferable to try to get an agent to commit to his/her position in writing whenever possible. If they won't do that, the next best thing is to follow up a conversation with a fax or email that confirms what they have committed to.

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[22] *See* 5 U.S.C. § 552.
[23] I.R.C. § 6103.
[24] See 1998 IRS Restructuring and Reform Act, § 1203(b) and Notice 99-27, 99-1 CB 1097 for situations requiring IRS employee termination.
[25] IRM 4.10.6.4.
[26] I.R.C. § 7521(c).
[27] See I.R.C. § 7802(d) for duties of the TIGTA office.

VII. CONCLUSIONS/RECOMMENDATIONS

A. Damage Control

The practical reality is that a revenue agent's job is not to seek truth, justice, and equity. Instead, his goal is to find adjustments and maximize the deficiency that your client allegedly owes. He generally doesn't care whether somebody up the line ultimately reverses his decision(s). For that reason, "no change" reports are the exception to the rule.

Toward the end of the examination process, a representative's function shifts from furnishing documents and answering questions to one of damage control. By the end of the audit, the agent will likely have developed one or more issues that you do not agree with. Further argument with the agent at that point is generally fruitless. You then have to consider your options, using a cost-benefit analysis.

At today's prices, an administrative appeal in a non-docketed case will cost in the neighborhood of $5,000 to $15,000, even for a simple case. A Tax Court case, on the other hand could easily cost in the range of $50,000 to $100,000, depending on when and if the case settles before trial. These costs must then be compared with the amount of the deficiency (including penalties and interest) and the relative strength of your case.

A number of critical decisions must be made when the IRS audit is in its final stages. In making these decision, remember what your job is: to minimize the client's liability while doing so within legal and ethical boundaries.