



IRS Examinations: Old Dogs and New Tricks

by Gary M. Harden

Over the last decade, policy changes in Washington, budget cuts and staff reductions by attrition made that old dog, the traditional IRS tax audit, much less likely for businesses and individuals alike. Expect to see something new and different, as the IRS looks to reduce the estimated \$345 billion tax compliance gap. It has re-trained and equipped its remaining agents, hired additional employees and established new protocols to accompany the old. Here's a quick summary of what we have seen over the last year and what you might expect in the near future.

New Agents

America's largest employer, the federal government, has been hiring. Published statistics show that during 2008 - 2009 the US private sector lost over 3.6 million employees while the federal government annually hired 300,000, and increased net employment by 150,000. Some sources project hiring for 2010 at about 450,000. The IRS receives its share.

Toledo's four remaining revenue agents are now part of Detroit, and share area assignments with the Lima and Defiance offices. Both of Toledo Exam's Group managers have retired, but one remains as a recruiter, visiting colleges and other venues in search of new agents and officers.

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Old and New Protocols

New theme audits, and traditional random and computer selected exams are enhanced by technology and teamwork. At field examinations performed at your business or home, agents enter data into laptop computers, process it with specialized programs and generate document requests and/or a final report on site. In many instances, the information gathered and computer programs allow an agent to determine unreported income tying out investments, expenditures and non-taxable sources of funds such as gifts, inheritances and loans. Following is a discussion of two new protocols and ideas on what you might experience if you are selected.

- **National Research Program Audits.** The IRS is tasked with gathering tax compliance information to update its computer selection software for the next decade. Reminiscent of the Tax Compliance Measurement Program (TCMP) audits discontinued in 1988 because they were so intrusive, NRP audits take less time and are more efficient. The IRS fills the gap of information by accessing available information in all forms, including a search of the taxpayer's online hits. So, if you have a website, expect it to be visited. These audits randomly select individuals and businesses with certain characteristics and subject them to a broad scope review. The IRS explores unreported income, employment tax compliance, off-shore investments, material purchases and sales, barter transactions, retirement plans, and other areas with a long list of questions. The agent follows up in-depth with each area so identified. From my experience, NRP appears to be as effective as TCMP.
- **Employment Taxes.** The IRS aggressively reviews employment tax issues in most examinations, and reclassification of independent contractors to employee status is at the top of the list. The issue can arise in a traditional or NRP exam. It also can arise under the new National Research Employment Tax Project. Project exams review all aspects of employment related taxes on income tax returns, social security and other information returns on a line-by-line basis, and in particular, the classification of workers not treated as employees. Also included is a review of fringe benefits, reimbursement of expenses and other issues. In some situations, an IRS examination of independent contractors who do not pay their taxes, results in an exam of the business that hired them, as an alternative way to collect these taxes. A reclassification of a worker as an employee can result in reclassification of a larger group of workers, and the deemed employer being retrospectively liable for the deemed employees' income and employment taxes, in addition to the employer's share. It can result in a refund to the deemed employee(s). If an incorporated business or LLC cannot pay the amount, certain employees, directors, officers and managers can be personally liable for the withholding tax, and the obligation to pay is non-dischargeable in personal bankruptcy. Sometimes prompted by the revenue agent, a contractor's exam will result in an application for a determination letter on status submitted on Form SS-8, where the hiring business is provided an opportunity to provide information. Based upon experience, these determinations are heavily weighted in favor of employee status. Reclassification of one employee can result in a requirement to convert workers with similar job descriptions. If you receive such a notice, you should immediately contact a CPA or an attorney experienced in the SS-8 program, Revenue Act of 1978 Section 530 safe harbor and employment tax examination practice. This kind of an examination can be high risk, and should involve an experienced practitioner. We have regular involvement in these situations.

What to Do

Here are some ideas on what you can do proactively.

- **Self-Examination.** Critically review areas of potential noncompliance. Pay attention to the areas discussed in this article. Correction of a problem in advance, or a legal opinion on independent contractor status can cost less and provide alternatives. For example, a mistake in inventory can often be corrected by a change in accounting method with automatic approval and a four year installment payment opportunity, without interest. But if the IRS finds it in an exam, expect to pay it all immediately, with interest back to the due date, and an adjustment that takes into account misstatements from years beyond the normal statute of limitations. We can help identify areas and work with your staff to provide confidential advice, protected by privilege.

- **Responsibility for Notices.** Be ready when a notice arrives. Make sure the IRS has your current address and be sure the person who picks up and opens mail knows who to give it to. Some administrative reviews generated by a Service Center provide a very short time to respond and can result in a quick assessment, reducing your appeal rights increasing your cost to resolve a dispute. Field exams often require much preparation time to gather records and then to understand what the records indicate prior to the meeting. You may need all the time you can get to prepare.
- **Early Involvement of Outside Advisors.** An early call to your CPA, tax return preparer or us can be valuable. Your advisor can help you understand what is expected, help you prepare, and reduce exposure to tax, penalties and collateral consequences. Much of our audit experience comes from referrals by accountants because of the complexity or special circumstances involved in an examination.
- **Control the Audit.** Maintain control over the audit by taking the necessary time to carefully respond and by tailoring the scope of the response. Full cooperation is expected but staying on point, and avoiding collateral audits of additional years, related businesses, and owners is an art. Your accountant and we should be able to help manage the process.
- **Appeals and Other Tax Controversies.** If an examination results in a disagreement, tax controversies can often be resolved efficiently, without the cost or risk involved with judicial process. We are experienced in the many administrative remedies available and, in the few instances where legal action is required, we are experienced in the courts. As with our audit practice, most of this experience in tax controversies comes from referrals by accountants and other professionals.



Mr. Harden is the member of Eastman & Smith responsible for the Firm's tax practice. He is active in transactional business practice and frequently represents clients in tax controversies with IRS, state and local authorities. He is peer reviewed and recognized in Best Lawyers in America (since 1995) and Ohio Super Lawyers every year since its inception. He has a masters of tax law (LL.M) from New York University, a juris doctor from the University of Toledo College of Law and a bachelors of business administration, majoring in accounting, from The University of Notre Dame. Mr. Harden works out of our Toledo office (419-241-6000).

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