[By-Lined Article]

New IRS Strategic Initiative: Increased Audit Activity on Its Way?

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Exposure of fraudulent and unscrupulous tax preparers, along with increasing voluntary compliance with federal tax laws and closing the tax gap (currently estimated to be in the billions of dollars) are among the goals of the Internal Revenue Service's five-year strategic plan released April 27, and runs from 2009 through 2013. The IRS hopes to accomplish the objectives of the plan through a delicate balance of service and enforcement. According to Doug Shulman, IRS commissioner, the IRS has two overarching goals for the period covered by the plan.

While the first goal, namely "to improve service to taxpayers to make voluntary compliance easier," may have a positive effect on taxpayers, the second goal will likely cause pain. The second, and, according to Shulman, equally important goal "is to enforce the law to ensure everyone meets their obligation to pay taxes. We will be timely in our enforcement actions and expand the approaches and tools we use in compliance activities. We will meet the challenges of globalization by improving our expertise and coordinating better with international organizations."

Herein lies the hot button for audit activity. Clearly, and arguably appropriately, the objective of this second goal appears to focus on increased examination and collection activity. We noted in previously published Legal Intelligencer articles that the IRS was expected to upgrade its audit efforts and once again expect a significant uptick in examinations.

To achieve the goal of enforcing the law to ensure everyone meets their obligation to pay taxes, the IRS plans to:

- Proactively enforce the law in a timely manner while respecting taxpayer rights and minimizing taxpayer burden.
- Expand enforcement approaches and tools.
- Meet the challenges of international tax administration.
- Allocate compliance resources using a data-driven approach to target existing and emerging high-risk areas.
- Continue focused oversight of the tax-exempt sector.
- Ensure that all tax practitioners, tax preparers and other third parties in the tax system adhere to professional standards and follow the law.

The Focus on Enforcement

The second goal of the plan is to increase the enforcement of tax law to ensure that all individuals and businesses with a U.S. tax obligation, whether domestic or foreign, pay their full tax liability. This is no surprise. With the current economic downturn, net tax revenue has decreased 3.3 percent, according to the 2008 IRS Data Book, while government spending has increased. So, it is logical that increased tax enforcement and collection efforts will follow. According to the IRS, nearly 84 percent of all taxes are paid on time by taxpayers reporting freely and voluntarily. This means that about 16 percent of taxpayers are either underreporting income, overstating deductions or otherwise not in full compliance. The percentage may be relatively small but represents a sizable tax gap that is estimated at well over $300 billion per year even after consideration is given to IRS enforcement actions that generate $55 billion to $60 billion. The IRS is concerned that in the current economic cycle the percentage of taxpayers not in full compliance will increase dramatically.

The IRS estimates that the largest component of the tax gap is underreporting noncompliance (mostly income related) and that individual income tax is the single largest source of the annual tax gap. The IRS asserts that this underreporting occurs most frequently in the area of business activities, as opposed to wages or investment income. The IRS declares that they owe it "to all the citizens who … pay their taxes to be vigorous in pursuing individuals who are not paying what they owe." At the same time, the plan indicates that "the IRS cannot audit its way to full compliance" and that a multi-pronged approach is required.

As a result of a three-year National Research Program study, which audited 46,000 individual income tax returns in 2001, the IRS ramped up its audits of high-income taxpayers and corporations, launched more criminal investigations and focused more attention on abusive tax shelters. In the IRS's previous strategic plan, which covered the period 2005-2009, the IRS focused its attention on:

- Promotion and use of abusive tax schemes and avoidance transactions.
- Misuse of offshore transactions.
- Nonfiling and underreporting of income by higher income individuals.
- Flow-through income.

It is expected that there will be continued focus on these areas. It is also expected that the IRS will continue to allocate increasing resources to the audits of large businesses (those with assets of $10 million or more) and continue its examinations of smaller businesses to study reporting compliance. As a result, business and individual taxpayers can expect increasing scrutiny.

Another significant area of IRS focus is on the underreporting or non-reporting of offshore income, as evidenced by the Voluntary Disclosure Program (we reported on this program in the June 2 issue of the *Legal*). The IRS remains strongly committed to development and utilization of a full range of information gathering tools for properly identifying offshore-based income and pursing those cases aggressively, as indicated by some recent large cases involving the provision of information to IRS by offshore banks on its U.S.-based customers accounts followed by prompt IRS pursuit.

Who Should be Concerned?

High-income taxpayers, self-employed individuals and those who receive flow-through income from a partnership, S corporation or limited liability company or claim deductions disproportionate to reportable income will likely be targets of increased audit focus.

Individual Taxpayers

In light of the IRS's plan and historical targets, we expect increased audit activity for high-income taxpayers, including both in-person examinations and correspondence audits, although a greater weight toward correspondence audits.

According to the 2008 IRS Data Book, just under 2 percent of individual income tax returns with adjusted gross income between $200,000 and $500,000 filed in calendar year 2007 were selected for examination in fiscal year 2008. Although this appears, on a percentage basis, to be insignificant, consider the fact that 2.25 percent of all individual income tax returns filed in 2007 reported income within this range. The examination coverage consists of more than 59,000 returns at this level of income. Even more telling, returns filed during this period reporting adjusted gross income, or AGI, between $500,000 and $5 million represented only 0.66 percent of returns filed, yet 7 percent, or more than 63,000 of these returns were selected for examination in fiscal year 2008.

Also according to the Data Book, the number of 2007 individual returns audited with AGI levels between $1 million and $5 million were nearly 35 percent higher than those audited with AGI levels between $500,000 and $1 million. Taxpayers with AGI exceeding $5 million, while representing only 0.03 percent of all individual tax returns filed, were examined at the rate of 16.24 percent of the total number of returns filed at this level of AGI, higher than audits of all other levels of AGI combined. Another interesting and likely continuing focus of IRS enforcement efforts include those returns reporting no AGI, which often happens, more so during periods of recession, when a taxpayer reports losses or deductions that exceed total income.

We expect even greater audit activity in the foregoing categories plus enhanced information matching by the IRS.

Business Taxpayers

We expect increased audit emphasis on the growing area of pass-through entities. Audits of S corporation and partnership returns are at their highest level in more than 10 years and have increased by more than 25 percent since fiscal year 2007. Perhaps because of the increase in S corporation and partnership audits, audits of large C corporations are down from previous years, however, audits of C corporations with $5 million or more in total assets have increased.

We anticipate greater IRS attention in pass-through businesses as well as sole proprietors in high-risk industries.

Non-Filers

We expect increased hits, quicker assessments and stronger collection efforts in connection with non-filers.

In addition to examinations of returns filed, the IRS examined more than 158,000 cases in which no return was filed. These nonfiler cases were referred for examination by the Collections Program and the Automated Substitute for Return Program, or ASFR. In the ASFR Program, the IRS uses information returns (such as Forms W-2 and 1099) to identify people who failed to file a return and constructs tax returns for certain nonfilers based on that third-party information. Also, the Automated Underreporter Program, or AUP, is another tool used by the IRS for enforcement purposes. In addition to receiving information about taxpayers' self-reported income and tax on returns that are filed, the IRS gathers independent information about income received and taxes withheld on information returns, such as Forms W-2 and 1099 from employers and other third parties. With its AUP, the IRS matches these information returns to tax returns and contacts taxpayers to resolve discrepancies.

Examination Methods

The IRS uses a variety of methods to select returns for examination, including computer scoring, identification of potential participants in abusive tax avoidance transactions, information matching and random sampling. We expect greater proficiency from the IRS in the deployment of these methods.

One of the IRS's primary methods used in selecting returns is the Market Segment Specialization Program, or MSSP. The MSSP focuses on the industry the taxpayer is in rather than on the type of return the taxpayer files, the amount of gross income reported or the ratio of deductions to income. Compliance activity is organized around market segments where practical. A market segment can be an industry such as construction, a professional group such as attorneys or an issue such as tax shelter transactions. Individual market segments are then assigned to examiners with auditing experience, training and research responsibilities in that area. Interestingly, lawyers and law firms have been subject to heightened scrutiny longer than most of the other targeted groups, and we expect no let up in the foreseeable future.

Another primary method used in selecting returns is a computer program called the Discriminant Index Function, or DIF. Under the DIF, a return is scored by mathematical formulas. The chances of an audit increase as the DIF score increases. Some of the items that may increase a DIF "score," and therefore increase audit risk, include:

- Higher income, greater than $200,000.
- Losses from a flow-through entity, such as a partnership, S corporation or limited liability company.
- Deductions/losses disproportionate to income.
- High non-cash charitable contributions.
- Large business meals and entertainment deductions or other business or unreimbursed employee deductions.
- Low income with large business deductions.
- Large casualty losses.
- Little or no profit from a business operation.
- Hobby losses.
- Self-employment income or a low gross profit margin from self-employment income.

Worker classification examination will likely also increase. The IRS realizes misclassification of employees as independent contractors is costly in terms of lost or delayed collections of income taxes as well as social security taxes.

Other Targets

Paid tax preparers, self-preparers and those with offshore accounts — watch out. In addition to those taxpayers reporting activity in the risk areas noted above, the IRS is expected to increase its enforcement efforts on those tax preparers and taxpayers preparing and filing fraudulent tax returns, as well as those with documented or suspected unreported or underreported offshore income. In fact, the IRS reported on Aug. 19, in news release 2009-75, that they are about to receive unprecedented information on U.S. holders of accounts at the Swiss bank UBS. Consequently, the IRS is expected to continue its relentless pursuit of U.S. taxpayers with foreign financial accounts.

Based on historical targets and the new IRS strategic plan, it is evident that the IRS will continue the trend of its increased enforcement efforts. It is, therefore, critical for taxpayers to ensure their tax records are organized and up-to-date. Additionally, taxpayers may wish to engage a tax professional to conduct a "simulated audit" for the purpose of reviewing record-keeping policies and existing tax positions and obtaining advice on correcting problems or deficiencies that would likely be targets of an IRS examination.

In the event you or a client is contacted by the IRS regarding an audit or an adjustment, consult with a qualified tax professional immediately. It is usually more efficient and less costly for a tax professional to represent taxpayers before the examination and collection division of the IRS.

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