

THE AUDIT EXAMINATION PROCESS



A. First Step in the Audit Examination Process – the IRS picked your client for audit

- a. **Examination of Returns** – The IRS may examine a taxpayer's return for a variety of reasons, and the examination may take place in any one of several ways.

i. **Reason for examination and selection criteria.**

1. **DIF Score** - A computer program called the Discriminant Inventory Function System (DIF) assigns a numeric score to each individual, and some corporate, tax returns after the IRS processed the returns.
2. **Third Party Information** - information received from third-party documentation (i.e. Forms 1099 and W-2) that does not match the information reported on a tax return.
3. **Other third party information** - information from a number of sources, including newspapers, public records, and individuals.
4. **Bad Luck.**

b. **Place of Examination.**

- i. entirely by mail;
- ii. in taxpayer's home;
- iii. in taxpayer's place of business;
- iv. at an IRS office; or
- v. at the office of the taxpayer's attorney, accountant, or enrolled

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

Late one night a mugger wearing a ski mask jumped into the path of a well-dressed man and stuck a gun in his ribs. "Give me your money," he demanded.

Indignant, the affluent man replied, "You can't do this - I'm a US Congressman!"

"In that case," replied the robber, "Give me MY money!"

A nervous taxpayer was unhappily conversing

agent.

Note: *The IRS makes the final determination of when, where, and how the examination will take place.*

c. Who represents the taxpayer?

- i. The taxpayer (pro se);
- ii. If a joint return, either the taxpayer or spouse, or both, can meet with the IRS; or
- iii. Any federally authorized practitioner, including an attorney, a certified public accountant, an enrolled agent (a person enrolled to practice before the IRS), an enrolled actuary, or the person who prepared the return and signed it as the preparer.

d. How is representation accomplished?

- i. **Power of Attorney (Form 2848)** - If the taxpayer wants someone to represent him/her, the taxpayer must furnish that person with proper written authorization. Taxpayer can use Form 2848. If the taxpayer wants to consult with an attorney, a certified public accountant, an enrolled agent, or any other person permitted to represent the taxpayer during an interview for examining a tax return or collecting tax, the taxpayer should make arrangements with that person to be available for the interview. In most cases, the IRS must suspend the interview and reschedule it if the taxpayer's representative is not available. *The IRS cannot suspend the interview if the taxpayer received administrative summons.*
- ii. **Third party authorization.** If the taxpayer checked the box in the signature area of his/her income tax return (Form 1040, Form 1040A, or Form 1040EZ) to allow the IRS to discuss a tax return with another person (a third party designee), that person has the authority to receive information about the processing of the tax return and the status of the taxpayer's refund during the period a tax return is being processed. Note, this authorization does not replace Form 2848 and does not allow the third party designee to represent the taxpayer before the IRS.

with the IRS Tax auditor who had come to review his records. At one point the auditor exclaimed, "Mr. Carr, we feel it is a great privilege to be allowed to live and work in the USA. As a citizen you have an obligation to pay taxes, and we expect you to eagerly pay them with a smile."

"Thank goodness," returned Mr. Carr, with a giant grin on his face from ear to ear. "I thought you were going to want me to pay with cash."

A new arrival, about to enter hospital, saw two white coated doctors searching through the flower beds.

"Excuse me," he said. "Have you lost something?"

"No," replied one of the doctors. "We're doing a heart transplant for an income-tax inspector and want to find a suitable stone."

B. The Second Intermediate Step in the Audit Examination – Give the IRS

your records

- a. **IDR – (Information Document Request)** – The IRS informs the taxpayer which records it needs to review to complete the audit.
- b. **Summons**. Congress has given the IRS broad powers to compel the production of information it requires to ascertain tax liability or to collect tax. I.R.C. § 7602 permits the IRS, for any statutorily authorized purpose, to:
- i. Examine any books, papers, records or other data;
 - ii. Summon the taxpayer or any other person, requiring him/her to appear, produce books and records, and give testimony under oath; and
 - iii. Take testimony under oath.
- c. **Third Party Contact**
- i. **Notice of the IRS contact of third parties.** The IRS must give reasonable notice before contacting other persons (ex. taxpayer's neighbors, banks, employer or employees) about the taxpayer's tax matters. The IRS **must** also give the taxpayer notice of specific contacts by providing a record of persons contacted on both a periodic basis **and upon your request**.
 1. Notice of the IRS contact of third parties, however, does not apply:
 - a. To any pending criminal investigation;
 - b. In a situation where notice would jeopardize collection of tax liability;
 - c. In a situation where providing notice may result in reprisal against any person; or
 - d. When the taxpayer consents.
- d. **Miscellaneous Aspects of an Examination**
- i. **Confidentiality privilege**. Generally, the same confidentiality protection that the taxpayer has with an attorney also applies to

**TAXPAYER'S
LAMENT**

Tax his cow, Tax his goat;
Tax his pants, Tax his coat;
Tax his crop, Tax his work;
Tax his ties, Tax his shirt;

Tax his chew, Tax his smoke (now ain't that the truth);
Teach him taxing is no joke.
Tax his tractor, Tax his mule;
Tell him, Taxing is the rule.

Tax his oil, Tax his gas (again ain't that the truth)
Tax his notes, Tax his cash (oh boy a pattern emerges);
Tax him good and let him know,
That after taxes, he has no dough.

If he hollers, Tax him more;
Tax him till he's good and sore.
Tax his coffin, Tax his grave,
Tax his sod in which he's laid.

Put these words upon his tomb,
"Taxes drove him to his doom."
After he's gone, we won't relax,
We'll still collect inheritance tax.

certain communications that the taxpayer has with federally authorized practitioners.

Confidential communications are those that:

- Advise the taxpayer on tax matters within the scope of the practitioner's authority to practice before the IRS,
- Would be confidential between an attorney and the taxpayer, **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.

NOTE that in the case of communications in connection with the promotion of a person's participation in a tax shelter,¹ the confidentiality privilege does not apply to written communications between a federally authorized practitioner and that person, any director, officer, employee, agent, or representative of that person, or any other person holding a capital or profits interest in that person.

- ii. **Recordings.** The taxpayer can make an audio recording of the examination interview. The taxpayer must request to record the interview in writing. The taxpayer must notify the examiner 10 days in advance and bring his/her own recording equipment. The IRS also can record an interview. If the IRS initiates the recording, it must notify the taxpayer 10 days in advance and the taxpayer can get a copy of the recording at his/her expense.
- iii. **Transfers to another area.** Generally, the IRS examines a tax return in the same area where the taxpayer resides. But if it can examine the tax return in another area, namely, where the taxpayer's books and records are located then the taxpayer can ask the IRS to transfer the case to that area.
- iv. **Repeat examinations.** The IRS tries to avoid repeat examinations of the same items, but sometimes this happens. If the taxpayer's return was examined for the same items in either of the 2 previous years and no change was proposed to the tax liability, a request should be made to the IRS to discontinue the examination.

C. The final step in the audit examination process – is it the end?

a. **No Change Letter** - If the IRS accepts the tax return as filed, then the taxpayer will receive a letter in a few weeks after the audit stating that the examiner proposed no changes to the tax return. This letter should be kept with the tax records.

b. **Taxpayer Agrees** - The taxpayer may agree to the proposed changes to the tax return by signing an agreement form and paying any additional taxes he/she owes. The taxpayer must pay the accrued interest on any additional tax. If the taxpayer pays additional tax at the time the taxpayer signs the agreement, the interest payment covers the due date of the tax return to the date of payment.

One day, at a local buffet, a man suddenly called out, "My son's choking! He swallowed a quarter! Help! Please, anyone! Help!"

If the taxpayer does not pay any additional tax when the taxpayer signs the agreement, then the taxpayer will receive a bill that includes the interest. If the taxpayer pays the amount due within 10 business days of the billing date, the taxpayer will not have to pay any additional interest or penalties. This period is extended to 21 calendar days if the amount due is less than \$100,000.

A man from a nearby table stood up and announced that he was quite experienced at this sort of thing. He stepped over with almost no look of concern at all, wrapped his arms around the boy, and squeezed. Out popped the quarter. The man then went back to his table as though nothing had happened.

If the taxpayer is due a refund, the taxpayer will receive it sooner if the taxpayer signs the agreement form. The taxpayer will be paid interest on the refund.

"Thank you! Thank you!" the father cried. "Are you a paramedic?"

"No," replied the man. "I work for the IRS."

c. **Taxpayer Does Not Agree**

i. **Request Supervisory Review** - If the taxpayer does not agree with the proposed changes, the examiner will explain the appeal rights to the taxpayer. If examination takes place in an IRS office, the taxpayer can request an immediate meeting with the examiner's supervisor to discuss the return. If the supervisor and the taxpayer reach an agreement, the IRS will close the taxpayer's case.

ii. **30-day letter - Revenue Agents Report (RAR)** - If the taxpayer 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 the case explaining the taxpayer's and the IRS' position. The examiner will forward the case for processing to the right unit within the IRS. The taxpayer generally has 30 days from the date of the 30-day letter to accept or appeal the IRS' proposed changes. The 30-day letter will explain the steps

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the taxpayer must follow depending on which action the taxpayer chooses.

- iii. **90-day letter.** If the taxpayer does not respond to the 30-day letter, or if the taxpayer later does not reach an agreement with an Appeals Officer, the IRS will send the taxpayer a 90-day letter, also known as a **NOTICE OF DEFICIENCY**. The taxpayer will have 90 days (150 days if it the taxpayer's address is outside of the United States) from the date of this notice to file a petition with the Tax Court.