RECEIVING AN IRS NOTICE

ANSWERS TO IMPORTANT FIRST QUESTIONS

There are few things in business life less pleasant than finding out you’re being audited. But it doesn’t have to be painful. The process begins with a notice in the mail that your return has been flagged by the IRS. Your first order of business: don’t panic.

Review the information included in the contact letter. It should list the fiscal years under examination, the name and contact information of the revenue agent handling your case, and a request for an opening conference. Schedule this meeting upon receipt (with your tax advisor present). The date of the notice is important; once you are under examination you may be restricted from filing letter ruling requests or a change of accounting method. You should also anticipate the IRS issuing preliminary information document requests (IDRs) for basic financial and tax information. Be prepared.

What type of notice was received?

Large Business and International (LB&I) examinations
Most exams of businesses and individuals with assets of $10 million or more are managed through the LB&I Division, and the majority of the discussion in this book relates to LB&I exam. If you receive such a notice, you’ll need to have your preliminary IDRs completed for the opening conference with the IRS. The revenue agent assigned to your case may be accompanied by a team of professionals at the meeting, depending on the issues identified.

Partnership examinations
Partnerships fall under complex administrative guidelines known as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) rules. Under TEFRA, the Node B Application Part (NBAP) notice from the IRS will go to the partner representing the partnership in tax matters. This document is the partnership’s official notice that the IRS intends to examine its return. The IRS will then begin a preliminary review. They have 45 days to decide whether or not they’ll pursue the case; if the investigators decide there are no issues, they can withdraw the NBAP. For this reason, the date on which you receive the notice is extremely important—the IRS may delay issuing an NBAP to give themselves more time to make a determination.
Small Business/Self-Employed (SB/SE) examinations
If you own a small business (less than $10 million in assets), or are self-employed, you’ll be dealing with the SB/SE Division of the IRS. SB/SE examinations are less formal than exams conducted by LB&I, although your case may still be referred to LB&I depending on the complexity of the issues. A notice of examination from SB/SE might require you to appear at an IRS office, or they may come to wherever you do business.

Correspondence examinations
In some instances, the IRS may initiate a correspondence examination to substantiate specific items on your tax returns. If this happens, you will receive a contact letter from the IRS Service Center asking for information to substantiate certain things. The scope of correspondence examinations is limited, and they are handled without you having to meet with a revenue agent directly.

When is a notice not an examination?
Notice of errors
You may get a notice from the IRS correcting a computational error and adjusting the tax liability. These are used merely to correct obvious errors and do not constitute an examination of the tax return.

Penalty notices
The IRS may issue a penalty notice assessing a penalty for the late filing of a return, late payment of tax or any other delinquency penalty. The IRS will assess delinquency penalties without a specific examination of the return. While a penalty notice is not considered an examination of a return, the IRS may subsequently decide to examine it for substantive tax issues.

Repeat examinations
The IRS tries to avoid repeat examinations. If a taxpayer has been examined in the previous two years on an issue and there has been no adjustment, the taxpayer should ask the IRS to discontinue a further examination of the issue. If a tax return has been examined and the examination has closed, the IRS will generally not reopen an examination absent a compelling reason such as fraud.
What triggered the notice?

Generally, at the outset of the examination, the revenue agent handling your case should tell you what prompted the audit—which can be triggered in a number of different ways:

**Discriminant Inventory Function (DIF) score**

The IRS utilizes a computer algorithm known as the Discriminant Inventory Function System, which assigns a numeric score to all tax returns after processing. A high DIF score means a return includes items that fall outside normal parameters, and may subsequently be sent to an examination unit for further action.

**Campaigns**

The IRS’s LB&I Division has changed its audit procedures, and now launches “campaigns” to focus on specific issues the IRS determined have the highest potential for tax avoidance. One example: the micro captive insurance arrangements some taxpayers employ to self-insure risk. You may receive an examination notice if a campaign issue is identified in your return.

**Matching**

The IRS may be conducting an unrelated audit that turns up information which is then matched to you. For instance, income from an unrelated party issued with Form 1099 may lead the IRS to examine the receiving taxpayer to determine if the income was properly reported. Alternatively, examination adjustments to one taxpayer may lead to an examination of a different taxpayer on the other end of a related transaction.

**Outside contacts**

Open-source information may also lead to an examination. If an SEC filing, news article or other publicly available document piques an IRS investigator’s interest, they may decide to dig deeper. Perhaps your corporation is going through a major reorganization; the IRS may initiate an examination to determine the correct tax reporting of the transaction.

**Who do you call first?**

Your tax advisor.

**Helpful IRS links:**

- [IRS Publication 3498 – The Examination Process](#)
- [IRS Publication 556 – Examination of Returns, Appeal Rights, and Claims for Refund](#)
PREPARING FOR THE AUDIT

KNOW YOUR SURROUNDINGS

Know who is conducting the audit

It is very important to understand who within the IRS will be conducting your examination so you can get your information organized and establish the proper lines of communication. There are four separate divisions within the IRS that conduct audits, depending on the type of taxpayer concerned. Most business taxpayers fall under the jurisdiction of the LB&I Division, which is organized into nine different “practice areas” based on geography and subject matter.

Review the relevant tax return

Does the return contain disclosures? If the return in question discloses uncertain tax positions on Schedule UTP or Form 8275, be prepared to discuss the issue with the IRS examiner.

Are there obvious errors that need to be corrected? If so, you won’t incur any penalties if you concede them to the examiner at the outset of the exam.

Are there any claims for refund that need to be prepared? If you’ve overlooked any deductions or credits that might have resulted in a refund, make sure to present any claim early on in the examination process to get full consideration.

New LB&I high-level organizational chart
Common areas of concern

**Accounting methods**
Upon review, you may discover that an incorrect accounting method was used to calculate your tax liability. If you have not yet been contacted by the IRS for examination, simply filing for a change of accounting method on Form 3115 may provide you with audit protection. If an incorrect audit method is discovered during the examination, consider elevating the issue to Appeals for a chance at a more flexible resolution.

**Transactions**
Often, acquisitions, reorganizations, and tax-free spin-offs require adhering to very specific tax rules. The examination will go much more smoothly if you are prepared to address the issues raised by such transactions.

**Penalty identification**
The IRS may impose accuracy-related penalties on any underpayment based on negligence, disregard of rules and regulations, or a substantial understatement of tax. Even for uncertain tax positions, penalties can be avoided if you can demonstrate substantial authority or reasonable cause.

**Documentation**
Having all the proper documentation you need to support a tax position is crucial to addressing an IRS examiner’s inquiries. Get everything organized before the audit to avoid surprises later.
Outline of the audit process

An audit begins with a contact letter from the IRS scheduling an opening conference. At the outset of the examination, the IRS will issue three IDRs asking for three things: general books and records; disclosure of any tax shelter transactions; and any transfer pricing studies you may have performed. From there, the IRS will determine the scope of the audit, the time frame and which issues they will look at.

Helpful IRS links:

- IRS Publication 5125 - LB&I Examination Process
- IRS News Release – LB&I Launches Compliance Campaigns
ESSENTIAL ELEMENTS OF THE IRS EXAMINATION

Opening conference

An audit begins with a contact letter from the IRS scheduling an opening conference. At the outset of the examination, the IRS will issue three IDRs asking for three things: general books and records; disclosure of any tax shelter transactions; and any transfer pricing studies you may have performed. From there, the IRS will determine the scope of the audit, the time frame and which issues they will look at.

In the contact letter, the IRS agent handling your case will propose a time for an opening conference. This meeting will include the lead revenue agent, team manager and any IRS specialists involved. It’s an important point in the process during which you will be able to set expectations and develop a working relationship with the IRS team. You can expect these officials to discuss what to expect: the procedures for conducting the examination, expectations on the exchange of information, target dates for completing the field examination and the issuance of any Notice of Proposed adjustments. For your part, be prepared to present an overview of your business operations and to discuss the timing of the audit.

Before the opening conference, review the return in question to identify any issues that might be conceded in order to avoid a penalty. At the outset of the examination, the IRS will generally permit taxpayers to provide the IRS with agreed adjustments. Under Rev. Proc. 94–69, you have a short window to square these up—things like computational errors—without triggering the accuracy-related penalty.

Information document requests

Before the opening conference, the IRS will issue preliminary IDRs requesting basic financial information, transfer pricing documentation (if applicable) and answers about any reportable transactions you may have entered into. The responses to these IDRs should be ready by the time of the opening conference.

After analyzing the preliminary data, the IRS will shift to so-called “issue focused IDRs” which each pertain to a specific issue. New IRS procedures require the examiner to issue an IDR in draft form first. This allows you to discuss it with the agent, gather the proper documentation and agree on a timeline for your response.

Once the details have been squared away, you will be required to stick to the agreed-upon schedule. Failure to respond in a timely fashion can trigger enforcement procedures.
Proposed adjustments

Once the revenue agent handling your case has completed their field examination, each potential issue they have found will be presented to you in what is called a Notice of Proposed Adjustment, or Form 5701. It details the applicable legal authorities under which the action is proceeding, the IRS rationale for the proposed adjustment and the taxpayer’s position, if known. You’ll be given three choices:

- Agree with the proposed adjustment
- Disagree with the proposed adjustment
- Present additional information that might help resolve the issue

The Notice of Proposed Adjustment can be quite helpful as it provides the IRS’s view of the facts and its analysis of the issue. With this information, you can prepare a tight, focused response to correct any misunderstandings of the facts, explain your position and present any additional legal authorities to support your case.

Resolution options

Even if you find yourself and the IRS at loggerheads, there are still several ways to move your case toward a resolution.

*Industry practice groups*

The IRS has established industry practice groups (IPGs) that informally advise IRS examiners on industry-specific issues. Getting an IPG to bring in IRS personnel who are familiar with the industry and the issue involved may help.

*Technical advice*

For issues involving a technical interpretation of a rule or regulation, you can ask that the issue be considered by IRS Chief Counsel through the technical advice process. Technical advice is at the discretion of the IRS, but for purely technical (not factual) issues, the IRS examiner may be inclined to go this route.

*Fast Track Settlement*

The IRS has instituted a dispute resolution technique called Fast Track Settlement (FTS), which tries to resolve cases at the examination level when there are a limited number of issues. If you request that your case be fast tracked, an IRS appeals officer will be assigned to act as a mediator between you and the IRS exam team to try to resolve the issues. It can save a lot of time; most FTS cases are resolved within 120 days.
30-day letter
If a case can’t be resolved at the examination level, taxpayers have the option of escalating to IRS Office of Appeals (Appeals). The examiner will issue a 30-day letter detailing the IRS’s position, and will propose a tax deficiency. You will then have 30 days to protest the IRS position, in writing, and request Appeals’ consideration.

Settlement consideration

Deciding to settle or contest the IRS examination results requires strategy as well as resources. For example, a recurring issue such as depreciation may be something needing to be addressed in a closing agreement. An issue that involves accounting methods may be reserved for IRS Appeals, which has greater flexibility to fashion a settlement.

Any settlement of the IRS examination will have ramifications for both state tax liability and the filing of amended returns. Thus, state tax filings play an important role in the strategy and timing of a settlement. Once an IRS exam is settled, there’s a limited period during which you may file amended state returns reflecting the agreed adjustments. By settling some issues related to the IRS exam now, and settling some later, you may be saddled with having to file two sets of amended state returns.

Helpful IRS links:

IRS Memorandum for Examiners – New Process for Information Document Requests

IRS Internal Memo – Tiered Issues and Issue Practice Groups
CONSIDER THE FUTURE TAX IMPACT OF THIS CHOICE

At the conclusion of the IRS field examination, the examiner will present to you any adjustments they have prepared. If you agree with their findings, the revenue agent involved will ask you to sign a Form 870, which allows for additional taxes to be assessed. If you object, you have a decision to make—try to settle the issues at IRS Appeals, or forego any further administrative steps and proceed to litigation.

Administrative Appeals

IRS Appeals is a division wholly independent of the examination function. It exists to resolve disputes in a way that is fair to both the taxpayer and the government. Ninety percent of cases brought to Appeals are successfully resolved, with outcomes acceptable to both sides. In devising a settlement, Appeals is permitted to consider the “hazards of litigation” — the odds of either side prevailing in court. This allows Appeals far greater flexibility than the Examination Division has in coming to an acceptable agreement.

30-day letter

As described in Chapter 3, the traditional route to Appeals’ consideration is through a 30-day letter. At the end of the examination, any disputed issues will be written up in a Revenue Agent Report, and a 30-day letter issued. You’ll then have a month to draft a protest. The case will then be transferred to Appeals for consideration.

90-day letter

If you don’t respond to the 30-day letter within 30 days, the IRS will automatically issue a Statutory Notice of Deficiency, or a “90-day letter.” This puts you on notice that taxes will be assessed, as determined by the IRS, after 90 days. If you disagree with the proposed assessment, there are still two options:

- Pay the tax and sue for a refund
- File a petition in United States Tax Court and seek a redetermination of the tax deficiency. (Petitioning the Tax Court increases the odds of the matter being sent back to Appeals for another shot at resolution before either side incurs the cost of litigation.)

While there is always a “worst-case scenario,” most taxpayers will be given an opportunity to resolve their case with Appeals on terms acceptable to both sides.
Alternative Dispute Resolution

Court battles can be both costly and time consuming, and these factors can sometimes outweigh the amount of taxes at issue to begin with. To avoid litigation, the IRS has instituted several alternative dispute resolution programs to resolve unagreed issues. You need to consider all options available—Appeals settlement, alternative dispute resolution, Tax Court litigation and District Court litigation—in developing your strategy moving forward.

Fast Track Settlement

As mentioned in the previous chapter, the FTS program tries to resolve cases at the examination level. An IRS appeals officer acts as a mediator between the IRS exam team and the taxpayer, and cases are usually resolved inside of four months.

Appeals mediation

If a case under Appeals’ consideration cannot be resolved, Appeals mediation can be invoked to broker an agreement. An unrelated appeals officer will be assigned to act as a mediator between you and the original appeals officer, and will try to reach a settlement acceptable to both parties.

If no settlement is reached, you’ll have to decide whether or not to take it to court.
Litigation takes place in one of two forums—the United States Tax Court or a United States District Court (also known as the Court of Claims or District Court). It is important to consider carefully which will be best for your particular situation.

**United States Tax Court**
The Tax Court is an administrative court established by Congress to deal specifically with federal tax issues. Most tax cases are litigated in Tax Court. The Tax Court’s jurisdiction is limited; for a taxpayer to get a case heard in Tax Court, they must have received a 90-day letter (Notice of Deficiency) from the IRS, after which they petitioned the Tax Court within the three-month period. The advantage of trying a case in Tax Court is that the taxpayer does not have to pay the tax deficiency for the case to be heard. In addition, Tax Court judges are career tax attorneys familiar with tax issues. If yours is a complex case, this may be the most favorable forum. Lastly, the Tax Court has its own set of procedural rules, which are somewhat more relaxed than the formal rules of civil procedure found in District Court.

**United States District Court**
District Court (and the Claims Court) are judicial courts established under Article III of the Constitution. For a case to proceed in the District Court, the litigant has to have a “case or controversy,” which generally means that the taxpayer is suing the government for a tax refund. District Court can be a favorable forum if the court has decided favorably on an issue similar to yours, and is likely to follow its precedent. Of course, there are drawbacks. You will be required to pay the tax deficiency first, then sue for a refund. Also, the government is represented by Justice Department Attorneys in District Court, not IRS Chief Counsel, and District Court judges are not necessarily experts in tax law. For these reasons, trying a complex tax case in District Court may present its own unique set of challenges.

**Helpful IRS links:**
- IRS Publication 5 – Your Appeal Rights and How To Prepare a Protest If You Don’t Agree
- IRS Publication 4167 – Appeals, Introduction to Alternative Dispute Resolution
- IRS Publication 4539 – Fast Track Settlement
IRS penalties generally fall into two categories: delinquency penalties and accuracy-related ones.

**Delinquency penalties**
Filing or paying late can trigger delinquency penalties. These are what the IRS calls “assessable penalties,” meaning the IRS will assess the penalty and send you a bill. But being late can have serious consequences beyond having to pay a fine. If a return (or an extension) is filed late, any elections that would have normally been acceptable are now invalid. For corporations, an extension filed without the amount of taxes due fully paid, the extension may be declared invalid, causing the return to be filed late and triggering a penalty.

**Accuracy-related penalties**
Penalties such as the “negligence penalty” are accuracy-related sanctions that come up during an IRS exam. If the examination results in a proposed tax deficiency and the IRS attaches a penalty, the penalty then becomes part of the overall deficiency. This means it will not be assessed until you agree to the adjustments or any litigation becomes final.

**Penalty avoidance**
Delinquency penalties are calculated on the amount of tax owed after the due date (without extensions) of the tax return. If you are unable to file your return on time, paying off any tax liability will avoid a penalty. A late filing penalty can be avoided by filing on time, even if you can’t make full payment of the amount due.

Often, accuracy-related penalties can be avoided by filing a disclosure statement with your tax return. Some return positions lack a clear basis, as there are conflicting tax authorities making their own interpretations, regulations are vague or the taxpayer has utilized an unusual set of facts. To the extent a position lacks “substantial authority,” taxpayers can file a disclosure statement on Form 8275 and demonstrate a reasonable basis for taking the position. A position that has been disclosed to the IRS may be subject to an adjustment, but will generally not be subject to a penalty.
Accuracy-related penalties

An IRS examiner may impose a penalty on any proposed adjustment. Accuracy-related penalties are computed at 20 percent of the tax deficiency. In fact, the accuracy-related penalty consists of several penalties grouped together, only one of which can actually be applied to the tax deficiency. The potential penalties are:

**Negligence**
Negligence is defined as a failure to make a reasonable attempt to comply with the tax law, or not to exercise ordinary and reasonable care in preparing a tax return. Negligence can include failure to substantiate items on the return, as well as failure to keep adequate records.

**Disregard**
The accuracy-related penalty applies only if an underpayment results from the reckless or intentional disregard of a rule or regulation. “Rule” includes the Internal Revenue Code, revenue rulings and notices. “Regulation” includes final or temporary Treasury regulations.

**Substantial understatement**
This penalty applies if there is an understatement of income tax, and the understatement is “substantial.” That generally means 10 percent of the tax required to be shown.

**Valuation misstatements**
Valuation misstatements come in several varieties, including substantial valuation misstatements of income tax deductions, substantial overstatements of pension liabilities, and substantial estate or gift tax valuation understatement. In the case of gross misstatements, the penalty may be as high as 40 percent of the tax deficiency.

**Interest**
On any tax deficiency, interest will accrue from the due date of the return until final payment is made. Interest is imposed by statute, and the IRS is not afforded discretion to waive it. The interest rate on an underpayment is the Federal short-term rate plus 3 percentage points. For large corporations, the interest rate can increase from 3 to 5 percentage points after receipt of a 30-day letter from the IRS.
Penalty relief

At the end of the audit, the IRS examiner will decide whether or not to include a penalty with any proposed adjustment. For a taxpayer to prevail in litigation for the underlying tax adjustment, they need to show that the position taken on the tax return was “more likely than not” to be correct. Expressed in numerical terms, that’s a +50 percent chance of being correct—a relatively high standard. However, avoiding the accuracy-related penalty requires clearing a somewhat lower bar—either substantial authority for the position or reasonable basis.

“Substantial authority” is defined as the weight of authorities supporting a position must be substantial in relation to the weight of authorities supporting the contrary position. This is often seen as having a 35 to 40 percent chance of prevailing in litigation. Generally, if you can demonstrate substantial authority for a position, the accuracy-related penalty will not apply.

“Reasonable basis” is an even lower threshold—one need only to demonstrate that the return position is reasonably based on one or more authorities. In numerical terms, reasonable basis represents about a 20 percent chance of prevailing in litigation. To avoid the negligence penalty, you need only to show that there was a reasonable basis for the position. For penalties such as the disregard and substantial understatement penalty, a taxpayer can file a disclosure statement with their return, then later demonstrate a reasonable basis for the position.

A taxpayer can be relieved from the accuracy-related penalty by demonstrating either substantial authority or a reasonable basis for the return position. For any return position that might be challenged, you should research and prepare a list of relevant authorities to support the position. In some cases, filing a disclosure statement on Form 8275 will result in you having to show nothing more than a reasonable basis for the position. Thus, it is entirely possible that a taxpayer may not prevail on the underlying tax issue, but be able to avoid a penalty by demonstrating substantial authority or a reasonable basis for the position.

Helpful IRS links:

MANAGING COLLECTIONS

FIND A WAY TO WORK TOGETHER

Broadly speaking, the IRS fulfills two functions: It examines tax returns to determine if they’re accurate, proposing adjustments when necessary, and it pursues payment once a tax assessment has been made, a process carried out by its Collections Division.

IRS assessments

The collection process cannot begin until there is an assessment of tax, which is the recording of a tax liability with the government. This will usually occur in one of two ways, either through self-assessment, when a taxpayer files a return, or upon the completion of an examination process.

When you file a tax return that shows a liability and you fail to pay the tax after the IRS demands the payment of tax, the case goes to collections. In an examination process, an assessment is made when you agree to the proposed adjustments, default on either a Notice of Demand for the payment of the tax or at the end of litigation in tax court (including the appeal).

At the end of an examination, if there are agreed adjustments, you’ll be asked to sign a Form 870 (or 870-AD for IRS Appeals), which allows the IRS to assess the tax. The IRS has 60 days from the date of the assessment of tax to issue a bill (Notice and Demand) through collections. You, the taxpayer, have 10 days from the date of the Notice to pay the tax. The Notice will show the amount of tax due, plus interest, through the date of the demand. If you fail to pay, interest will continue to accrue, and you might face a late payment penalty. The IRS has 10 years to collect the tax due once it has been assessed.

Collection options

Not paying a tax after you’ve received a Notice can lead to serious consequences. When the IRS issues a Notice, and you do not pay within the 10-day period, the IRS assesses the tax. After the assessment, a general tax lien arises. The IRS can also levy on your property after if offers you Collection Due Process (CDP) Rights. In certain situations, CDP Rights can be provided after the IRS levies on your property. Thus, it is important that you pay the amount due or discuss your options with the IRS Collection Division, or a tax professional.

Installment agreements

One option may be to enter into an installment agreement that will allow you to pay the tax due in installments over a three-year period, a possibility for those taxpayers unable to immediately pay a bill. Not every taxpayer will qualify for an installment plan; however, applicants, who must be current in their tax filing, are required to submit financial information to the IRS. For business taxpayers, a Form 433-B “Collection Information Statement for Business” must be submitted detailing the business’ assets, liabilities, monthly income and expenses. Based on the information provided, the IRS will determine whether to approve an installment agreement, but note that interest will continue to accrue on the outstanding balance until it is paid in full.
**Offers in compromise**
In rare circumstances, you can apply for an Offer in Compromise and negotiate a reduced bill for the outstanding tax liability. This might be an appropriate option to consider when there’s doubt as to liability (whether the tax was assessed properly), or doubt as to collectability (inability to pay tax). As with installment agreements, you must be current in your tax filing obligation and provide the IRS with detailed financial information on Form 656 to apply for an offer in compromise.

If necessary, it’s possible to have an adverse decision about an installment agreement or offers in compromise application reviewed by the Office of Appeals.

**Collection due process: Penalty disputes**

Taxpayers can request a Collection Due Process hearing to review collection actions such as a Notice of a Federal Tax Lien Filing or a Notice of Intent to Levy. Although Collection Due Process is a venue for reviewing the procedural aspects of collections efforts, it can sometimes be used to review the underlying liability, too.

In penalty cases, many delinquency penalties, such as those for a late filing, are “assessable” penalties; the IRS will assess the penalty without launching an examination. Once the penalty has been assessed, the IRS can issue a Notice and Demand for the payment of tax (Notice) through the collection process. This means that you may receive a Notice, even though you have not had an opportunity to challenge the assessment. By requesting a Collections Due Process hearing, however, you might have that opportunity. Hearings allow taxpayers to explain why a penalty should not have been assessed and ask that it be abated.

It’s important to remember that Examination and Collections are completely separate divisions, functioning separately, within the IRS. Once a tax liability has been assessed by the Examination Division, the deficiency in tax becomes the subject of the Collections Division. When closing out an IRS examination, taxpayers need to consider how the tax deficiency will be paid, and what procedures will need to be followed.

**Helpful IRS links:**

MITIGATING FUTURE RISK

PLAN AHEAD TO AVOID SIMILAR—OR RESIDUAL—MISTAKES

Applying the audit findings to future years
When settling an IRS audit, it’s important to consider that the results of an IRS examination can have implications for future tax years and tax returns. (For example, an adjustment to a depreciable asset might affect its depreciation rates in subsequent years.) Fortunately, there are procedures in place that allow taxpayers to settle examination issues that will recur in annual tax returns without going through a protracted review each time.

Delegation orders
One procedure that can save you the hassle of taking a recurring issue to Appeals every year involves delegating authority to a third-party agent who can apply an Appeal Settlement to future returns. Under Delegation Order 4–23, LB&I team managers are delegated the authority to apply an Appeals Settlement to the same issues in a subsequent examination. However, in order to qualify for a delegation order, four conditions must be met: the facts surrounding the issue in subsequent years must be similar to those considered by Appeals in the initial case; the tax law must not have changed significantly in the intervening period; the underlying issue must have been settled by Appeals, without trading off issues; and the same taxpayer must be involved.

Closing agreements
In certain situations, the IRS will enter into a closing agreement to make a final determination of a tax liability (Form 866), or agree to a final determination of a specific matter (Form 906). Therefore, if your examination leads to an adjustment that has implications for subsequent tax filings, under a closing agreement with the IRS, the tax treatment of that asset will be settled for future years. Note that the IRS has wide discretion to enter into closing agreements. It might do so when there’s a clear advantage to having an issue permanently closed and sees no downsides for the government.

Fundamentals of audit avoidance
To avoid resolving tax issues through an IRS audit, which can be a lengthy and expensive process, there are several proactive steps you can take before an examination. Anticipating issues that could arise during an audit, and taking protective action when possible, will make the process more manageable.
Accounting method changes
If you’re using an arguably incorrect or less accurate accounting method for inventory, income recognition or other relevant accounting items, filing for an approval to change methods may allow you to avoid an examination adjustment later. That said, many accounting method changes are automatic, meaning they can go forward without approval from the IRS.

Documentation
Some deductible expenses, such as entertainment expenses, or research that qualifies for a research tax credit, require documentation to verify the taxpayer’s position. Making sure that contemporaneous documentation is both recorded and preserved as transactions occur will save time during an IRS examination. In addition, meeting with the IRS agent to review the available documentation together can reduce the number of IDRs the agent will need to make during the audit process.

Disclosures
Tax law is complex, and different authorities may hold conflicting views about how certain issues should be treated. If you’re uncertain about a tax position, filing a disclosure (on Form 8275) might be your best course of action, because it would allow you to avoid penalties if there is an adjustment. Generally, a taxpayer need only to have substantial authority to report a tax position on a return, but with a disclosure, the taxpayer need only show a reasonable basis for the position. Remember, while filing a disclosure may prevent the IRS from assessing penalties for an uncertain tax position, it does not necessarily raise a taxpayer’s audit profile.

IRS examinations can be time-consuming, tedious and costly, but having a strategy to deal with complex tax issues before an examination can save much time and frustration. What’s more, knowing what to expect during an examination, and planning accordingly, can make the process more efficient and lead to a more expedient, successful resolution.

Helpful IRS links:
IRS News Release – Closing Agreements
IRS News Release – Uncertain Tax Positions – Schedule UTP