

How To Detect & Mitigate IRS Exams Before They Begin

Learn how to detect IRS Exams early by understanding the IRS audit selection process and mitigate the effects for your clients.



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Roger Nemeth, EA

- Started managing tax franchises in 2006.
- President and primary developer of Tax Help Software Transcript Analysis Software.
- Qualified as an N.T.P.I. Fellow in 2015.
- Worked as a programmer for the largest Tax Resolution Company integrating automated transcript systems into workflow programs.
- Assisted in the downloading and research of over 30 million transcripts.
- To date the software has been used to download just under one-fifth of a billion transcripts.



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Objective

- Understand how the IRS Examination process works and how to identify IRS Examinations before they officially begin.
- Understand how to mitigate the audit outcome through early detection.
- The previous e-Services & Transcript Presentation covered how to obtain the necessary information. This presentation will not cover how to obtain IRS transcripts, but stands on it's own.

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Upon Course Completion

- Understand the different audit/examinations performed by the IRS on individuals.
- Understand how to identify the presence of an examination on an IRS transcript.
- Understand what type of audit is underway.
- Understand how to identify the subject of the audit when possible.
- Understand how to mitigate the effects of the audit.
- Understand how to search multiple transcripts from any computer without software.

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Introduction

The IRS is a giant bureaucracy with massively complicated computer systems. An outsider might assume that the IRS would not want taxpayers to know they were under an impending audit and would keep it hidden. Fortunately for tax practitioners the IRS does post flags to a taxpayer's account months before an audit officially starts. This window offers an opportunity for tax practitioners to be pro-active in dealing with impending client issues saving their client's money and allowing practitioners to generate additional revenue while retaining existing clients at a higher rate. This presentation will teach you how to implement this process into your firm.

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Blame Game

How many of you are accused each and every year of "screwing up" your client's return because they received a letter from the IRS?

Imagine being able to call a client six months before they receive a notice and advise them they forgot a couple of 1099s or maybe a 1099r for \$20,000!!!! The blame game stops if you can notify them before the IRS does.

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How To Generate Revenue From Early Audit Detection

By detecting audits in advance it provides a revenue opportunity for a tax professional and/or firm.

1. CP2000 / Automated Under Reporter (AUR)
 1. Allows for an amended return to be filed plus any associated penalty abatement opportunities.
2. Field/Correspondence Audit
 1. Possibly allows for an amended return.
 2. Allows billable prep time in anticipation of audit.
3. Charge for the monitoring annually to all existing/new clients.

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Exam Vs Audit

There is always a great debate about what is an audit and what is an exam. For purposes of this presentation the words are interchangeable while acknowledging that there is some debate on the subject.

Presentation Note: A taxpayer can receive a CP2000 and also be audited with a field or correspondence audit.

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Types of Audits¹

- Correspondence Audit
 - Exam conducted via mailed correspondences.
- Field Audit
 - Exam conducted at taxpayer's business or residence.
- Office Audit
 - Exam conducted at IRS office.
- National Research Program (**NRP**) Audits
 - Randomly selected audits.
- Automated Under Reporter(**AUR**) - CP2000
 - This correspondence exam compares income & deductions reported with income filed on return.

¹ IRS IRM Part 4. Examining Process

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Automated Substitute For Return (**ASFR**) Procedures

According to the IRM¹ the ASFR System identifies unfiled returns that show income on the Information Returns Processing (IRP) (IRP = Wage & Income Data). The system then files an SFR and sends the letter to the taxpayer usually without any input from any IRS employees. IRS employees then work the responses manually.

¹ IRS IRM 5.18.1.3 (04-06-2016) ASFR Processing

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ASFR Program On & Off Again

According to an IRS Inspector General Press Release¹ the IRS basically suspended the ASFR program in late 2017 due to staffing requirements. The IRS suspended the program due to the employee resources reviewing ASFR responses from taxpayers.

Officially it was not “suspended” but instead “significantly reduced”.

My understanding from conversations with other tax practitioners is that the program has resumed and the IRS is adding personnel to ramp it back up. There has not been an official statement published yet for reference.

¹ TIGTA Press Release, A Significantly Reduced Automated Substitute for Return Program Negatively Affected Collection and Filing Compliance, October 16, 2017 TIGTA-2017-27

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Chances Of Audit And AUR

According to the IRS 2016 & 2017 Data Books (Statistics of Income October 1, 2015/2016 to September 30, 2016/2017) an individual tax return had between a 2.82% and 3.02% chance of receiving an audit or AUR.

2015 Tax Year	2016 IRS Fiscal Year Totals						
Individual Returns Filed	Total Audit/AUR %	Audit %	Total Audits	Field/Office Audits	Correspondence Audits	AUR %	Closed AUR Totals
147,967,324	3.04%	0.69%	1,034,955	243,722	791,233	2.34%	3,477,000
2016 Tax Year	2017 IRS Fiscal Year Totals						
Individual Returns Filed	Total Audit/AUR %	Audit %	Total Audits	Field/Office Audits	Correspondence Audits	AUR %	Closed AUR Totals
149,919,416	2.82%	.620%	933,785	214,582	719,203	2.20%	3,295,000

¹ 2016 & 2017 IRS Data Books, Enforcement: Examinations Section

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IRS Transaction Codes For Exam¹

- TC 420/424 Examination of return
 - Correspondence Audit.
 - Field Audit.
 - Office Audit.
 - NRP Audit.
- TC 922 Review of unreported income
 - Automated Under Reporter(AUR) - CP2000

¹ IRS Transaction Codes Pocket Guide IRS.gov https://www.irs.gov/pub/irs-utl/transaction_codes_pocket_guide.pdf

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Exam Flag Transaction Codes

All exam flags except AUR are:

- 420 Examination of tax return
- 424 Examination of tax return

670	Payment	06-23-2006	-\$48.74
420	Examination of tax return	08-10-2006	\$0.00
300	Additional tax assessed by examination	20080608 02-18-2008	\$0.00
n/a	49247-430-00357-8		

AUR Flag is: 922 Review of unreported income

971	Tax period blocked from automated levy program	12-29-2008	\$0.00
922	Review of unreported income	03-08-2010	\$0.00
971	Pending installment agreement	04-29-2009	\$0.00
971	Account match for federal levy payment program	11-30-2009	\$0.00

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Common Misconception About IRS Audits on IRS Transcripts

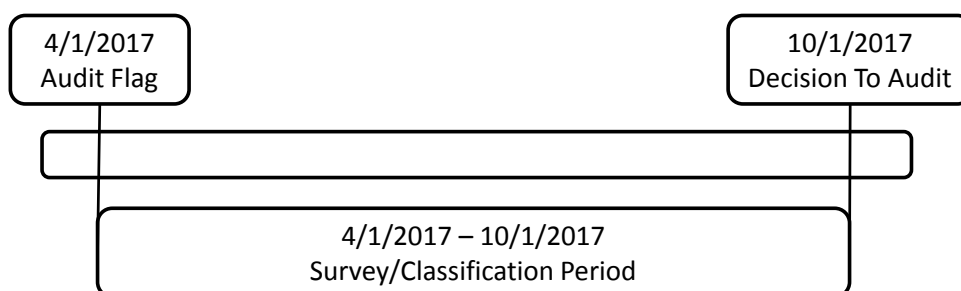
The misconception about the Audit Codes on the IRS transcripts is that the audit has begun and the letter has been mailed when the 420/424 is posted:

1. The Module (the tax year and period if quarterly) are flagged for audit. The transaction is recorded on the account transcript.
2. There is then a classification/survey period that takes place to determine if the actual audit should begin.¹
 - a. The classification/survey period can vary.
3. If the IRS decides to move forward the letter is sent and the audit officially begins.

¹ IRS IRM 4.63.4.5.5 (01-25-2018) Procedures for Surveying Returns After Assignment

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Audit Timeline



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AUR Information

A common misconception with AURs is that they are automated. The IRS computer determines what was filed on the return with what was reported to IRP and if the two do not match resulting in more tax being owed then the audit letter is sent.¹

AURs are reviewed by IRS personnel just like regular audits except they are done within the AUR unit.

From the IRM, "Selected cases undergo an in-depth review by a tax examiner to identify underreported and/or overdeducted issues which require further explanation to resolve the discrepancy."

¹ IRS IRM 4.19.2.1.1 (08-15-2017) Background

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Wage & Income Complete Date

The IRS considers the Wage & Income Transcripts to be complete in July after the year they were earned. For example for 2017 the W&I Transcripts would not be complete until July, 2018

Complete income information may not be available until the earnings are reported, usually by July of the following year. TDS can only deliver 198 wage and income documents.

* Product Type:
 * Request Purpose:

Presentation Note: Third parties who are delinquent can add information years after the Tax Year deadline.

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Wage & Income Transcript Release Dates

In 2018, the IRS delayed the release of Wage & Income Transcripts until May 7, 2018 (After the initial filing period is over).¹ The IRS did this due to identity theft cases that had used the taxpayer's actual data to create fake tax returns that were able to get by the IRS fraud filters undetected. Not sure why waiting until May worked since the IRS fraud filters compare the prior year info to the new return.

(2019 W&I were released May 28).

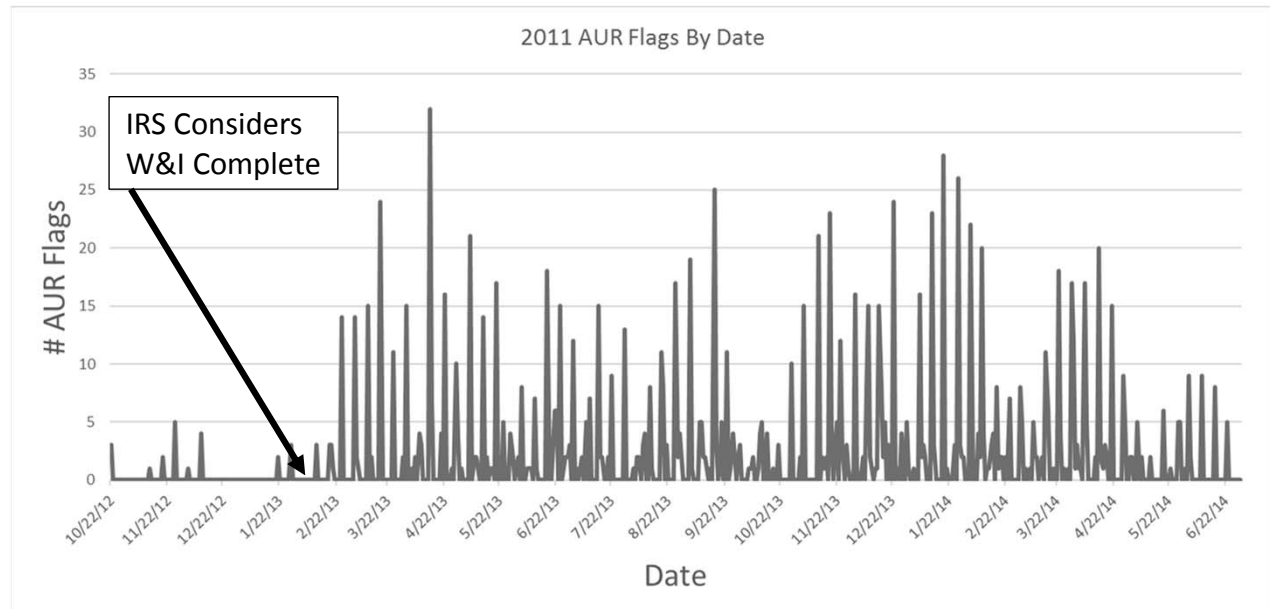
¹ IRS IRM 21.2.3.5.7.8 (07-17-2018) Transcript Restrictions and Special Handling

When Do AUR Audits Take Place

Another misconception is AUR's are all sent during the same time frame. A review of 1,290 AUR's from the 2011 tax year show they are spread out through the year. (next slide)

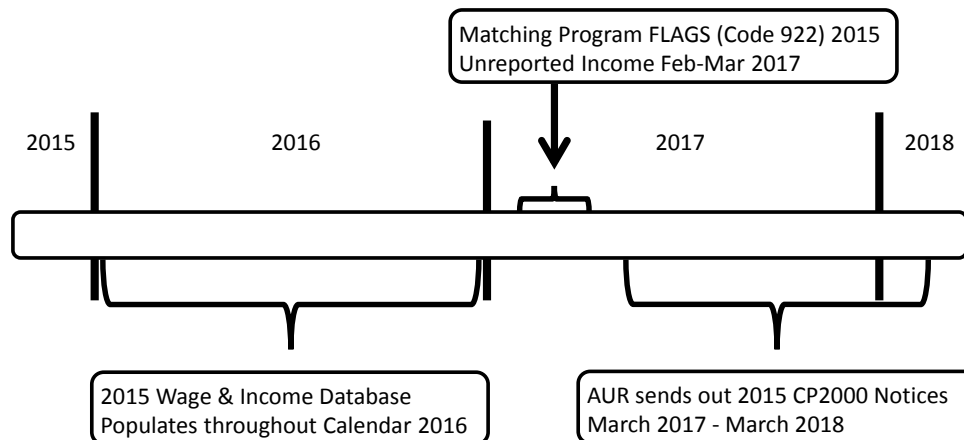
Although the date changes after the letter is sent it appears AUR's occur during the year and not all at once, but the best practice is to check for them early in the following year (January through March) to get the biggest head start.

2011 AUR Flag Breakdown



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2015 W&I Populates through 2016



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AUR Transaction Date Will Change As Audit Proceeds

The date on the AUR 922 transaction code will update as follows.

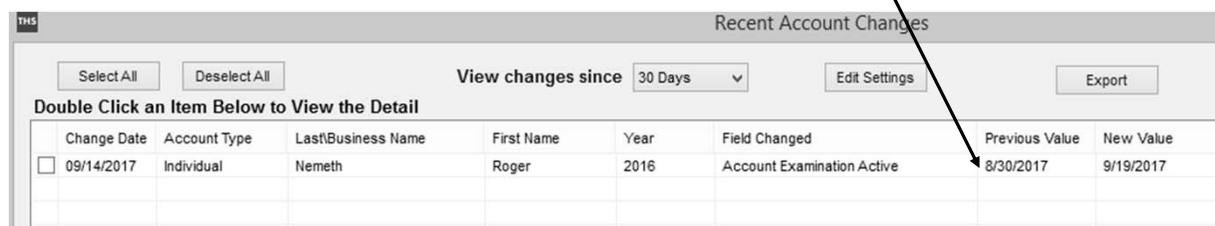
1. The first posting is the AUR Flag.
2. The second posting will be the sending of the CP2000 or 2501 Notice.
3. The third date change will be when the audit results in an assessment.

Presentation Note: There will only be one 922 transaction on the transcript. The date is just changed.

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Detecting AUR Notice Sent

When you see the initial date change for an AUR/CP2000 that usually means the notice is sent to the taxpayer.



Recent Account Changes								
Select All		Deselect All		View changes since 30 Days		Edit Settings		Export
Double Click an Item Below to View the Detail								
Change Date	Account Type	Last Business Name	First Name	Year	Field Changed	Previous Value	New Value	
<input type="checkbox"/> 09/14/2017	Individual	Nemeth	Roger	2016	Account Examination Active	8/30/2017	9/19/2017	

Presentation Note: The date change can also indicate the assessment is being made as well.

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IRS Discriminate Index Function (DIF) Score

IRS 6209 Section 12 - Examination

2. Discriminate Function (DIF)

Discriminate Function (DIF) is a mathematical technique used to classify income tax returns as to Examination potential.

Under this concept, formulas are developed based on available data and are programmed into the computer to classify returns by assigning weights to certain basic return characteristics. These weights are added together to obtain a composite score for each return processed. This score is used to rank the returns in numerical sequence (highest to lowest). **The higher the score, the higher the probability of significant tax change.** The highest scored returns are made available to Examination upon request.

The DIF-system involves computer classification to mathematically determine the Examination potential of returns, and manual screening to set the scope of examinations and to select needed workload.¹

¹ Document 6209 - ADP and IDRS Information Section 12

DIF Score Summary

The IRS DIF Score does not determine Audit Chances for that return. It identifies the potential change in tax amount. The decision to audit is made during the Classification/Survey Period.

Higher income returns are selected at a higher rate based on the calculation. The IRS is concerned about total amounts not percentages.

Example 1: Two taxpayers take 75% itemized deductions (in relation to income). Taxpayer 1 wages = \$100,000. Taxpayer 2 wages = \$1,000,000. Taxpayer 2 will have a much higher DIF score because his itemized deductions are 10 times more than Taxpayer 1.

Example 2: Two taxpayers take \$75,000 in itemized deductions. Taxpayer 1 wages = \$100,000. Taxpayer 2 wages = \$1,000,000. Taxpayer 1 will probably have a higher DIF score, but not by much if all things are static.

Who Has The #1 DIF Score



Possibly? Just thought I would put a fun slide in. The story about the carry forward loss was just breaking while I was finalizing this presentation and thought it was a good example of someone with a high DIF Score.

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IRS Unreported Income Discriminate Function (UIDIF) Score

From FS-2006-10, January 2006

The Unreported Income DIF (UIDIF) score rates the return for the potential of unreported income. IRS personnel screen the highest-scoring returns, selecting some for audit and identifying the items on these returns that are most likely to need review.¹

Presentation Note: Could not find much information on the UIDIF in the IRM and had to use other sources. The above Fact Sheet (FS-2006-10) is one of the presentation's Appendix. It is possible that the IRS views the UIDIF as a sub set of the DIF for the IRM.

UIDIF Scores are high for those return types which have historically high unreported income.

¹ IRS Fact Sheet FS-2006-10, January 2006

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UIDIF Audits Are Not The Same As AUR/CP2000s

The UIDIF Audits are looking for UNREPORTED income.

Example: UIDIF focuses on cash businesses like exotic dancers, contractors, and sole proprietors.

An AUR/CP2000 looks for UNDERREPORTED income.

Example: A taxpayer did not report all of their W-2's.

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Return Flagged For Audit

4.19.11.2.2 (10-11-2017) Sources of Returns for Classification¹

1. Discriminate Index Function (DIF) and Non-DIF tax returns are selected for examination:
 - By computer
 - By manual identification

Presentation Notes:

- Once a return is selected for audit survey/classification the transaction code is placed on the account module and should be visible on the account transcript.
- The audit flag stops any refunds from being sent out for the module and also prevents an amended return from being accepted (it will still show as being received).
- This is the beginning of the survey period.

¹ IRS IRM 4.19.11.2.2 (10-11-2017) Sources of Returns for Classification

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Survey/Classification Period

IRS IRM 4.19.11.2 (06-22-2016) Examination Classification of Work¹

1. Classification is the process of determining:
 1. whether a return should be selected for examination,
 2. what issues should be examined, and
 3. where the examination should be conducted.
2. According to Policy Statement P-4-21, the primary objective in identifying tax returns for examination is to promote the highest degree of voluntary compliance. See IRM 1.2.13.1.10, *Policy Statement 4-21*.
3. Due to limited resources, the IRS can examine only a small percentage of the returns filed. The classifier's role is to ensure that these resources are used effectively.
4. The classifier must decide which returns are most in need of examination. Thorough examination promotes the highest degree of voluntary compliance.

Presentation Note: Not all returns flagged for audit are selected for audit.

¹ IRS IRM 4.19.11.2 (06-22-2016) Examination Classification of Work

Determine Audit Method

IRS IRM 4.19.11.2.1 (06-22-2016) Procedures for Screening Individual Returns

1. Once you determine that the return will be selected, decide if the examination should be conducted by a:
 - a. Revenue Agent,
 - b. Tax Auditor, or
 - c. by correspondence.
2. This determination is based upon:
 - a. the complexity of issues involved,
 - b. the degree of accounting and auditing skills required to perform the examination, and
 - c. whether it can be effectively completed by correspondence

¹ IRS IRM 4.19.11.2.1 (06-22-2016) Procedures for Screening Individual Returns

Audit Begins Or It Doesn't

1. If the survey/classification period results in an audit the case is assigned and a letter goes out.
2. This is the official start of the audit.
3. If the return is not selected for audit during the survey/classification period the audit does not begin and the audit flag officially expires on the ASER (If an original return was filed).
4. There is usually no indication on the transcript that the audit letter is sent or the decision was made not to audit the return.

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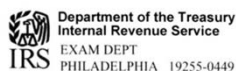
Audit Does Not Begin Example

670	Payment	10/27/2014	(\$1,000.00)
420	Examination of tax return	10/31/2014	\$0.00
276	Penalty for late payment of tax	11/17/2014	\$31.67
670	Payment	4/12/2015	(\$422.55)
196	Interest charged for late payment	5/4/2015	\$184.70
971	No longer in installment agreement status	5/4/2015	\$0.00
276	Penalty for late payment of tax	5/4/2015	\$237.85
421	Closed examination of tax return	6/9/2015	\$0.00

1. The actual transcript above shows a portion of a 2011 transcript filed a year late and 420 Examination of tax return on 10-31-2014.
2. Code 421 Closed Examination of tax return 7 months later
3. NO EXAM letter was sent – Budget problems and resources may have been the reason since a prior audit took over a year to get additional \$40K in tax.

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Typical Examination Letter



Date:
August 22, 2017
Taxpayer ID number:
[REDACTED]
Form:
1040
Tax periods ended:
December 31, 2015
Person to contact:
Tax Examiner
Employee ID number:
[REDACTED]
Contact telephone number:
1-866-897-0161 Toll Free
Contact hours:
7AM - 7PM Local
Contact fax number:
1-855-235-6788 Not Toll Free

We're auditing your 2015 Form 1040, and need a response from you

Dear Taxpayer:

We're auditing your 2015 federal income tax return and need additional information to support the items listed below that you claimed on your return.

<input checked="" type="checkbox"/> Schedule C Expenses	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

What you need to do

• Please see the enclosed explanation of the documentation you need to provide.

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CP2000 Versus CP2501

A CP2501 has no proposed changes or amounts. It can be a pre-cursor to the CP2000. The CP2501 is basically a hint from the IRS that there is a discrepancy between the filed return and the IRP.

The CP2000 proposes changes based on the discrepancy.¹

¹ IRS IRM 4.19.3 IMF Automated Underreporter Program

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CP2000 Notice – (“Hard Notice”)



Department of Treasury
Internal Revenue Service
AUR CORR 5-E08-113
PHILADELPHIA PA 19255-0521

007357.616256.154052.27578 2 AT 0.416 1010



C/O WILLIAM G NEMETH
2970 CLAIRMONT RD NE STE 960
BROOKHAVEN GA 30329-4445

Notice CP2000
Tax Year 2013
Notice date November 23, 2015
Social Security number [REDACTED]
AUR control number 50073-5147
To contact us Phone 1-800-829-8310
Fax 1-877-477-9602

Page 1 of 9



Changes to your 2013 Form 1040

Proposed amount due: \$24,278

The income and payment information we have on file from sources such as employers or financial institutions doesn't match the information you reported on your tax return. If our information is correct, you will owe \$24,278 (including interest), which you need to pay by December 23, 2015.

Summary of proposed changes

Tax you owe	\$21,456
Payments	\$2,224
Substantial tax understatement penalty	\$3,846
Interest	\$1,200
Amount due by December 23, 2015	\$24,278

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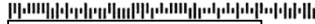
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CP2501 Notice (“Soft Notice”)



Department of Treasury
Internal Revenue Service
AUR CORR 5-E08-113
PHILADELPHIA PA 19255-0521

010080.534780.380734.17480 1 AT 0.406 690



C/O WILLIAM G NEMETH
2970 CLAIRMONT RD NE STE 960
BROOKHAVEN GA 30329-4445

Notice CP2501
Tax Year 2013
Notice date February 23, 2015
Social Security number [REDACTED]
AUR control number 40013-0910
To contact us Phone 1-800-829-8310
Fax 1-877-477-9602

Page 1 of 6



Important message about your 2013 Form 1040

Your tax return doesn't match the information we have on file

The income and payment information we have on file from sources such as employers or financial institutions does not match the information you reported on your tax return.

What you need to do immediately

Review this notice and compare what you listed on your 2013 tax return to the amounts reported to the IRS by others.

If you agree with the information reported by other sources

- Complete, sign and date the Response form on Page 5, and mail it to us so we receive it by March 25, 2015.

If you don't agree with the information reported by other sources

- Complete the Response form on Page 5, and send it to us along with a signed statement and any documentation that supports your claim so we receive it by March 25, 2015.

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Assessed Statutes Expiration Date (ASED)¹

Definition: The ASED defines how long the IRS has to assess tax for a specific module/period.

In most cases the ASED is calculated as 3 years after the original return received date.

Common Tolling:

- Filing amended Return within 60 days of ASED.
- Voluntary extension of ASED.
- Joint return after filing MFS.
- Fraudulent Return.
- Underreporting of tax (Under by 25%).

Presentation Note: The ASED only limits the amount of time the IRS has to assess not audit, but the assessment is one result of an audit.

¹ IRC 26 U.S. Code § 6501. Limitations on assessment and collection

Determine What Audit Is On

Evaluate the Tax Return and or the Tax Return Transcript for content and type and then compare it to the IRS IRM Classification of Work section. This is basically an educated guess as to what the audit is on. In my personal experience I can almost always identify what the audit is on just based on doing taxes for a decade. I am sure most of you can as well.

Here is an example from the Classification of Work section:¹

4.19.11.1.3.1.15. Moving Expenses:

- a. Check to see if the taxpayer actually moved via IDRS research on addresses.
- b. Check for employer reimbursement.
- c. Also consider sale of the residence.

¹ IRS IRM 4.19.11.1.3.1 (06-22-2016) Non-Business Issue Conducive to Correspondence Examination

Audit Techniques Guides (ATGs)

The ATGs can also be reviewed prior to a potential audit, during the audit and for audit reconsideration. These guides are used by IRS Examiners during audits for industry specific methods. These explain industry-specific techniques, issues, business practices and terminology.

¹ Audit Techniques Guides (ATGs) IRS.gov available on the Small Business and Self-Employed Page

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Entertainment ATG Example

Live Performers Questionnaire (Not all-inclusive)

- How are live performances scheduled? (Is a booking agent used? Do you schedule your own performances, etc.?)
- Obtain copies of the performance schedule/calendar/itinerary for the year under examination and copies of the engagement contracts, if available.
- Do you usually perform for a fixed fee, or a "percent of the gate", or some other method? Explain, in detail, how this works.
- Are you paid in cash, check, or some other method for performance?
- How do you account for the payments? (Is the money deposited? Is a ledger maintained, etc.?)
- Do you use any of the performance proceeds to pay any of your on-the-road expenses?
- How are souvenir sales during live performances handled? (Do you manage your own or do you contract it out?)
- Whom do you use to actually man the souvenir booths, and how are they paid?
- Exactly how are proceeds from sales of souvenirs accounted for?
- Do you belong to any unions? Please provide the names.

¹ IRS Entertainment Audit Technique Guide Publication Date: 10/2015

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SCHEDULE A SUMMARY				
SCHEDULE A - ITEMIZED DEDUCTIONS	2012	2013	2014	2015
TAX RETURN FILED:	Original	Original	Original	Original
MEDICAL/DENTAL				
MEDICAL AND DENTAL EXPENSES:	\$0	\$0	\$0	\$0
AGI PERCENTAGE LIMITATION PER COMPUTER:	-	-	-	-
ADJUSTED GROSS INCOME PERCENTAGE:	-	\$0	\$0	\$0
ADJUSTED GROSS INCOME PERCENTAGE PER COMPUTER 10 PERCENT:	-	\$19,537	\$24,228	\$30,040
ADJUSTED GROSS INCOME PERCENTAGE PER COMPUTER 7.5 PERCENT:	-	\$14,652	\$18,168	\$22,529
NET MEDICAL DEDUCTION:	\$0	\$0	\$0	\$0
TAXES PAID				
STATE AND LOCAL INCOME TAXES:	\$4,196	\$14,077	\$17,455	\$21,645
INCOME TAX OR GENERAL SALES TAX:	Income Taxes	Income Taxes	-	-
REAL ESTATE TAXES:	\$3,568	\$3,731	\$4,628	\$5,737
NEW MOTOR VEHICLE TAXES:	\$0	-	-	-
OTHER TAXES AMOUNT:	\$0	\$2,011	\$2,494	\$3,092
SCH A TAX DEDUCTIONS:	\$7,762	\$19,819	\$24,576	\$30,474
INTEREST PAID				
MORTGAGE INTEREST (FINANCIAL):	\$17,905	\$85,042	\$105,452	\$130,761
MORTGAGE INTEREST (INDIVIDUAL):	\$0	\$0	\$0	\$0
DEDUCTIBLE POINTS:	\$0	\$0	\$0	\$0
QUALIFIED MORTGAGE INSURANCE PREMIUMS:	\$0	\$0	\$0	\$0
DEDUCTIBLE INVESTMENT INTEREST:	\$0	\$0	\$0	\$0
TOTAL INTEREST DEDUCTION:	\$17,905	\$85,042	\$105,452	\$130,761
CHARITABLE CONTRIBUTIONS				
CASH CONTRIBUTIONS:	\$800	\$200	\$248	\$308
OTHER THAN CASH: Form 8283:	\$0	\$0	\$0	\$0
CARRYOVER FROM PRIOR YEAR:	\$0	\$0	\$0	\$0
SCH A TOTAL CONTRIBUTIONS:	\$800	\$200	\$248	\$308
CASUALTY AND THEFT LOSS				
CASUALTY OR THEFT LOSS:	\$0	\$0	\$0	\$0
JOBS AND MISCELLANEOUS				
UNREIMBURSED EMPLOYEE EXPENSE AMOUNT:	\$0	\$0	\$0	\$0
TOTAL LIMITED MISC EXPENSES:	\$0	\$0	\$0	\$0
NET LIMITED MISC DEDUCTION:	\$0	\$0	\$0	\$0
OTHER MISCELLANEOUS				
OTHER THAN GAMBLING AMOUNT:	\$0	\$0	\$0	\$0
OTHER MISC DEDUCTIONS:	\$0	\$0	\$0	\$0
TOTAL ITEMIZED DEDUCTIONS				
TOTAL ITEMIZED DEDUCTIONS:	\$26,467	\$105,061	\$130,276	\$161,542
ELECT ITEMIZED DEDUCTION INDICATOR:	0	0	0	0
SCH A ITEMIZED PERCENTAGE PER COMPUTER:	0	0	0	0

Schedule A Summary

- Compare the year under audit with the other years.

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SCHEDULE C SUMMARY				
SCHEDULE C - PROFIT OR LOSS FROM BUSINESS	2012	2013	2014	2015
TAX RETURN FILED:	No	No	No	Original
SCHEDULE C - GENERAL INFORMATION				
NUMBER OF SCHEDULE C'S ON RETURN:	3	1	1	1
SOCIAL SECURITY NUMBER:	***-9-9999	***-9-9999	***-9-9999	***-9-9999
EMPLOYER ID NUMBER:	88-8888888	88-8888888	88-8888888	88-8888888
BUSINESS NAME:	North Pole Toy Company	North Pole Toy Company	North Pole Toy Company	North Pole Toy Company
DESCRIPTION OF BUSINESS/PROFESSION:	Manufacturing	Manufacturing	Manufacturing	Manufacturing
NAICS CODE:	123456	123456	123456	123456
ACCT MTHD:	Cash	Cash	Cash	Cash
FIRST TIME SCHEDULE C FILED:	YES	N	N	N
STATUTORY EMPLOYEE IND:	N	N	N	N
INCOME				
GROSS MERCHANT CARD AND THIRD PARTY NETWORK RECEIPTS AND SALES:	\$99,483	\$1,234,600	\$743,326	\$1,238,640
GROSS RECEIPTS OR SALES (NON-MERCHANT-CARD AND NON-THIRD-PARTY):	-	-	-	-
INCOME REPORTED TO YOU ON FORM W-2:	-	-	-	-
TOTAL GROSS RECEIPTS:	-	-	-	-
GROSS RECEIPTS OR SALES:	\$154,273	\$154,273	\$154,273	\$154,273
RETURNS AND ALLOWANCES:	\$0	\$0	\$0	\$0
NET GROSS RECEIPTS:	\$154,273	\$154,273	\$154,273	\$154,273
COST OF GOODS SOLD:	\$0	\$0	\$0	\$0
SCHEDULE C FORM 1099 REQUIRED:	YES	YES	YES	YES
SCHEDULE C FORM 1099 FILED:	YES	YES	YES	YES
OTHER INCOME:	-	-	-	-
EXPENSES				
CAR AND TRUCK EXPENSES:	\$20,402	\$28,359	\$39,419	\$54,792
DEPRECIATION:	\$0	\$0	\$0	\$0
INSURANCE (OTHER THAN HEALTH):	\$1,486	\$2,068	\$2,871	\$3,991
MORTGAGE INTEREST:	-	-	-	-
LEGAL AND PROFESSIONAL SERVICES:	\$2,182	\$3,033	\$4,216	\$5,860
REPAIRS AND MAINTENANCE:	\$11,658	\$16,205	\$22,524	\$31,309
TRAVEL:	\$4,057	\$5,639	\$7,839	\$10,896
MEALS AND ENTERTAINMENT:	\$2,628	\$3,653	\$5,078	\$7,058
WAGES:	\$0	\$0	\$0	\$0
OTHER EXPENSES:	\$26,899	\$37,390	\$51,972	\$72,240
TOTAL EXPENSES:	\$61,702	\$85,766	\$119,214	\$165,708
EXP FOR BUSINESS USE OF HOME:	\$2,769	\$3,849	\$5,350	\$7,436
SCH C NET PROFIT OR LOSS PER COMPUTER:	\$89,802	\$124,825	\$173,506	\$241,174
AT RISK CD:	0	0	0	0
OFFICE EXPENSE AMOUNT:	\$6,927	\$9,629	\$13,384	\$18,603
UTILITIES EXPENSE AMOUNT:	\$4,423	\$6,148	\$8,546	\$11,878

Schedule C Summary

- Compare the year under audit with the other years.

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National Research Program (NRP) Audits

NRP Audits are random line by line exams so there may not be an issue that needs resolving. It is difficult to tell the difference between an NRP Audit and a regular DIF generated Audit until after it has begun. If you are unable to determine what the audit is covering have the client confirm they have mileage logs and other proof of deductions ready to go.

IRS was charged with the responsibility to collect data on taxpayer compliance and non-compliance. For strategic planning and budget purposes, the IRS requires regular estimates of compliance. NRP supports this critical need. NRP seeks to increase public confidence in the fairness of our tax system by helping the IRS identify where compliance problems occur so that the IRS can efficiently and effectively utilize its resources to address those problems.¹



¹ IRS IRM 4.22.1.1.1 (09-06-2017) Background

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NRP Audit Example

When Jeff Long, EA was an auditor with the IRS and conducted NRP exams in SB/SE, he was forced to adjust a couple who had been married for 60 years back to 'single' filing status because they couldn't find their marriage certificate. NRP exams are painful.

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 Department of the Treasury Internal Revenue Service Small Business Self Employed 401 W Peachtree Street, NW Stop 418-D, Group 1105	Date: April 4, 2016 Taxpayer Identification Number: 2323 Form: 1040 Tax period ended: 2013 Person to contact: Earl Contact telephone number: 404- Contact fax number: 855- Employee identification number: 1000	<p>Someone may represent you You may have someone represent you during any part of this examination. If you decide you want representation, the representative you authorize will need a completed Form(s) 2848, <i>Power of Attorney and Declaration of Representative</i>, before we can discuss any of your tax matters.</p> <p>If you choose to have someone represent you, please provide a completed Form 2848 by our first appointment. You can mail or fax the form to me or have your representative provide it at the first appointment, if you won't be present. You can obtain Form 2848 from our office, from our web site, www.irs.gov or by calling (800) 829-3676.</p> <p>If you filed a joint return, you and your spouse may attend the examination. If you and/or your spouse choose not to attend with your representative, you must provide completed Form(s) 2848. You should provide a separate Form 2848 for each spouse if you filed jointly even if you use the same representative.</p> <p>Your rights as a taxpayer We have enclosed Publication 1, <i>Your Rights as a Taxpayer</i> and Notice 609, <i>Privacy Act Notice</i>. The Declaration of Taxpayer Rights found in Publication 1 discusses general rules and procedures we follow in examinations. It explains what happens before, during, and after an examination, and provides additional sources of information.</p> <p>A video presentation, "Your Guide to an IRS Audit," is available at http://www.irsvideos.gov/audit. The video explains the examination process and will assist you in preparing for your audit.</p> <p>Thank you for your cooperation and I look forward to hearing from you by April 13, 2016</p> <p>Sincerely,  Earl Supervisory, Internal Revenue Agent </p> <p>Enclosures: Publication 1 Publication 4134, <i>Low Income Taxpayer Clinic List</i> Notice 609 Notice 1332 </p>
---	--	---

THOMAS
177 1A 30549-1077

Dear THOMAS:

Your federal income tax return for the year shown above was selected at random for a compliance research examination. We must examine randomly-selected tax returns to better understand tax compliance and improve the fairness of the tax system. We'll give you the opportunity to explain any errors we may find during the examination.

The results of this and other compliance research examinations will improve our efforts to help taxpayers understand and follow the tax law. It will also reduce unnecessary and costly examinations, and reduce burden on taxpayers. Please read the enclosed Notice 1332, *Why Your Return is Being Examined*.

What you need to do
 Please call me on or before April 13, 2016. You may contact me from 8:00 am to 4:30 pm at the telephone number provided above.

What we will discuss
 During our telephone conversation, we will discuss:

- Items on your return that I will be examining.
- Types of documents I will ask you to provide.
- The examination process.
- Any concerns or questions you may have.
- The date, time and agenda for our first meeting.

Letter 2205-B (Rev. 8-2012)
Catalog Number 38759Y

Letter 2205-B (Rev. 8-2012)
Catalog Number 38759Y

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How To Identify The AUR Discrepancy

1. Review the Wage & Income Transcripts.
 - Compare the number of Wage & Income Document Types to what was filed in your tax return software.
 - Use the Wage & Income Summary Transcript to compare to the tax return for discrepancies.
 - Remember if the return is MFJ both spouses transcripts will need to be reviewed.
2. Review the tax return and/or tax return transcript and look for any discrepancies with the Wage & Income Transcript.

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1. Wage & Income Forms - shows data from information returns reported to IRP such as Forms W-2, 1099, 1098 and Form 5498, IRA Contribution Information, etc.
2. Wage & Income Summary – shows the sum of different income types from the IRS forms. Example the summary shows the total wages from all of the W-2 forms reported to IRP.

 Internal Revenue Service
United States Department of the Treasury

Request Date: 05-21-2018
Response Date: 05-21-2018
Tracking Number: 1003697234

SSN Provided: 777-CC-7777
Tax Period Requested: December, 2017

Employer:
Employer Identification Number (EIN): 338008899
NORTH POLE TOY COMPANY LLC
1816 WATFORD GLEN
LAKENAVILLE, CA 95913-3000

Employee:
Employee's Social Security Number: 111-22-7777
SANTA CLASS
18.6 HATFORD GLEN
LAWRENCEVILLE, GA 30043-2000

[illegible]

 **Internal Revenue Service**
United States Department of the Treasury

Geopost. Basel	C9-25-2016
Geopost. Basel	C9-25-2016
Geopost. Basel	CC294807708

SSN Provided: 777-CC-7777
Tax Period Requested: January, 2004

Hydrex Tax Withheld:	\$4,444.00
Mopac:	\$43,632.00
Auto/Gasoline Taxes:	\$6.00
Interest:	\$6.00
Maritime Interest Paid:	22,338.00
Points Paid:	\$6.00
FLC: Texas Rentals:	\$144.00
Revolving Credit:	\$6.00
U.S. Bonds:	\$6.00
Health and Accident:	\$6.00
Life Insurance:	\$6.00
Non-employee Compensation:	\$6.00
Capital Gains:	\$6.00
Real Estate Sales:	\$6.00
Group Contributions:	\$223.00
Cashable Amount:	\$233.00
Deferred Compensation:	\$126.00
U.S. Tax Withheld:	\$7,637.00
Real Estate Withheld:	\$675.00
Real Estate Taxes:	\$13,456.00
U.S. Tax Withheld:	\$13,456.00
Qualifying Dividend and Related Expenses:	\$1,844.00

This product contains sensitive taxpayer data.

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Number Of Income Docs

Compare the number of income documents from the Wage & Income Transcript to the number reported on the tax return in your tax software.

INCOME DOCUMENTS											
Transcript Date:	2006 6/19/2014	2007 6/19/2014	2008 6/19/2014	2009 6/19/2014	2010 6/19/2014	2011 6/19/2014	2012 6/19/2014	2013 6/19/2014	2014 6/19/2014	2015 6/19/2014	
W-2	1	1	1	1	0	1	0	0	0	0	0
1098	3	3	3	3	3	3	1	1	2	0	0
1098-E	0	0	0	0	1	0	0	0	0	0	0
5498	0	0	2	2	2	2	2	0	0	2	2
1099-B	2	2	23	14	8	20	0	0	11	0	0
1099-C	0	0	0	0	0	0	1	3	0	0	0
1099-DIV	1	3	3	3	2	2	1	0	0	6	6
1099-INT	1	1	1	0	1	1	1	1	5	0	0
1099-MISC	8	12	12	13	15	8	6	6	0	3	3
1099-R	1	0	0	1	0	3	0	0	0	0	0
TOTAL	17	22	45	37	32	40	12	11	18	11	

Total Corrected and/or Amended Income Documents											
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
1099-MISC	0	0	0	0	1	0	0	0	0	0	0
TOTAL	0	0	0	0	1	0	0	0	0	0	0

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WAGE INCOME SUMMARY												
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Totals	
Federal Tax Withheld:	\$0	\$3	\$9	\$3	\$0	\$2,070	\$0	\$0	\$0	\$3	\$2,088	
Wages:	\$1,009	\$962	\$229	\$33	\$0	\$37	\$0	\$0	\$1,080	\$1,029	\$4,379	
Allocated Tips:	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	
Interest:	\$21	\$0	\$113	\$0	\$27	\$24	\$12	\$2	\$22	\$0	\$221	
Mortgage Interest Paid:	\$19,572	\$34,173	\$31,307	\$21,518	\$16,769	\$13,051	\$1,521	\$713	\$20,942	\$36,565	\$196,131	
Points Paid:	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	
Prior Year Refund:	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	
Savings Bonds:	\$0	\$6,004	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$6,424	\$12,428	
Dividends:	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	
Pensions and Annuities:	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	
IRA Contributions:	\$0	\$0	\$2,250	\$3,000	\$500	\$0	\$0	\$0	\$0	\$0	\$5,750	
Non-employee Compensation:	\$64,766	\$138,668	\$202,475	\$240,068	-	\$114,849	\$154,270	\$58,171	\$69,300	\$148,375	\$1,190,941	
Capital Gains:	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	
Real Estate Sales:	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	
Gross Distributions:	\$1,474	\$0	\$0	\$1,820	\$0	\$26,580	\$0	\$0	\$1,577	\$0	\$31,451	
Taxable Amount:	\$1,474	\$0	\$0	\$1,820	\$0	\$26,580	\$0	\$0	\$1,577	\$0	\$31,451	
Ordinary Dividends:	\$680	\$2,892	\$3,529	\$2,533	\$855	\$224	-	-	\$728	\$3,094	\$14,535	
Ordinary Income K-1:	-	-	-	-	-	-	-	-	-	-	\$0	
Roth IRA Contribution:	-	-	-	-	-	-	-	-	-	-	\$0	
Fair Market Value:	-	-	\$11,754	\$15,415	\$17,402	\$1,569	\$1,698	-	-	-	\$47,838	
Section 179 Expense:	-	-	-	-	-	-	-	-	-	-	\$0	
FICA Tax Withheld:	\$62	\$59	\$14	\$2	-	\$1	-	-	\$66	\$63	\$267	
Medicare Withheld:	\$14	\$13	\$3	-	-	-	-	-	\$15	\$14	\$59	
Medicare Wages:	\$1,009	\$962	\$229	\$33	-	\$37	-	-	\$1,080	\$1,029	\$4,379	
Taxable FICA Wages:	\$1,009	\$962	\$229	\$33	-	\$37	-	-	\$1,080	\$1,029	\$4,379	
Stocks & Bonds:	\$1,623	\$900	\$9,860	\$45,522	\$9,557	\$34,127	-	-	\$1,737	\$963	\$104,289	
Simple Contributions:	-	-	-	-	-	-	-	-	-	-	\$0	
Gross Winnings:	-	-	-	-	-	-	-	-	-	-	\$0	
Taxable FICA Tips:	-	-	-	-	-	-	-	-	-	-	\$0	
Student Loan Interest:	-	-	-	-	\$154	-	-	-	-	-	\$154	
Deferred Compensation:	-	-	-	-	-	-	-	-	-	-	\$0	
Foreign Tax Paid:	-	-	-	\$1	\$1	-	-	-	-	-	\$2	
Qualified Dividends:	\$645	\$2,873	\$3,477	\$2,527	\$849	\$224	-	-	\$690	\$3,074	\$14,359	
Scholarships or Grants:	-	-	-	-	-	-	-	-	-	-	\$0	
Rent:	\$8,800	\$9,650	\$10,349	\$9,600	\$6,353	\$10,200	\$8,450	-	\$9,416	\$10,326	\$83,144	

Wage & Income Summary

- Use it to confirm income when filing prior year returns or use it to look for past year issues with troubled clients.

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INCOME SUMMARY

INCOME	2012	2013	2014	2015
	Original	Original	Original	Original
TAX RETURN FILED:				
WAGES, SALARIES, TIPS, ETC:	\$80,570	\$88,627	\$97,490	\$107,239
TAXABLE INTEREST INCOME: SCH B:	\$12	\$13	\$15	\$16
TAX-EXEMPT INTEREST:	\$0	\$0	\$0	\$0
ORDINARY DIVIDEND INCOME: SCH B:	\$0	\$0	\$0	\$0
QUALIFIED DIVIDENDS:	\$0	\$0	\$0	\$0
REFUNDS OF STATE/LOCAL TAXES:	\$0	\$0	\$0	\$0
ALIMONY RECEIVED:	\$0	\$0	\$0	\$0
BUSINESS INCOME OR LOSS (Schedule C):	\$45,695	\$50,265	\$55,291	\$60,820
CAPITAL GAIN OR LOSS: (Schedule D):	(\$3,000)	\$11,500	(\$4,200)	(\$4,620)
OTHER GAINS OR LOSSES (Form 4797):	\$0	\$0	\$0	\$0
TOTAL IRA DISTRIBUTIONS:	\$0	\$0	\$0	\$0
TAXABLE IRA DISTRIBUTIONS:	\$0	\$0	\$0	\$0
TOTAL PENSIONS AND ANNUITIES:	\$0	\$0	\$0	\$0
TAXABLE PENSION/ANNUITY AMOUNT:	\$0	\$0	\$0	\$0
RENT/ROYALTY/PARTNERSHIP/ESTATE (SCH E):	(\$13,362)	\$51,236	(\$14,562)	(\$16,018)
RENT/ROYALTY INCOME/LOSS:	(\$13,362)	\$51,236	(\$14,562)	(\$16,018)
ESTATE/TRUST INCOME/LOSS:	\$0	\$0	\$0	\$0
PARTNERSHIP/S-CORP INCOME/LOSS:	\$0	\$0	\$0	\$0
FARM INCOME OR LOSS (Schedule F):	\$0	\$0	\$0	\$0
UNEMPLOYMENT COMPENSATION:	\$0	\$0	\$0	\$0
TOTAL SOCIAL SECURITY BENEFITS:	\$0	\$0	\$0	\$0
TAXABLE SOCIAL SECURITY BENEFITS:	\$0	\$0	\$0	\$0
OTHER INCOME:	\$0	\$0	\$12,365	\$2,145
SCHEDULE EIC SE INCOME:	\$0	\$0	\$0	\$0
SCHEDULE EIC EARNED INCOME:	\$0	\$0	\$0	\$0
SCH EIC DISQUALIFIED INC:	\$0	\$0	\$0	\$0
TOTAL INCOME:	\$109,915	\$120,907	\$132,997	\$146,297

Income Summary

- Compares the Income from the last 4 years of returns.

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Mitigating A Potential Audit

1. Once the potential audit issue is identified look at doing an amended return if the taxpayer will owe more tax. This will allow you to contest the accuracy related penalties.
2. Use the **F**irst **T**ime Penalty **A**batement (FTA) to offset the assessment.
 - Under Circular 230 you can charge a contingency fee for FTA.¹
3. Review the last four years of tax returns for a refund opportunity and do an amended return.

¹ Treasury Department Circular No. 230 (Rev. 6-2014) § 10.27 Fees section (b)3

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IRS Accuracy Related Penalties

26 U.S. Code § 6662A - Imposition of accuracy-related penalty on understatements with respect to reportable transactions

(a) Imposition of penalty if a taxpayer has a reportable transaction understatement for any taxable year, there shall be added to the tax an amount equal to 20 percent of the amount of such understatement.¹

¹ IRC 26 U.S. Code § 6662A - Imposition of accuracy-related penalty on understatements with respect to reportable transactions

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IRS Accuracy Related Penalties

If you can file an amended return prior to the audit beginning (any of the audits including CP2000s) the accuracy related penalty may not be assessed. An IRS employee must add the accuracy related penalty manually. This is not an automated process.

This author has received feedback from multiple tax practitioners that if they file an amended return prior to an audit letter being sent the IRS does not always add the accuracy related penalty.

If the penalty is applied and an amended return was filed prior to the letter the tax practitioner can take the position that under the IRC the accuracy related penalty can be applied for several reasons but the most common is "Negligence or disregard of rules or regulations". Since the issue was self discovered and rectified prior to the audit no accuracy related penalty should be applied.

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IRS Accuracy Related Penalties

From the Taxpayer Advocate's 2013 Annual Report

The amount of an accuracy-related penalty equals 20 percent of the portion of the underpayment attributable to the taxpayer's negligence or disregard of rules or regulations or to a substantial understatement.

- The IRS may assess penalties under both IRC § 6662(b)(1) and IRC § 6662(b)(2), but the total penalty rate cannot exceed 20 percent (i.e., the penalties are not "stackable").
- Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.
- In addition, a taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. If a taxpayer wrongly reports multiple items of income, for example, some errors may be justifiable mistakes while others might be the result of negligence; the penalty applies only to the latter.¹

¹ Taxpayer Advocate's 2013 Annual Report

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IRS Accuracy Related Penalties

If the audit actually begins the tax practitioner can negotiate the accuracy related penalties (as well as the other penalties) during the audit negotiation.

Actual Example (From Bill Nemeth, EA)

- Completed 1040 Office Audit for 3 years.
- Balance due is \$55,089 which triggers the 20% Accuracy-IRC 6662 Penalty of **\$11,017.80**
- Audit is Un-Agreed at this point.
- Taxpayer has agreed that POA can accept audit and request penalty reduction or abatement.
- Using the script on the next page, representative abated the **\$11,017.80** Accuracy – IRC 6662 Penalty.

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IRS Accuracy Related Penalties

Actual Script

“Taxpayer cannot provide compelling documentation to prove more of their ordinary and necessary expenses. I will agree and sign the audit agreement today ***IF*** you remove the Accuracy-Related Penalties. If you do not, Taxpayer will petition Tax Court and get them removed in that venue. Let’s save everyone time and money and remove the penalties today. Please check with your manager to see if we have a deal.”

Outcome: Examiner agreed and removed the **\$11,017.80** accuracy related penalty.

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IRS Accuracy Related Penalties

Form 843 Claim for Refund and Request for Abatement (OMB No. 1545-0047)

Use Form 843 if your claim or request involves:

- (a) a refund of one of the taxes (other than income taxes or an employer's claim for FICA tax, FUTA tax, or income tax withholding) or a fee shown on line 3;
- (b) an abatement of FUTA tax or certain excise taxes; or
- (c) a refund or statement of interest, penalties, or additions to tax for one of the reasons shown on line 5a.

Do not use Form 843 if your claim or request involves:

- (a) an overpayment of income taxes or an employer's claim for FICA tax, FUTA tax, or income tax withholding (use the appropriate amended tax return);
- (b) a refund of excise taxes based on the nontaxable use or sale of fuel; or
- (c) an overpayment of excise taxes reported on Form 911-C, 720, 720-1, or 2290.

Name: _____ Your social security number: _____

Address (number, street, and room or suite no.): _____ Spouse's social security number: _____

City or town, state, and ZIP code: _____ Employee identification number (EIN): _____

Name and address shown on return if different from above: _____ Optima telephone number: _____

1 **Period.** Prepare a separate Form 843 for each tax period or fee year: _____

2 **Amount to be refunded or abated:** \$ _____

3 **Type of tax or fee.** Indicate the type of tax or fee to be refunded or abated or to which the interest, penalty, or addition to tax is related: ☐ Estate ☐ Gift ☐ Excise ☐ Income ☐ Fee

4 **Type of penalty.** If this claim or request involves a penalty, enter the Internal Revenue Code section on which the penalty is based (see instructions, IRS section _____).

5a **Interest, penalties, and additions to tax.** Check the box that indicates your reason for the request for refund or abatement. (If none apply, go to line 6.)

- ☐ Interest was assessed as a result of IRS errors or delays.
- ☐ A penalty or addition to tax was the result of erroneous written advice from the IRS.
- ☐ Reasonable cause or other reason allowed under the law (other than erroneous written advice) can be shown for not abating a penalty or addition to tax.

b (Date) of payment: _____

6 **Original return.** Indicate the type of tax or return, if any, filed to which the tax, interest, penalty, or addition to tax relates.

☐ 106 ☐ 109 ☐ 940 ☐ 941 ☐ 945 ☐ 986-OT ☐ 1040 ☐ 1120 ☐ 4320 ☐ Other (specify): _____

7 **Explanation.** Explain why you believe this claim or request should be allowed and show the computation of the amount shown on line 2. If you need more space, attach additional sheets.

Signature. If you are filing Form 843 to request a refund or statement relating to a joint return, both you and your spouse must sign the claim. Claims filed by corporations must be signed by a corporate officer authorized to sign, and the officer's title must be shown. (Under penalty of perjury, I declare that I have prepared this claim, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Under penalty of perjury, I declare that I am not a preparer or a paid preparer for any taxpayer.)

Signature (Date) of preparer (Claims by corporations must be signed by an officer): _____ Date: _____

Signature (Date) of preparer: _____ Date: _____

Paid Preparer Use Only Preparer's name: _____ Preparer's signature: _____ Date: _____ Check ☐ if FTR ☐ not required

For the preparer and the taxpayer's signature, see separate instructions. Form 843 (Rev. 02/2019)

If the accuracy related penalties have been assessed the tax practitioner can file an IRS Form 843 Claim for Refund and Request for Abatement.

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IRS Accuracy Related Penalties

- Accuracy Related Penalties can also be challenged in a Collection Due Process Hearings (CDP), Equivalency Hearing, and Tax Court (Don't forget about Pro Se).
- These options require more preparation and the practitioner should weigh the time cost versus the reward.
- Most penalty abatement work can be charged on a contingency basis per Circular 230.

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Conclusion

Practitioners have been using IRS Transcripts for decades to better serve their clients. Through ongoing best practices that have evolved over time practitioners now have the ability to become pro-active in handling issues with their clients instead of being reactive. This is a win-win for both the client and the practitioner. The practitioner can generate additional revenue while providing better customer service, including clients who may have held the practitioner responsible for an IRS issue and the clients will have an improved experience interacting with their practitioner as opposed to getting potentially bad news from an IRS letter or unexpected levy.

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QUESTIONS?

Roger W. Nemeth, EA & NTPI Fellow
Email: nemethrw@AuditDetective.com

IRS Fact Sheet

Media Relations Office
www.irs.gov/newsroom

Washington, D.C.

Media Contact: 202.622.4000
Public Contact: 800.829.1040

The Examination (Audit) Process

FS-2006-10, January 2006

The IRS examines (audits) tax returns to verify that the tax reported is correct.

Selecting a return for examination does not always suggest that the taxpayer has either made an error or been dishonest. In fact, some examinations result in a refund to the taxpayer or acceptance of the return without change.

The overwhelming majority of taxpayers files returns and make payments timely and accurately. Taxpayers have a right to expect fair and efficient tax administration from the IRS, including verification that taxes are correctly reported and paid with enforcement actions against those who fail to comply voluntarily.

TAXPAYER RIGHTS

The IRS trains its employees to explain and protect taxpayers' rights throughout their contacts with taxpayers. These rights include:

- A right to professional and courteous treatment by IRS employees.
- A right to privacy and confidentiality about tax matters.
- A right to know why the IRS is asking for information, how the IRS will use it and what will happen if the requested information is not provided.
- A right to representation, by oneself or an authorized representative.
- A right to appeal disagreements, both within the IRS and before the courts.

HOW RETURNS ARE SELECTED FOR EXAMINATION

The IRS selects returns using a variety of methods, including:

- Potential participants in abusive tax avoidance transactions – Some returns are selected based on information obtained by the IRS through efforts to identify promoters and participants of abusive tax avoidance transactions. Examples include information received from “John Doe” summonses issued to credit card companies and businesses and participant lists from promoters ordered by the courts to be turned over to the IRS.

—More—

- **Computer Scoring** – Some returns are selected for examination on the basis of computer scoring. Computer programs give each return numeric “scores”. The Discriminant Function System (DIF) score rates the potential for change, based on past IRS experience with similar returns. The Unreported Income DIF (UIDIF) score rates the return for the potential of unreported income. IRS personnel screen the highest-scoring returns, selecting some for audit and identifying the items on these returns that are most likely to need review.
- **Large Corporations** – The IRS examines many large corporate returns annually.
- **Information Matching** – Some returns are examined because payer reports, such as Forms W-2 from employers or Form 1099 interest statements from banks, do not match the income reported on the tax return.
- **Related Examinations** – Returns may be selected for audit when they involve issues or transactions with other taxpayers, such as business partners or investors, whose returns were selected for examination.
- **Other** – Area offices may identify returns for examination in connection with local compliance projects. These projects require higher level management approval and deal with areas such as local compliance initiatives, return preparers or specific market segments.

EXAMINATION METHODS

An examination may be conducted by mail or through an in-person interview and review of the taxpayer's records. The interview may be at an IRS office (office audit) or at the taxpayer's home, place of business, or accountant's office (field audit). Taxpayers may make audio recordings of interviews, provided they give the IRS advance notice. If the time, place, or method that the IRS schedules is not convenient, the taxpayer may request a change, including a change to another IRS office if the taxpayer has moved or business records are there.

The audit notification letter tells which records will be needed. Taxpayers may act on their own behalf or have someone represent or accompany them. If the taxpayer is not present, the representative must have proper written authorization. The auditor will explain the reason for any proposed changes. Most taxpayers agree to the changes and the audits end at that level.

APPEAL RIGHTS

Appeal Rights are explained by the examiner at the beginning of each audit. Taxpayers who do not agree with the proposed changes may appeal by having a supervisory conference with the examiner's manager or appeal their case administratively within the IRS, to the U.S. Tax Court, U.S. Claims Court or the local U.S. District Court. If there is no agreement at the closing conference with the examiner or the examiner's manager, the taxpayer has 30 days

to consider the proposed adjustments and their next course of action. If the taxpayer does not respond within 30 days, the IRS issues a statutory notice of deficiency, which gives the taxpayer 90 days to file a petition to the Tax Court. The Claims Court and District Court generally do not hear tax cases until after the tax is paid and administrative refund claims have been denied by the IRS. The tax does not have to be paid to appeal within the IRS or to the Tax Court. A case may be further appealed to the U.S. Court of Appeals or to the Supreme Court, if those courts accept the case.

MLI
#1

Accuracy-Related Penalty Under IRC §§ 6662(b)(1) and (2)

SUMMARY

Internal Revenue Code (IRC) §§ 6662(b)(1) and (2) authorize the IRS to impose a penalty if a taxpayer's negligence or disregard of rules or regulations caused an underpayment of tax, or if an underpayment exceeded a computational threshold called a substantial understatement, respectively. IRC § 6662(b) also authorizes the IRS to impose five other accuracy-related penalties.¹ We did not analyze these other accuracy-related penalties because during our review period of June 1, 2012, through May 31, 2013, taxpayers litigated these penalties less frequently than the negligence and substantial understatement penalties.²

PRESENT LAW

The amount of an accuracy-related penalty equals 20 percent of the portion of the underpayment attributable to the taxpayer's negligence or disregard of rules or regulations or to a substantial understatement.³ The IRS may assess penalties under both IRC § 6662(b)(1) and IRC § 6662(b)(2), but the total penalty rate cannot exceed 20 percent (*i.e.*, the penalties are not “stackable”).⁴ Generally, taxpayers are not subject to the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith.⁵ In addition, a taxpayer will be subject to the negligence component of the penalty only on the portion of the underpayment attributable to negligence. If a taxpayer wrongly reports multiple items of income, for example, some errors may be justifiable mistakes while others might be the result of negligence; the penalty applies only to the latter.

Negligence

The IRS may impose the IRC § 6662(b)(1) negligence penalty if it concludes that a taxpayer's negligence or disregard of the rules or regulations caused the underpayment. Negligence is defined to include “any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.”⁶ Negligence includes a failure to keep adequate books and records or to substantiate items that gave rise to the underpayment.⁷ Strong indicators of negligence include instances where a taxpayer failed to report income on a tax return that a payor reported on

1 IRC § 6662(b)(3) authorizes a penalty for any substantial valuation misstatement for income taxes; IRC § 6662(b)(4) authorizes a penalty for any substantial overstatement of pension liabilities; IRC § 6662(b)(5) authorizes a penalty for any substantial valuation understatement of estate or gift taxes; IRC § 6662(b)(6) authorizes a penalty when the IRS disallows the tax benefits claimed by the taxpayer when the transaction lacks economic substance; and IRC § 6662(b)(7) authorizes a penalty for any undisclosed foreign financial asset understatement.

2 Note, however, that there has been some recent significant litigation involving IRC § 6662(h) (the 40 percent penalty in the case of a gross valuation misstatement). See, e.g., *United States v. Woods*, 471 F. App'x 320 (5th Cir. 2012), *aff'g per curiam* 794 F. Supp. 2d 714 (W.D. Tex. 2011), *cert. granted*, 133 S. Ct. 1632 (Mar. 25, 2013); *Nevada Partners Fund L.L.C. v. United States*, 111 A.F.T.R.2d (RIA) 2416 (5th Cir. 2013), *aff'g* 714 F. Supp. 2d 598 (S.D. Miss. 2010).

3 IRC § 6662(b)(1) (negligence/disregard of rules or regulations) and IRC § 6662(b)(2) (substantial understatement).

4 Treas. Reg. § 1.6662-2(c). The penalty rises to 40 percent if any portion of the underpayment is due to a “gross valuation misstatement.” See IRC § 6662(h)(1).

5 IRC § 6664(c)(1).

6 IRC § 6662(c).

7 Treas. Reg. § 1.6662-3(b)(1).

an information return as defined in IRC § 6724(d)(1),⁸ or failed to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion.⁹ The IRS can also consider various other factors in determining whether the taxpayer's actions were negligent.¹⁰

Substantial Understatement

Generally, an “understatement” is the difference between (1) the correct amount of tax and (2) the tax reported on the return, reduced by any rebate.¹¹ Understatements are reduced by the portion attributable to (1) an item for which the taxpayer had substantial authority, or (2) any item for which the taxpayer, in the return or an attached statement, adequately disclosed the relevant facts affecting the item's tax treatment and the taxpayer had a reasonable basis for the tax treatment.¹² For individuals, the understatement of tax is substantial if it exceeds the greater of \$5,000 or ten percent of the tax that must be shown on the return.¹³ For corporations (other than S corporations or personal holding companies), an understatement is substantial if it exceeds the lesser of ten percent of the tax required to be shown on the return (or, if greater, \$10,000), or \$10,000,000.¹⁴

For example, if the correct amount of tax is \$10,000 and an individual taxpayer reported \$6,000, the substantial underpayment penalty under IRC § 6662(b)(2) would not apply because although the \$4,000 shortfall is more than ten percent of the correct tax, it is less than the fixed \$5,000 threshold. Conversely, if the same individual reported a tax of \$4,000, the substantial understatement penalty would apply because the \$6,000 shortfall is more than \$5,000, which is the greater of the two thresholds.

Reasonable Cause

The accuracy-related penalty does not apply to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith.¹⁵ A reasonable cause determination takes into account all of the pertinent facts and circumstances.¹⁶ Generally, the most important factor is the extent to which the taxpayer made an effort to determine the proper tax liability.¹⁷

⁸ IRC § 6724(d)(1) defines an information return by cross-referencing various other sections of the Code that require information returns (e.g., IRC § 6724(d)(1)(A)(ii) cross-references IRC § 6042(a)(1) for reporting of dividend payments).

⁹ Treas. Reg. § 1.6662-3(b)(1)(i)-(ii).

¹⁰ These factors include the taxpayer's history of noncompliance; the taxpayer's failure to maintain adequate books and records; actions taken by the taxpayer to ensure the tax was correct; and whether the taxpayer had an adequate explanation for underreported income. Internal Revenue Manual (IRM) 4.10.6.2.1, *Negligence* (May 14, 1999).

¹¹ IRC § 6662(d)(2)(A)(i)-(ii).

¹² IRC § 6662(d)(2)(B)(i)-(ii). No reduction is permitted, however, for any item attributable to a tax shelter. See IRC § 6662(d)(2)(C)(i).

¹³ IRC § 6662(d)(1)(A)(i)-(ii).

¹⁴ IRC § 6662(d)(1)(B)(i)-(ii).

¹⁵ IRC § 6664(c)(1).

¹⁶ Treas. Reg. § 1.6664-4(b)(1).

¹⁷ *Id.*

Penalty Assessment and the Litigation Process

In general, the IRS proposes the accuracy-related penalty as part of its examination process¹⁸ and through its Automated Underreporter (AUR) computer system.¹⁹ Before a taxpayer receives a notice of deficiency, he or she has opportunities to engage the IRS on the merits of the penalty.²⁰ Once the IRS concludes an accuracy-related penalty is warranted, it must follow deficiency procedures (*i.e.*, IRC § 6211-6213).²¹ Thus, the IRS must send a notice of deficiency with the proposed adjustments and inform the taxpayer that he or she has 90 days to petition the United States Tax Court to challenge the assessment.²² Alternatively, taxpayers may seek judicial review through refund litigation.²³ Under certain circumstances, a taxpayer can request an administrative review of IRS collection procedures (and the underlying liability) through a Collection Due Process (CDP) hearing.²⁴

Burden of Proof

In court proceedings, the IRS bears the initial burden of production regarding the accuracy-related penalty.²⁵ The IRS must first present sufficient evidence to establish that the penalty is warranted. The burden of proof then shifts to the taxpayer to establish any exception to the penalty, such as reasonable cause.²⁶

ANALYSIS OF LITIGATED CASES

We identified 178 opinions issued between June 1, 2012 and May 31, 2013 where taxpayers litigated the negligence/disregard of rules or regulations or substantial understatement components of the accuracy-related penalty. The IRS prevailed in full in 139 cases (78 percent), the taxpayers prevailed in full in 28

18 IRM 4.10.6.2(1), *Recognizing Noncompliance* (May 14, 1999) (“assessment of penalties should be considered throughout the audit”). See also IRM 20.1.5.3(1)-(2), *Examination Penalty Assertion* (Jan. 24, 2012).

19 The AUR is an automated program that identifies discrepancies between the amounts that taxpayers reported on their returns and what payors reported via Form W-2, Form 1099, and other information returns. See IRM 4.19.2, *Liability Determination, IMF Automated Underreporter (AUR) Control* (Aug. 16, 2013). IRC § 6751(b)(1) provides the general rule that IRS employees must have written supervisory approval before assessing any penalty. However, IRC § 6751(b)(2)(B) allows an exception for situations where the IRS can calculate a penalty automatically “through electronic means.” The IRS interprets this exception as allowing it to use its AUR system to propose the substantial understatement and negligence components of the accuracy-related penalty without human review. If a taxpayer responds to an AUR-proposed assessment, the IRS first involves its employees at that point to determine whether the penalty is appropriate. If the taxpayer does not respond timely to the notice, the computers automatically convert the proposed penalty to an assessment. See National Taxpayer Advocate 2007 Annual Report to Congress 259 (“Although automation has allowed the IRS to more efficiently identify and determine when such underreporting occurs, the IRS’s over-reliance on automated systems rather than personal contact has led to insufficient levels of customer service for taxpayers subject to AUR. It has also resulted in audit reconsideration and tax abatement rates that are significantly higher than those of all other IRS examination programs.”).

20 For example, when the IRS proposes to adjust a taxpayer’s liability, including additions to tax such as the accuracy-related penalty, it typically sends a notice (“30-day letter”) of proposed adjustments to the taxpayer. A taxpayer has 30 days to contest the proposed adjustments to the IRS Office of Appeals, during which time he or she may raise issues related to the deficiency, including any reasonable cause defense to a proposed penalty. If the issue is not resolved after the 30-day letter, the IRS sends a statutory notice of deficiency (“90-day letter”) to the taxpayer. See IRS Pub. 5, *Your Appeal Rights and How to Prepare a Protest If You Don’t Agree* (Jan. 1999); IRS Pub. 3498, *The Examination Process* (Nov. 2004).

21 IRC § 6665(a)(1).

22 IRC § 6213(a). A taxpayer has 150 days instead of 90 to petition the Tax Court if the notice of deficiency is addressed to the taxpayer outside the United States.

23 Taxpayers may litigate an accuracy-related penalty by paying the tax liability (including the penalty) in full, filing a timely claim for refund, and then timely instituting a refund suit in the appropriate United States District Court of the Court of Federal Claims. 28 U.S.C. § 1346(a)(1); IRC §§ 7422(a), 6532(a)(1); *Flora v. United States*, 362 U.S. 145 (1960) (requiring full payment of tax liabilities as a prerequisite for jurisdiction over refund litigation).

24 IRC §§ 6320 and 6330 provide for due process hearings in which a taxpayer may raise a variety of issues including the underlying liability, provided the taxpayer did not receive a statutory notice of deficiency or did not otherwise have an opportunity to dispute such liability. IRC §§ 6320(c), 6330(c)(2).

25 IRC § 7491(c) provides that “the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.”

26 IRC § 7491(a). See also Tax Court Rule 142(a).

cases (16 percent) and 11 cases (six percent) resulted in split decisions. Table 1 in Appendix III provides a detailed list of these cases.

Taxpayers appeared *pro se* (without representation) in 100 of the 178 cases (56 percent) and convinced the court to dismiss or reduce the penalty in 20 (20 percent) of those cases. Represented taxpayers fared slightly better, achieving full or partial relief from the penalty in 19 of their 78 cases (24 percent).

In some cases, the court found taxpayers liable for the accuracy-related penalty but failed to clarify whether it was for negligence under § 6662(b)(1), or a substantial understatement of tax under § 6662(b)(2), or both.²⁷ Regardless of the subsection at issue, the analysis of reasonable cause is the same. As such, we have combined our analyses of reasonable cause for the negligence and substantial understatement cases.

Adequacy of Records and Substantiation of Deductions to Show Reasonable Cause and as Proof of Taxpayer's Good Faith

Taxpayers are required to maintain records sufficient to establish the amount of gross income, deductions, and credits claimed on a return.²⁸ Taxpayers were most successful in establishing a defense for an asserted underpayment when they produced adequate records or proved they made a reasonable attempt to comply with the requirements of law. For example, in *Bauer v. Commissioner*,²⁹ the taxpayer engaged in a household goods transport business and sought to deduct contract labor expenses. Although a deduction is allowed for ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business,³⁰ the IRS disallowed the contract labor expenses for failure to substantiate the deduction. In *Bauer*, the taxpayer kept a logbook of contract labor expenses that the court deemed inadequate to substantiate the deduction taken on Schedule C.³¹ Pursuant to the *Cohan* rule,³² however, the court was able to estimate the amount of deductible expense. The court did not uphold the accuracy-related penalty asserted against the taxpayer because his logbook demonstrated that he made a good faith effort to maintain a record of his contract labor expenses even though his attempt at recordkeeping fell short for substantiation purposes.³³

While the Tax Court has been sympathetic to honest misunderstandings of a complex tax code,³⁴ it will still impose an accuracy-related penalty on taxpayers not demonstrating a good faith effort to comply with

27 See, e.g., *Snow v. Comm'r*, T.C. Memo. 2013-114 (IRS proposed accuracy-related penalties against the taxpayer for both § 6662(b)(1) and (b)(2), but the Tax Court ultimately held him liable for "the accuracy-related penalty under section 6662(a)," without identifying which subsection applied). Compare with *Holmes v. Comm'r*, T.C. Memo. 2012-251 (IRS proposed accuracy-related penalties under both § 6662(b)(1) and (b)(2); however, once the IRS established that the taxpayer had substantially understated his income under § 6662(b)(2), the court declined to consider the negligence claim).

28 IRC § 6001; Treas. Reg. § 1.6001-1(a).

29 T.C. Memo. 2012-156.

30 IRC § 162(a).

31 *Bauer*, T.C. Memo. 2012-156.

32 See *Cohan v. Comm'r*, 39 F.2d 540, 544 (2d Cir. 1930) (holding that if a taxpayer establishes that he or she paid a deductible business expense but cannot substantiate the precise amount, the court may estimate the amount of the deductible expense, "bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making").

33 *Bauer*, T.C. Memo. 2012-156.

34 See, e.g., *Armstrong v. Comm'r*, 139 T.C. No. 18 (2012) (declining to impose an accuracy-related penalty on a taxpayer who improperly claimed a dependency exemption but was not sufficiently experienced in tax accounting and law to be found negligent); *Chien v. Comm'r*, T.C. Memo. 2012-277 (relieving from the accuracy-related penalty a taxpayer who failed to understand that she was liable for self-employment tax because of her inexperience and honest misunderstanding, after consulting instructions for Form 1040, of her employment status).

the law. For example, in *Striefel v. Commissioner*,³⁵ the taxpayer destroyed records because he was told he would die soon. Although the court acknowledges the taxpayer was understandably upset, it found the taxpayer's actions negligent and not justifiable pursuant to IRC § 6001, which requires the maintenance of tax records.³⁶ In *Fitch v. Commissioner*,³⁷ the taxpayers sought to deduct a net operating loss carried over from prior years pursuant to IRC § 172(a). The IRS disallowed the deduction for failure to substantiate, and the taxpayers were responsible for an accuracy-related penalty. Although the husband, who worked as a certified public accountant (CPA), suffered a brain aneurysm during the tax year, the deterioration of his health did not suffice to support a finding that the married couple acted with reasonable cause sufficient to avoid the accuracy-related penalty.³⁸ While the court sympathized with the taxpayer's health circumstances, it relied on Mr. Fitch's continued practice as a CPA to show that the illness alone did not support a reasonable cause or good faith defense sufficient to avoid the penalty.³⁹

While expectations for compliance with the tax code are high, taxpayers avoided an accuracy-related penalty by adequately substantiating deductions to show reasonable cause and proof of good faith in connection with an unresolved legal issue. For example, in *Patel v. Commissioner*,⁴⁰ the taxpayers claimed a charitable contribution when they donated their house to the local fire department to conduct live fire training exercises on the property. The state of the law regarding the type of ownership interest in the house that the taxpayers transferred to the fire department was unsettled. The Tax Court denied the deduction but declined to impose the accuracy-related penalty. The IRS disagrees with the Tax Court's conclusion that the uncertain state of the law is a factor that supports a finding of reasonable cause when the taxpayers failed to obtain competent professional advice or do their own investigation of the state of the law.⁴¹

In *Olive v. Commissioner*,⁴² the taxpayer was found negligent for failure to keep adequate books and records, and he substantially understated income in connection with his medical marijuana dispensary. The taxpayer deducted costs of goods sold and other business expenditures, some of which were properly substantiated while others were not. Accuracy-related penalties were imposed on the portion of the understatement that arose from unsubstantiated deductions, but not on the portion of the understatement stemming from properly substantiated deductions. Because the correct treatment of expenditures for the sale of marijuana was not resolved at the time the taxpayer filed the returns, the court focused the penalty application on whether the expenses had been properly substantiated as a sign of a good faith effort to comply with the tax code.⁴³

35 T.C. Memo. 2013-102.

36 See *supra*, note 28.

37 T.C. Memo. 2012-358.

38 *Id.*

39 *Id.* See also *Perry v. Comm'r*, T.C. Memo. 2012-237 (holding an accuracy-related penalty was appropriate where the taxpayer was a certified public accountant (CPA) and former IRS revenue agent and failed to substantiate deductions for travel expenses and depreciation on his home).

40 138 T.C. 395 (2012).

41 See *Patel*, 138 T.C. at 395, *action on dec.*, 2013-7 (Feb. 11, 2013).

42 139 T.C. 19 (2012).

43 139 T.C. 19 (2012).

Negligence by Creation of Artificial Capital Loss

We also reviewed several cases in which the taxpayer contested an accuracy-related penalty after creating an artificial capital loss by implementing a scheme called CARDS (Custom Adjustable Rate Debt Structure). In *Kerman v. Commissioner*,⁴⁴ the taxpayer was held liable for an accuracy-related penalty for a substantial understatement in tax resulting from the implementation of a CARDS scheme to generate tax losses to offset the capital gain realized from the sale of securities. A CARDS strategy begins with a foreign borrower taking a loan from a foreign bank in foreign currency. The taxpayer for whom the strategy is designed would then receive some of the funds from the company, agreeing to be jointly liable for the full amount of the loan. The taxpayer would then exchange the foreign currency for United States dollars. As the exchange of foreign currency is a taxable event, the taxpayer claims a basis in the foreign currency equal to the entire value of the loan taken from the foreign financial institution. The U.S. currency is then paid to the foreign company and the loan is paid off after a year, so as to avoid discharge of indebtedness income. This scheme lacks economic substance as it creates noneconomic losses to be used for tax benefits.⁴⁵

The taxpayer in *Kerman* had been warned in the CARDS promotional materials “that tax losses from transactions similar to CARDS that are designed to produce noneconomic tax losses by artificially overstating basis are not allowable as deductions for Federal income tax purposes.”⁴⁶ Relying in part on the copy of Notice 2000-44 the taxpayer received prior to engaging in the CARDS strategy, the court held that the taxpayer did not act with reasonable cause when entering into a transaction that lacked economic substance and was, therefore, a sham. Other courts besides the Tax Court have disallowed deductions resulting from this strategy and they impose accuracy-related penalties accordingly,⁴⁷ often times increasing the penalty to 40 percent for a gross misstatement penalty under IRC § 6662(h).⁴⁸

Reliance on Advice of a Tax Professional as Reasonable Cause

Another commonly litigated question was whether reliance on a tax professional established reasonable cause. The taxpayer’s education, sophistication, and business experience are relevant in determining whether his or her reliance on tax advice was reasonable.⁴⁹ To prevail, a taxpayer must establish that:

1. The adviser was a competent professional who had sufficient expertise to justify reliance;
2. The taxpayer provided necessary and accurate information to the adviser; and
3. The taxpayer actually relied in good faith on the adviser’s judgment.⁵⁰

44 713 F.3d 849 (6th Cir. 2013), *aff’g* T.C. Memo. 2011-54.

45 See IRS Notice 2000-44, 2000-2 C.B. 255 (“Taxpayers and their representatives are alerted that the purported losses arising from certain types of transactions are not properly allowable for federal income tax purposes.”); IRS Notice 2002-21, 2002-1 C.B. 730 (where CARDS transactions are listed).

46 *Kerman*, 713 F.3d at 870.

47 See *Crispin v. Comm’r*, 708 F.3d 507 (3d Cir. 2013), *aff’g* T.C. Memo. 2012-70; *Gustashaw v. Comm’r*, 696 F.3d 1124 (11th Cir. 2012), *aff’g* T.C. Memo. 2011-195.

48 IRC § 6662(h) (an overstatement in the basis of property by 400 percent or more will be treated as a gross valuation misstatement, thus doubling the penalty from 20 to 40 percent of the underpayment of income tax).

49 Treas. Reg. § 1.6664-4(c)(1). See also IRM 20.1.5.6.1(6), *Reasonable Cause* (Jan. 24, 2012).

50 *Neonatology Associates, P.A. v. Comm’r*, 115 T.C. 43, 99 (2000) (citations omitted), *aff’d*, 299 F.3d 221 (3d Cir. 2002).

Taxpayers argued their good faith reliance on a competent tax professional in several cases this year,⁵¹ including *Meinhardt v. Commissioner*.⁵² In *Meinhardt*, the IRS imposed an accuracy-related penalty for a substantial understatement of income tax resulting from a failure to substantiate business expense deductions. The taxpayers, having recognized their relative unfamiliarity with tax law, hired a practicing attorney to help them prepare their returns. Their attorney regularly handled tax returns in the community, and the taxpayers gave him all of the materials they thought were relevant to their tax return. Having established good faith reliance on a competent tax professional, the court declined to uphold the accuracy-related penalty.

In *Romanowski v. Commissioner*,⁵³ the IRS imposed an accuracy-related penalty on the taxpayers for income tax deficiencies related to the improper deduction of expenses of their horse-breeding activity. The Tax Court found that the horse-breeding activity was not engaged in for profit, and therefore disallowed the deductions.⁵⁴ The taxpayers, however, presented credible evidence of good faith reliance on a competent tax professional. The taxpayers were unsophisticated in the field of tax and they hired a “very experienced and highly accomplished accountant” and an “accomplished lawyer familiar with tax law,” upon whose advice they relied.⁵⁵ The taxpayers were able to establish the three criteria above, and the court held they were not liable for any accuracy-related penalties.

In several cases, the taxpayer could not establish all three of the above-mentioned criteria. For example, in *Mills v. Commissioner*,⁵⁶ the taxpayers hired their tax preparer to advise whether the LLC they had formed could amortize the value of the husband’s time and expertise in real estate management. The tax preparer was an accountant, but he was not a lawyer or a CPA. He was an enrolled agent who had passed a written examination administered by the IRS Office of Professional Responsibility, but his status became inactive while working with the taxpayers. At the time of trial, the tax preparer resided in a Colorado Federal penitentiary after stealing from clients’ individual retirement accounts using forged power of attorney forms. As the taxpayers were not able to establish the competence of the tax preparer, they failed to meet the *Neonatology* test and were liable for an accuracy-related penalty.

There are many more examples of taxpayers’ failure to establish the competence of their tax preparers.⁵⁷ While some taxpayers choose to use tax software to prepare their tax returns, the Tax Court does not find reliance on tax preparation software justifiable to avoid an accuracy-related penalty. In this regard, the Tax

51 See, e.g., *Cook v. Comm’r*, T.C. Memo. 2012-167 (finding the taxpayer reasonably relied on his CPA with respect to misplacement of commission expense on the wrong schedule for which the taxpayer provided proper documentation to his CPA; also finding the taxpayer failed to show that he had provided adequate documentation to his CPA for non-commission expenses and was, therefore, liable for an accuracy-related penalty for that portion of the underpayment in tax).

52 T.C. Memo. 2013-85.

53 T.C. Memo. 2013-55.

54 IRC § 183(a) (“In the case of an activity engaged in by an individual, ... if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.”).

55 *Romanowski*, T.C. Memo. 2013-55.

56 T.C. Memo. 2013-4.

57 See, e.g., *Yates v. Comm’r*, T.C. Memo. 2013-28, appeal filed (4th Cir. July 1, 2013) (holding taxpayers liable for an accuracy-related penalty because they offered no evidence concerning the expertise of their accountant); *Deutsch v. Comm’r*, T.C. Memo. 2012-318 (finding the taxpayer liable for an accuracy-related penalty because he failed to establish his CPA had adequate expertise). Taxpayers may have a difficult time demonstrating the competency of the majority of return preparers if the government is barred from regulating unenrolled preparers. See *Loving v. Internal Revenue Service*, 111 A.F.T.R.2d (RIA) 589 (D.D.C. 2013); Nina E. Olson, *More Than a ‘Mere’ Preparer: Loving and Return Preparation*, 2013 TNT 92-31 (May 13, 2013).

Court has observed that “[t]he misuse of tax preparation software, even if unintentional or accidental, is no defense to accuracy-related penalties under section 6662.”⁵⁸

In *Bartlett v. Commissioner*,⁵⁹ the taxpayer admitted to underpayment of tax due to misreporting the amount of taxable pension benefits received. The taxpayer sought to avoid an accuracy-related penalty by claiming the underpayment was an “honest mistake” and that she believed that the tax preparation software would “catch any mistakes she otherwise might make.”⁶⁰ The Tax Court found that the information the taxpayer had entered into the preparation software was incorrect, and the system was “only as good as the information entered into its software program.”⁶¹ The Tax Court found the taxpayer liable for an accuracy-related penalty as the mistakes were not made by the software, but by the taxpayer herself. Unless the taxpayer proves the software itself is flawed, the Tax Court is unlikely to accept reliance on tax preparation software as a justification to avoid an accuracy-related penalty.⁶²

No Affirmative Defense Offered by the Taxpayer

Many litigants offered no affirmative defense for the understatement in tax, failing completely to claim the reasonable cause and good faith defense under IRC § 6664(c). In *Powers v. Commissioner*,⁶³ the taxpayers were negligent in keeping adequate books and records related to their telephone company. In addition, the taxpayers failed to report income and claimed deductions to which they were not entitled, which resulted in a substantial understatement of income tax. While the taxpayers claimed that their 44 years of tax compliance should be a significant factor in determining the existence of negligence, the court held that evidence of prior compliance with the Code was insufficient on its own to avoid the accuracy-related penalty.⁶⁴ The taxpayers failed to raise any affirmative defense and were, therefore, held liable for the penalty.

CONCLUSION

Of the 178 cases we reviewed, the courts upheld the underlying tax deficiency, or portions of the deficiency, determined by the IRS in all cases. In over a fifth of the cases, the courts abated the accuracy-related penalties, partially or in full, where the taxpayer showed a reasonable and good faith attempt to ascertain the correct amount of tax due. The courts most commonly found reasonable cause on the bases of maintenance of adequate records to substantiate deductions and reasonable reliance on a competent tax professional. Taxpayers should also be aware that they must raise an affirmative defense to the penalty in order to have a chance at avoiding liability for the penalty.

⁵⁸ See *Langley v. Comm’r*, T.C. Memo. 2013-22, 2013 Tax Ct. Memo. LEXIS 22 at *10 (citations omitted).

⁵⁹ T.C. Memo. 2012-254.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² See *Morales v. Comm’r*, T.C. 2012-341.

⁶³ T.C. Memo. 2013-134.

⁶⁴ *Id.*



Department of the Treasury
Internal Revenue Service
Small Business Self Employed
401 W Peachtree Street, NW
Stop 418-D, Group 1105

THOMAS
177

JA 30549-1077

Date:

April 4, 2016

Taxpayer Identification Number:

2323

Form:

1040

Tax period ended:

2013

Person to contact:

Earl

Contact telephone number:

404-

Contact fax number:

855-

Employee identification number:

1000

Dear THOMAS

Your federal income tax return for the year shown above was selected at random for a compliance research examination. We must examine randomly-selected tax returns to better understand tax compliance and improve the fairness of the tax system. We'll give you the opportunity to explain any errors we may find during the examination.

The results of this and other compliance research examinations will improve our efforts to help taxpayers understand and follow the tax law. It will also reduce unnecessary and costly examinations, and reduce burden on taxpayers. Please read the enclosed Notice 1332, *Why Your Return is Being Examined*.

What you need to do

Please call me on or before April 13, 2016 . You may contact me from 8:00 am to 4:30 pm at the telephone number provided above.

What we will discuss

During our telephone conversation, we will discuss:

- Items on your return that I will be examining.
- Types of documents I will ask you to provide.
- The examination process.
- Any concerns or questions you may have.
- The date, time and agenda for our first meeting.

Someone may represent you

You may have someone represent you during any part of this examination. If you decide you want representation, the representative you authorize will need a completed Form(s) 2848, *Power of Attorney and Declaration of Representative*, before we can discuss any of your tax matters.

If you choose to have someone represent you, please provide a completed Form 2848 by our first appointment. You can mail or fax the form to me or have your representative provide it at the first appointment, if you won't be present. You can obtain Form 2848 from our office, from our web site, www.irs.gov or by calling (800) 829-3676.

If you filed a joint return, you and your spouse may attend the examination. If you and/or your spouse choose not to attend with your representative, you must provide completed Form(s) 2848. You should provide a separate Form 2848 for each spouse if you filed jointly even if you use the same representative.

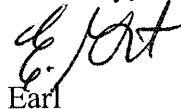
Your rights as a taxpayer

We have enclosed Publication 1, *Your Rights as a Taxpayer* and Notice 609, *Privacy Act Notice*. The Declaration of Taxpayer Rights found in Publication 1 discusses general rules and procedures we follow in examinations. It explains what happens before, during, and after an examination, and provides additional sources of information.

A video presentation, "Your Guide to an IRS Audit," is available at <http://www.irsvideos.gov/audit>. The video explains the examination process and will assist you in preparing for your audit.

Thank you for your cooperation and I look forward to hearing from you by April 13, 2016 .

Sincerely,



Earl

Supervisory, Internal Revenue Agent

Enclosures:

Publication 1

Publication 4134, *Low Income Taxpayer Clinic List*

Notice 609 .

Notice 1332