
CHAPTER I

Examination

IRS Audit Procedures

I. Introduction and Background

A. Background

Anyone who does any significant tax practice inevitably will be required to deal with the examination personnel of the Internal Revenue Service (IRS). In the event of an audit, a client justifiably expects his or her representative to be able to defend positions taken on tax returns. Thus a certified public accountant (CPA) or lawyer should be reasonably conversant with the intricacies and pitfalls of handling a tax audit.

B. Organizational Structure

There are four operating divisions within the IRS that are responsible for the Examination function. These are as follows:

1. *Small Business/Self-Employed (SB/SE)*

This division handles the examination of 1040s with Schedules C, E, and F as well as other business returns with assets of less than \$10 million.

2. *Large Business and International (LB&I)*

This division handles the audits of business returns (1065, 1120, and 1120S) having assets of more than \$10 million. LB&I is organized into five industry groups:

- a. communications, technology, & media,
- b. financial services,
- c. heavy manufacturing and transportation,
- d. natural resources and construction, and
- e. retailers, food, pharmaceuticals, and health care.

3. *Tax-Exempt and Governmental Entities (TEGE)*
4. *Wage and Investment (W&I)*

This division handles all other taxpayers; that is, individuals who have only wage and investment income. W&I does not conduct field audits. If it is necessary to do a field examination of a W&I taxpayer, it is done by SB/SE.

C. *Initial Screening*

In the initial processing of a return at regional service centers (now called “campuses”), returns are manually edited and computer scanned for math errors, defects in form or execution, and potentially unallowable items.¹ Returns may be classified as to audit potential according to various criteria predetermined through National Research Program (NRP) audits. The NRP is a program designed to provide information used in designing the discriminant function (DIF) formulas.² DIF is a mathematical technique used to score income tax returns as to examination potential based on NRP-developed data. A DIF formula is applied to each return, and each is assigned a three-digit DIF score. The hypothesis is that the higher the score, the greater the potential for audit deficiency. Corporate returns with balance sheets or assets over \$10 million are not DIF scored.³ The highly sophisticated formulas developed by the IRS to score tax returns are secret and thus unavailable to taxpayers.⁴

As a subset of the DIF procedures, the IRS has developed a tool for identifying returns with a high probability of unreported income. They call it the Unreported Income Discriminant Index Formula, known by its acronym UI DIF.⁵ All filed returns now receive a UI DIF score in addition to the traditional DIF score.

D. *Selection of Type of Audit*

If a DIF score indicates the need for an audit, the IRS first considers the types of potential issues. If the matter can be satisfactorily resolved by correspondence, then that will be the method. If not, and only a few documents need to be inspected, the taxpayer will be asked to bring them to the office (“office examination”). If several complex issues or many books are involved, a “field examination” will be made. Typically, only individuals will be scheduled for office exams. Business returns (corporations, partnerships, etc.) are always subject to field exams by revenue agents. The IRS determines whether an examination should be a field exam or an office exam based on the complexity of the return.⁶

II. Rules Governing Powers of Attorney

- A. During any kind of examination, the taxpayer under audit is entitled to be represented by a lawyer, CPA, enrolled agent, or other representative allowed by Circular 230.⁷ Because of the anti-disclosure

laws, the IRS scrupulously observes the rules regarding who is authorized to receive confidential tax information. Without a properly executed written authorization, the IRS will not disclose information to a representative.

B. A power of attorney (POA) need not follow any prescribed form;⁸ however, the IRS has provided Form 2848 for this purpose.⁹ It should be prepared with great care; otherwise, it will be rejected. At a minimum, it must contain the following:¹⁰

1. The taxpayer's complete name;
2. The taxpayer's identifying number (employee identification number [EIN] or Social Security number [SSN]);
3. The representative's
 - a. name,
 - b. address,
 - c. telephone number,
 - d. fax number, and
 - e. Central Authorization File (CAF) number (optional according to the regulations);¹¹
4. The exact years or periods;¹² e.g.,
 - a. 0903 (i.e., for quarter ended 3-31-2009),
 - b. 2010, or
 - c. year ended 12-31-13;
5. The type of tax (e.g., income, estate, or employment) or civil penalty;
6. The form number (e.g., 1040, 1120, 5500, 941, or SS-8); and
7. The declaration of authority (on the back of Form 2848).

Be careful that the client signs the POA *after* the representative does so; otherwise, it may be rejected for having an invalid date.

C. *Bypassing the Representative*

Examination personnel are forbidden from contacting the taxpayer directly where there is a valid POA on file, unless the representative has been dilatory or has unreasonably hindered the examination, in which case the revenue agent must request permission from the appropriate supervisory personnel.¹³

D. *Multiple Cases*

A 2848 (POA) may cover more than one matter; for example, a 1040 and a 941 (for employment tax issues).¹⁴ For business clients, it is generally advisable to cover "civil penalties" in addition to other types of taxes.

E. *Signature of Representative*

Form 2848 does *not* permit a representative to sign tax returns on behalf of the client. Nor does it permit the endorsing of checks.¹⁵ However, a taxpayer may modify a POA to authorize his or her representative to perform these functions.¹⁶

In addition to a signature, a representative must provide his license number and PTIN.

A representative may represent both a husband and wife, regardless of whether a joint return was filed. However, in all cases, separate POAs must be obtained for each spouse.

Practice Tip

If the husband and wife are currently divorced, separated, or otherwise having marital difficulties, it is advisable for them to have separate representatives.

F. Photocopies

A photocopy of a POA will suffice for the IRS. It need not be an original, despite the occasional protestations of some revenue personnel.¹⁷ A POA received by fax will also be accepted.¹⁸

G. Arrangements for Audits

Whenever there is a valid POA, all arrangements for the audit of a taxpayer are conducted through the authorized representative.

H. CAF Numbers

The IRS maintains a Central Authorization File for all representatives who have submitted a POA to represent their clients. Each authorized representative is assigned a unique CAF number and is asked to use that number when submitting a POA to the IRS.¹⁹ However, it should be noted that a POA will *not* be rejected solely because it does not contain a CAF number.²⁰

III. Correspondence and Office Audit

A. Initiation of Audits

Correspondence audits are usually initiated by computer-generated letters from the IRS service center. Office examinations are initiated by form letters from the office audit appointment clerk in the local IRS office. The initial letter will have a list of possible items the IRS wants to look at. This letter will also either set a specific appointment date or give a telephone number to call to set up the appointment.

B. Correspondence Audits

Each service center has an audit branch that conducts correspondence audits. Taxpayers are required to mail in certain documents and information. If an issue is raised, taxpayers are given an opportunity to appeal using regular appeals procedures.²¹

Another variation of the correspondence audit is the so-called cross-match audit. Because of statutory “information return” requirements, the IRS receives many millions of documents (W-2s, 1099s, K-1s, etc.) that contain information that should be reported on income-recipient tax returns. If, after matching the information returns with the corresponding income tax returns, there appears to be some discrepancy, a “proposed change” notice is mailed to the taxpayer. This frequently takes the form of a CP-2000 or CP-2501 computer-generated notice.²² If there is no response to a CP-2000 or -2501 notice, the IRS will issue a statutory notice of deficiency as prescribed by Internal Revenue Code (I.R.C.) § 6212.²³

C. *Office Audit*

In an office examination case,²⁴ the taxpayers are required to bring their records to the IRS office. The office auditors (now known as tax compliance officers, or TCOs) will not have screened the return before the audit. They will go through a routine questionnaire, asking if the taxpayer has ever been audited, among other questions (see list below). They will also have an Information Return Program (IRP) (1099, cross-match, etc.) report in front of them. If the auditor tries to go beyond questions indicated on the initial appointment letter, it is within the representative’s rights to tell the auditor that he or she is not prepared to discuss these other areas since they were beyond the scope of the original request.

Preliminary questions typically asked by auditors before the actual auditing begins may include some or all of the following:

1. Where does the taxpayer do his or her banking?
2. Is the taxpayer current on all of his or her tax return filing?
3. Have any amended returns been filed?
4. Are there any other tax return filing requirements?
5. Have there been any other prior-year IRS audits?
6. Is the taxpayer a member of any barter club?
7. Does the taxpayer have any foreign bank accounts?
8. What is the taxpayer’s age?

Taxpayers always have the right to raise new, favorable issues during the office interview process.²⁵

D. *Repetitive Audits*

If a taxpayer was audited and “no-changed” for the same issue in one of the two years preceding the one under examination, the auditor has the discretion to discontinue the audit for the current year.²⁶

E. *Conclusion of Office Audit*

Generally, at the conclusion of an office audit, which lasts usually two to four hours, the auditor will request additional information. If the

information is not provided within a few days, a machine-prepared report will be issued, disallowing all questioned items. If additional information is subsequently received, a “corrected” report will be issued. If no additional information is needed by the auditor, the report can be generated by computer and printed at the auditor’s desk.

IV. Field Audit Procedures

A. *Initiation of Field Audits*

Field examinations are normally initiated by a telephone call or letter from a revenue agent. Unannounced visits from revenue agents are rare. Accompanying the audit notice will also usually be a request for documents. This is called an Information Document Request, Form 4564.

B. *Pre-Audit Procedures*

Before the first field visit by a revenue agent, the agent will have done a significant amount of analysis and other work. The first thing the agent must do is a “risk analysis.” He or she must weigh the benefits of auditing a return against the resources required to complete the job. If the benefits do not outweigh the cost, the return will not be opened for examination.²⁷

By the time the revenue agent shows up at your office, he or she already knows a great deal about the taxpayer. Using online capability with services such as ChoicePoint or Accurint, the agent will have checked all public record sources for auto titles, real estate transactions, and court records. He or she may bring printouts of this information to the audit. The agent also has computer access to prior- and subsequent-year tax return information. This information contains line-by-line details, even for Schedules C, E, and F. He or she will also have IRP information based on information reporting.

IRS personnel often pick up leads and other relevant information from media sources such as newspapers. They can also access “public record” information such as lawsuits either by going to the courthouse or by Internet access. A practitioner should assume that the revenue agent already knows, before the start of the audit, everything about the taxpayer that the general public has access to (vehicle titles, real estate ownership, etc.).

Agents also have the capability of downloading tax return information without ever having seen a copy of the tax return. However, this computer information will not have detailed schedules that are attached to the tax return. Agents can even begin the audit with this computer information without a copy of the return in their file.

The agent may also have done a preliminary “cash T” analysis for sources and application of funds. This is done for purposes of a “rough and dirty” indication of unreported income.²⁸

A representative should remember that he is entitled to have a copy of all this preliminary and third-party information. Unfortunately, the typical revenue agent will not provide it voluntarily. The required course of action is to file a Freedom of Information Act (FOIA) request as soon as the case is closed out of the examination group. Of course this FOIA request should be prepared only if things have not gone well during the audit.

C. *General Authority of Revenue Agents*

Revenue agents have extremely broad authority in the auditing of tax returns. By statute, for the purpose of ascertaining the correctness of any return (or making a return where none has been made) and determining the tax liability of any person, an IRS agent is authorized to examine (1) books, (2) papers, (3) records, or (4) other data that may be relevant or material to the inquiry.²⁹

D. *Revenue Agent Qualifications*

Revenue agents typically have a degree in accounting (or equivalent accounting hours) and are much more technically competent than office auditors. Revenue agents are field personnel who, unlike office auditors, do not conduct their audits in the IRS office.

E. *Time and Place of the Audit*

Normally, the time and place of examination shall be such as may be determined by the revenue agent and as are reasonable under the circumstances.³⁰

Practice Tip

It is a good idea not to let the revenue agent work at the taxpayer's place of business, where he or she has free and unfettered access to all of the taxpayer's confidential data, much of which may be irrelevant to the agent's inquiry. The best approach is to convince the agent to work in the representative's office. See IRM 4.10.2.7.6 (5-14-99).

There may be circumstances under which a taxpayer may request a transfer of the place of examination from one place to another. For example, if a taxpayer has moved to a different area or can demonstrate that books and records are located elsewhere, the IRS will consider a transfer to another IRS office.³¹

F. *Use of Summons*

An IRS agent has the right to interview a taxpayer or his or her employee, but where there is a POA, that right is enforceable only by

the use of an administrative summons. In the absence of a summons, it is generally not advisable to have the taxpayer who is represented submit to an interview.³² Similarly, an agent can summons any third party having custody of a taxpayer's books of account.³³ If the agent insists on issuing a summons to the taxpayer or to third parties, there is an increased likelihood of a criminal investigation referral. See the separate subchapter in this chapter dealing with administrative summonses.

G. *Recording of Interviews*

Taxpayers and their authorized representatives are permitted to make audit recordings of in-person interviews relating to the determination or collection of any tax. However, videotaping is not permitted. Nor may a taxpayer record telephone conversations with IRS personnel. Ten days' advance written notice is usually required to record an interview.³⁴

H. *Claim-Auditing Procedures*

When claims (1040Xs, 1120Xs, and 843s) are audited, the same procedures are followed by the IRS as when the original returns are audited. Also, the taxpayer has the same appeal rights.³⁵

I. *Oral Opinions of IRS Personnel*

Oral statements and opinions are not binding on the IRS upon subsequent audit, even though the taxpayer or his or her representative may have relied on them to their detriment.³⁶

Practice Tip

Never rely on verbal statements made by a revenue agent. Get an agent to commit his or her positions in writing whenever possible.

J. *Access to Accountant's Working Papers*

In 1984, the IRS won a great victory in the U.S. Supreme Court, which decided, in *Arthur Young*,³⁷ that the IRS could have full access to an auditing firm's tax accrual working papers. Nevertheless, the IRS has self-imposed restraints.³⁸ Such requests are generally limited to those cases where unusual circumstances make it necessary to have access to complete an audit.³⁹

K. *Tour of Business Premises*

Field agents are told to conduct a tour of the business site early in the examination process. The purpose of this procedure is for the agent to attain a familiarity with the business operations and internal control.

Theoretically, it also allows agents to identify potential sources of unreported income and confirm the existence of assets. That is, such a tour may reveal areas of audit concern not evident on the tax return.⁴⁰

Practice Tip

Nothing in the rules says that the business owner has to conduct the tour of the business site. To prevent the agent from having a free shot at harassing the business owner with intrusive questions, it is a better plan to have the tour conducted by another employee.

L. Requests for Technical Advice

Occasionally a revenue agent will raise an issue requiring the national office of the IRS to make a ruling. A request for technical advice may be made by a taxpayer or his or her representative during an audit if there is

1. a lack of uniformity among authorities or
2. unusual or complex issues.⁴¹

Requests for technical advice are helpful to maintain consistent holdings throughout the IRS. If a taxpayer or his or her representative makes the request, it is submitted to the examining agent or appeals officer and must contain a full statement of facts and a discussion of relevant law.⁴²

M. Providing Photocopies of Documents

Contrary to prevailing opinion, the IRS cannot require a taxpayer to provide photocopies of requested documents during an audit. It is frequently recommended to provide such copies, however, particularly where they support a taxpayer's position.

N. Analytical Procedures

There is some question as to whether agents can require representatives to do analytical work. Generally, CPAs should not be required to do the agent's auditing work. Agents are trying to come up with the maximum deficiency with a minimum amount of thought and effort. Consequently, they will try to get the CPA to do as much of the work as possible. But there is nothing in the code or regulations that requires a representative to do anything more than furnish records and answer questions.

O. Extension of the Statute of Limitations

To avoid interruption of an audit, the regulations suggest (if the case is old) that taxpayers execute Form 872 or 872-A to extend the statute of limitations.⁴³ However, in the author's opinion, this should not be

done routinely. The reason that consent forms 872 and 872-A should not be executed is that they simply can give the IRS agent an unlimited amount of time to do what he or she was going to do anyway. And it is far easier to defend a poorly developed case than a well-developed case, even if a U.S. Tax Court petition has to be prepared.

P. Issues Favorable to the Taxpayer

During an audit, representatives should be on the alert for any adjustments in the taxpayer's favor. Then raise those issues at the *conclusion* of the audit. Be assured that the agent is not *looking* for issues in the taxpayer's favor, but he or she is permitted to make such adjustments in his or her report.

Q. Sworn Statements

IRS agents are authorized to take sworn statements from taxpayers.⁴⁴ This power is not frequently used, however. If a revenue agent wants to do it, the representative is within his or her rights to ask the reason for this extraordinary procedure.

R. Specialty Groups

There are several specialty groups within the IRS Examination Division, including the following:

- Estate and gift
- Economists
- Engineers
- Wage and excise
- Employee plan/exempt organizations
- Computer specialists

A more detailed discussion of these specialty audits is reserved for a later chapter.

S. Litigation Hazards

An agent may not consider hazards of litigation or take a position contrary to that announced by the IRS. Do not expect subtlety to work on a revenue agent. Even if a tax court case is unfavorable to the IRS, a revenue agent will not follow it unless the national office has issued an acquiescence.

T. "Package" Audits

During a field examination of an income tax return of a business taxpayer, the agent will typically inspect returns for other types of taxes to ensure voluntary compliance. Be prepared, therefore, to submit copies of employment tax returns (941, 942, and 940) and excise tax forms (e.g., 720 and 2290) to the agent for inspection.⁴⁵ If the agent selects an employment tax return for audit, the representative should consult the Internal

Revenue Manual (IRM), chapter 4.23. The agent will also ask to inspect copies of the taxpayer's prior- and subsequent-year tax returns. This is for the purpose of spotting inconsistencies between years. If the representative is also the preparer, he or she is required by law to allow the agent to inspect such returns.⁴⁶ Otherwise, he or she is under no obligation to allow such inspection unless the years are under audit. Before the commencement of the audit, the practitioner should always make sure that all required 1099s have been issued with correct Social Security numbers on them. This will prevent imposition of backup withholding.

U. Income Probe

Typically, field agents will request copies of personal bank statements. Their purpose in doing this is to see whether there are bank deposits representing unreported income. If the taxpayer has maintained personal bank statements and if he or she chooses to turn them over to the agent, then the taxpayer should make sure he or she has first inspected each deposit and determined the source of each one to establish its taxable or nontaxable nature. In nonbusiness audits, examiners are advised not to routinely ask for bank statements, canceled checks, or deposit slips.⁴⁷

V. Corporate Audits

It is particularly important in audits of corporations for practitioners to be alert for the possibility of the agent raising certain issues. Before the agent arrives, the practitioner should ensure that the corporate minutes book is available and up to date. The minutes book should cover such things as (1) officer/director compensation, (2) formula bonus arrangements, (3) reimbursement policy for business expenses incurred by executives, (4) use of company vehicles by employees, (5) the necessity for retaining earnings rather than declaring dividends, and (6) authorization for loans to executives.

V. Estate Tax Examinations

A. In General

Estate tax returns (Form 706) are examined in much the same way that income tax returns are. Estate tax examinations are under the jurisdiction of the SB/SE operating division of the IRS. Since estate tax examiners are always lawyers, the cases tend to be better developed than is the case with income tax audits. Estate tax examiners have no "settlement" authority. That is, they may not base their decisions on "hazards of litigation."

B. Internal Revenue Manual Provisions

Guidance for estate tax examiners is contained in the IRM at 4.25.1. Included in this provision are guidelines for scope, surveying, and other processes.

These provisions specify examination methods and techniques for issues, including the following:

- Valuation of real property
 - Valuation of stocks and bonds
 - Mortgages, notes, and cash
 - Life insurance
 - Jointly owned property
 - Miscellaneous property interests
 - Transfers
 - Powers of appointment
 - Survivorship annuities
 - Deductions—marital, charitable, and administrative expenses
- Practitioners should review these provisions in preparing for an estate tax examination.

C. *Statute of Limitations*

It is IRS policy to complete an examination of a 706 within eighteen months of the filing of the return.⁴⁸ The reason for this eighteen-month rule is that the federal estate tax return is the only return in which an extension of the statute of limitations for assessment cannot be secured.⁴⁹

D. *Related Returns*

As a part of his or her examination, an estate tax lawyer will always inspect related returns. These may include the following: (1) the decedent's 1040s for the last several years, (2) fiduciary returns (testamentary or inter vivos) filed on Form 1041, (3) gift tax returns (Form 709), or (4) entity returns (1065s, 1120s, etc.).

E. *Closing Letter*

If the estate tax audit is agreed to by the executor, a "closing" letter is issued. If the case is unagreed, no letter is issued until after the case is settled in appeals. If the case is litigated, no closing letter is issued. Note that the closing letter is *not* the same thing as a closing agreement.⁵⁰

Practice Tip

If you are facing a large estate tax deficiency on a controversial issue, agree with the examining lawyer, sign an agreement form (waiver of assessment restrictions), then file an amended 706 with a slightly lower value, claiming a refund. Then, after disallowance of this claim, file suit in district court so that you can have a jury hear your case. This procedure is a cheap ticket to the federal district court.

VI. Concluding the Audit

A. Closing Conference

At the conclusion of an audit, a revenue agent is required to give the taxpayer or his or her representative an opportunity to agree or disagree with any proposed adjustments.⁵¹ During this “exit” conference, the representative has an opportunity to obtain information from the agent’s files that may assist in the defense of the taxpayer’s case. The representative should always ask for copies of *all* working papers that support the agent’s position on each item for which an adverse adjustment is being proposed. If the agent allows an inspection of his or her file, the representative should also be on the alert for documents that will support a later claim for administrative or litigation costs. In the event that the agent refuses to allow photocopying, he or she should be advised that such documents can be obtained anyway through a FOIA request.

B. Agreement and Payment

If the taxpayer agrees with the agent, the agent is required to solicit immediate payment of the tax. Failing that, the taxpayer (or representative) will be asked to sign agreement Form 870 (or the equivalent). This form effectively waives any restrictions on assessment of the deficiency; therefore, one should be careful before signing it.⁵² At the conclusion of the audit, the agent will often solicit immediate payment of the agreed deficiency. If the taxpayer does not have the available funds for payment, the agent has the authority to enter into an installment payment agreement with the taxpayer.

C. Options Available at the Conclusion of an Audit

The options available at the conclusion of the audit are as follows:

1. Accept the proposal and sign Form 870 or Form 4549, following which the tax will be assessed and collection procedures will commence.
2. Do nothing and wait for the thirty-day or ninety-day letter.
3. Pay the tax, then
 - a. forget it, or
 - b. file a claim for a refund, wait six months, then file suit in federal district court.
4. Ask for a conference with a group manager.
5. Ask for an appeals conference.

In the author’s opinion, conferences with a group manager are almost always an exercise in futility, as group managers will typically support the positions taken by their auditors or agents.

D. Issuance of Deficiency Notice

If the statute of limitations is about to expire, either an office audit or field audit may be abruptly concluded when a deficiency notice

(ninety-day letter) is issued. The only appropriate response when a deficiency notice is received (assuming you do not want to pay the tax in full and initiate refund litigation in federal district court) is to file a petition with the U.S. Tax Court within ninety days of the date of the deficiency notice. A petition can be filed either by the taxpayer or by a representative (usually a lawyer) who is admitted to practice before the U.S. Tax Court.⁵³

E. Protests

In the event of disagreement, the representative may have to draft a protest. However, protests are *not* required after a correspondence or office audit, or after a field audit where the deficiency is less than \$2,500. In those cases, a simple request for an appeals conference is sufficient.⁵⁴ No fee is required for the filing of a protest. They need not be filed under oath, but they must be certified as true under the penalty of perjury.

F. Time Limits for Protests

Written audit reports in unagreed cases are accompanied by “thirty-day letters.” This means that the representative has thirty days within which to prepare and submit a written protest to the Examination function. The regulations do not provide for an extension of time to reply to a thirty-day letter by preparing a protest. However, as a matter of practice, extensions may be granted under reasonable circumstances enumerated in the IRM.⁵⁵

G. Contents of Protest

The contents of a protest are not fixed by law, but IRS instructions require the following:

1. A statement that the taxpayer seeks to appeal the examiner’s findings to the nearest appeals office.
2. The taxpayer’s name, address, and daytime telephone number.
3. The date and symbols shown on the thirty-day letter (or a copy of the letter showing proposed changes).
4. The tax period(s) or year(s) involved.
5. An itemized schedule of the disputed adjustments.
6. A statement of facts supporting the taxpayer’s position in any contested factual issue.
7. A statement outlining the law or other authority upon which the taxpayer relies.
8. A paragraph, signed by the taxpayer under oath, that the statement of facts is true and correct.
9. If prepared by a representative, this person is required to state that he or she prepared the protest and whether or not he or she knows the facts to be true.⁵⁶

H. *Full versus Skeleton Protest*

There are two schools of thought on preparing a protest:

1. *Skeleton* (the author's favorite—save back a few cards to play at the conference)—but be sure to identify all the issues, including those in your favor.
2. *Full*—but putting too much in the protest may “freeze” a taxpayer's position.

I. *New Issues Raised by the IRS*

A major disadvantage of the appeals process is in providing the IRS the opportunity to strengthen its case against the taxpayer or to raise new issues during the administrative appellate review. Of course appeals officers are prohibited from raising new issues except upon a showing of fraud or malfeasance, or misrepresentation of a material fact.⁵⁷

Practice Tip

A possible ploy if your case has some soft spots not initially recognized by the agent is to go ahead and get the case docketed in tax court, where it is more difficult for the government to raise new issues.

J. *Ex Parte Prohibition*

When an unagreed case gets to appeals, the revenue agent and appeals officer are generally precluded from having *ex parte* conversations without the taxpayer or his representative being a party to those conversations.⁵⁸

VII. Second Audits

A. *Successive Audits after “No Change”*

IRS has an internal policy whereby once an item is questioned and accepted, the following years will not be questioned as to that item, assuming the facts are substantially identical. For a general discussion of the prohibition on “repetitive audits,” see IRM 4.10.2.

B. *General Rule*

Taxpayers are not to be subjected to unnecessary audits, and only *one* inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the IRS notifies the taxpayer, in writing, that an additional inspection is necessary.⁵⁹

C. *Circumstances for Reopening*

A tax case may be reopened, after the first audit is concluded, only if there has been

1. fraud, concealment, or the like;
2. a serious administrative omission; or
3. a clearly defined substantial error.⁶⁰

A case is considered closed when the taxpayer is notified in writing of adjustments to tax liability or acceptance of the return without change.⁶¹

D. Doctrine of Estoppel

Taxpayers who are aware of a second inspection of books and records and do not object to it are estopped from raising the issue in a tax court petition.⁶²

E. Pass-through Entities

Under prevailing case law, after the first audit is concluded, a second audit may be made as the result of a flow-through adjustment of a partnership or S-Corp without violating § 7605(b).⁶³

F. Closing Agreement

If there is legitimate concern regarding a subsequent audit, the representative should consider entering into a statutory closing agreement.⁶⁴ One would want to use this procedure when there appears to be an advantage in having a case permanently and conclusively closed.

G. Audit Reconsideration

When an audit deficiency was assessed and the practitioner convinces the collection employee that the taxpayer did not get sufficient opportunity to present documentation substantiating the disallowed items during the audit process, according to the Internal Revenue Manual that employee may recommend that an audit reconsideration be granted.⁶⁵ Audit reconsiderations are discretionary. The following three conditions must be present for an audit reconsideration:

1. The taxpayer's address has changed since the original return was filed, and the deficiency notice was not sent to the taxpayer's new address.
2. The taxpayer has not received any notification from the IRS on any assessment or as to how the assessment was determined before receipt of the bill.
3. The taxpayer has not had an opportunity to submit any required substantiation to support his side of the story.

It is up to the practitioner to convince the collection employee that, had the taxpayer been allowed to present the documentation that is now being offered, the result of the audit would have been different.

H. Service Center Inquiries and Math Correction Notices

A taxpayer contacted by the IRS service center under a limited-contact program not involving the examination of records will not subject the

IRS to the prohibition of a “second inspection.” The most important of these programs are math correction notices and the Information Returns Program.

Practice Tip

Note that the way to circumvent the “math correction” rule is to require the IRS to issue a deficiency notice, petition the Tax Court, then agree to the deficiency. The case will thereafter be closed under the doctrine of *res judicata*.

VIII. Conclusions and Recommendations

A. *Preparation*

Be thoroughly prepared. Nothing wins cases like being better prepared than the revenue agent. During an audit, documentation is king. The representative should ensure that there is enough evidence to support the taxpayer’s position, and all data should be reviewed with the client before the audit.

B. *Cooperation and Attitude*

Always cooperate fully and do not be the cause of any delay. On the other hand, do not do the agent’s work for him or her or furnish information not required by law. Remember, you are working for the client, not the government. Nevertheless, a representative should not do or say anything that will cause a revenue agent to become irritated. Should the revenue agent develop an “attitude” toward you or your client, he or she can and usually will make life miserable for you.

C. *Procedural Rules*

In dealing with revenue agents, it is far more important to know procedural rules than substantive tax law. You can always look up the tax law, but you may have to make a snap decision on procedural issues that will significantly affect the result of the audit.

D. *Intimidation*

Many times agents try to win by intimidation. So do not be afraid to challenge their authority. Remember that, as a rule, you are more intelligent and more experienced than the revenue agent. In practice, agents routinely go beyond the announced scope of the audit. Their most common transgression is asking for information about tax years other than the one under examination. The representative should not permit this to happen. If the agent wants to look at records pertaining to other years, then he or she needs to officially open those years for audit.

E. Volunteering Information

Do not volunteer information that is not asked for, no matter how innocuous it may seem. Do not give revenue personnel one scrap of information that you do not have to. Also, do not tip your hand as to what you intend to do procedurally or substantively.

F. Early Commitment

A representative should get the agent committed to a position in writing as early as possible during the examination process. You can always disagree, but the agent will not likely come back with higher deficiency numbers. Lock the agent into a position before you commit to an agreement.

G. Time Is Always on the Side of the Taxpayer

If, during the pendency of an audit, the agent (for whatever reason) is not actively pursuing the case, this is not necessarily a bad sign. He or she may be preoccupied with other matters or in training classes, for example. The representative should let as much time pass as possible so that the agent will be ultimately pressured by management to close the case out without incurring any additional time.

Another ploy, if too much time goes by, is to ask for an interest abatement.⁶⁶ This is appropriate where there has been a ministerial or managerial delay that is not the fault of the taxpayer.

H. Personal Living Expenses

Occasionally a revenue agent will ask a taxpayer to fill out Form 4822, Statement of Annual Estimated Personal and Family Expenses. This is part of a recent emphasis on “economic reality” or “financial status” audits. The better part of wisdom, however, is not to fill out this form. Nothing good can come of its completion. And it is not required by law to be filled out. In all “financial status” audits, taxpayers should refuse to answer such questions on the grounds that they are not relevant to any item being examined.

I. Representative-IRS Relationship

Never forget that while your relationship with the IRS agent should be professionally cordial, it is inherently adversarial. Do not be lulled into a false sense of security. Remember whom you represent. You never know what examination has elements of civil or criminal fraud.

IX. Notes

1. Treas. Reg. § 601.105(a).
2. See IRM 4.1.3.2 *et seq.* for an overview of the DIF system and its application.
3. IRM 4.1.3.2.3(1).
4. IRM 4.1.3.2(3).

5. IRM 1.4.40.7.3(3).
6. Treas. Reg. § 301.7605-1(c).
7. 31 C.F.R. pt. 10.
8. Treas. Reg. § 601.503(b)(2).
9. *See* Treas. Reg. § 601.503 for POA requirements generally.
10. Treas. Reg. § 601.503(a).
11. Treas. Reg. § 601.506(d)(2).
12. POAs may cover up to three years beyond the year in which the POA is received by the IRS. Treas. Reg. § 601.506(d)(3)(ii).
13. Treas. Reg. § 601.506(b); IRM 4.10.1.6.1 (5-14-1999).
14. Treas. Reg. § 601.503(a)(5).
15. Treas. Reg. § 601.504(a)(5).
16. Treas. Reg. § 601.504(a)(5),(6).
17. Treas. Reg. § 601.504(c)(4).
18. *Id.*
19. *See* IRM 21.3.7.5.1 (10-1-05) regarding the assignment of CAF numbers to representatives.
20. Treas. Reg. § 601.506(d)(2).
21. Treas. Reg. § 601.105(b)(2)(i).
22. A CP-2501 may precede the CP-2000. The CP-2501 does not calculate a proposed tax change; it is merely an inquiry that requires a response. A CP-2000, on the other hand, calculates a proposed tax deficiency, statutory interest, and any applicable penalties. This is part of the IRS automated underreporter program (AUP), a discussion of which can be found in IRM 4.19.2.1 (9-1-03).
23. All references here to the I.R.C. or to section numbers refer to Title 26 U.S.C., the Internal Revenue Code of 1986, as amended, unless specifically otherwise designated.
24. *See* Treas. Reg. § 601.105(b)(2)(ii) for a discussion of office examinations at local IRS offices.
25. *Id.*
26. IRM 4.10.2.4.2.
27. IRM 4.10.2.4.1.2.1.
28. *See* IRM §§ 4.10.2.4, 4.10.4.3.3.1.
29. I.R.C. § 7602(a)(1).
30. Treas. Reg. § 601.105(b)(3) provides that field examinations are to be conducted on the taxpayer's premises. However, for the convenience of all concerned, audits are frequently conducted at the offices of the representative. *See also* Treas. Reg. § 301.7605-1(e) regarding requests by taxpayers to change the place of examination.
31. Treas. Reg. § 601.105(k).
32. Indeed, the statute provides that a revenue agent may not require the taxpayer to attend such an interview in the absence of a summons where the representative holds a valid power of attorney. *See* I.R.C. § 7521(c).
33. I.R.C. § 7602(a)(2).
34. I.R.C. § 7521(a); Notice 89-51, 1989-1 CB 691.
35. Treas. Reg. § 601.105(e)(2).
36. Treas. Reg. § 601.201(k)(2); *United States v. Guy*, 92-2 USTC ¶ 50,581 (6th Cir. 1992); *Williams v. United States*, 92-1 USTC ¶ 50,160 (N.D. Ala. 1992); *First Ala. Bank NA v. United States*, 93-1 USTC ¶ 50,138 (11th Cir. 1993).

37. *United States v. Arthur Young & Co.*, 84-1 USTC ¶ 9305 (S. Ct. 1984).
38. IRM 4.10.20; I.R.S. Ann. 2002-63, 2002-27 I.R.B. 72.
39. *Arthur Young*, 84-1 USTC at ¶ 83,677.
40. IRM 4.10.4.3.3.3; IRM 4.10.4.3.3(1)C.
41. Treas. Reg. § 601.105(b)(5).
42. Rev. Proc. 98-2, 1998-1 I.R.B. 74.
43. *See generally* Treas. Reg. § 601.105(f).
44. I.R.C. § 7602(a)(3); I.R.C. § 7622.
45. IRM 4.10.52.6.1.
46. I.R.C. § 6107(b)(2). Failure to comply with this provision can subject the preparer to a civil penalty under I.R.C. § 6695(d) and to a possible lifetime injunction from preparing returns for clients. *See United States v. Nordbrock*, 90-1 USTC ¶ 50,089 (D. Ariz. 1990), *aff'd*, 94-1 USTC ¶ 50,532 (9th Cir. 1994).
47. IRM 4.10.4.3.2.1(1).
48. IRM 4.25.1.5.1(1).
49. I.R.C. § 6501(c)(4)(A).
50. *See* I.R.C. § 7121.
51. Treas. Reg. § 601.105(b)(4).
52. *Id.*
53. *See* I.R.C. §§ 6212–6213.
54. Treas. Reg. § 601.105(c)(1).
55. Treas. Reg. § 601.105(d); IRM 4.71.4.4.7 (1-1-06).
56. I.R.S. Publ'n No. 5 (revised Jan. 1999).
57. IRM 8.6.1.6(1).
58. IRS Restructuring and Reform Act of 1998, Act § 1001(a)(4).
59. I.R.C. § 7605(b); IRS procedures for reopening cases are contained in Rev. Proc. 85-13, 85-1 CB 514.
60. Treas. Reg. § 601.105(j).
61. Rev. Proc. 85-13.
62. *Harrington v. Comm'r*, 48 T.C. 939, at 953 (1967).
63. *Williams v. United States*, 80-1 USTC ¶ 9740 (W.D. Tex. 1980).
64. I.R.C. § 7121.
65. *See generally* IRM 4.13.1.
66. I.R.C. § 6404(e).