Surviving an IRS Audit

Guide 4 of 7 Tax Guides

Robert G. Nath, Tax Attorney
Concentrating in IRS and State Tax Controversy Matters

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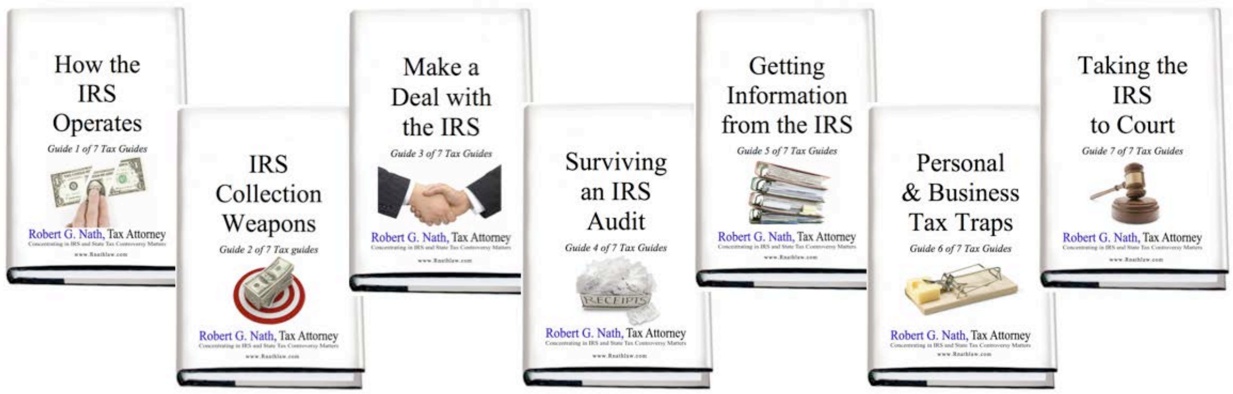

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4 of 7 Tax Guides

Written by

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One of the most unnerving letters you can receive is the envelope with the return address "Internal Revenue Service." Then you open the letter-carefully, slowly, like a letter-bomb. It begins innocently enough, "Dear Taxpayer." Then it hits: you have lost the audit lottery. You are one of the lucky nearly 1 percent of individuals or 5 percent of businesses whose tax returns will now be examined. (Despite these low percentages, they amount to more than one million audits per year.)

In calendar year 2012, over 189 million tax returns were filed, including 145 million income tax returns. Of all returns, the IRS audited 1.5 million, or 6/10 of one percent. The mathematical chances of an audit were 1 percent if you made under $25,000, 2.3% if income was between $25,000-$50,000. On the other hand, if you made more than $1,000,000, you had a 10.8% chance of an audit.

How do people react? There is a range, from, "Oh my gosh-get my toothbrush, kiss the kids, I am going to jail," to, "Oh no, not again," to, "Those so and sos-into the trash you go." Probably the more useful reaction would be, "What's this all about? What type of audit is this?" WHY ME? Why are you the lucky one? In most cases, it goes back to the return you filed.

"Hey, What's Your DIF?

The IRS has a scoring system known as DIF – Discriminant Function System. Your tax return is scored and earns "points" according to DIF criteria when you send it in. The details of the DIF scoring system are nearly as secret as our nuclear strike command codes or an aging star's birth date. Few people know all the items on the scorecard, or how many points a return earns for each. But educated guesses abound; after all, the score sheet is intended to make the IRS money.

Tip: As the IRS put it in a recent fact sheet, "It [DIF] rates the potential for change, based on past IRS experience with similar returns. 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."

So, the scoring system likely assigns points for your occupation, the types of income you earn (whether wages or independent contractor income), and your deductions in type and amount. Your tax return may earn DIF points for your being a doctor, for gross income of $50,000 or $100,000, or $1,000,000, for being in a business that deals in cash. Even common types of deductions such as mortgage interest or real estate taxes can yield a high score if the amounts you deduct are high. Your return probably also scores high if you've been a good customer in the past, that is, if the IRS has made money from past audits. (Everyone likes repeat business.) Higher income individuals such as doctors, lawyers, and other professionals probably merit bonus points. Unusual occupations are on the list, also occupations that deal in cash: jewelers, car dealers, boatyards, and junkyards. Any income tax loss that you claim on a return may increase your DIF score.

> Fun Fact: The IRS has estimated that an astounding 70% of Schedule C filers (people who own their own business without incorporating) make "errors" on their returns.

Remember also that the IRS is out to make money, so almost any type of tax loss is likely to earn DIF points: casualty losses, business losses, losses on sales of non-publicly traded stock. Also, it stands to reason that the most commonly used and abused deductions will stand out from the crowd: home office deduction, noncash charitable deductions, travel and entertainment expenses.

Tip: Under the 1998 tax reform act, the IRS must include in Publication 1 (Your Rights as a Taxpayer) a general statement, in simple and nontechnical terms, of its criteria and the procedures it uses to select returns for audit. This does not mean you'll get any inside information, nor any statistics nor data that will help you in your audit, or to avoid an audit. You should look to this for only a general statement of its audit criteria, and no more.

If your return scores "high" enough, the computer selects it for a closer look, and off it goes to an office in your area of the country. But DIF doesn't exclude Joe Sixpack from its clutches. A certain number of low or moderate income, plain vanilla returns also are examined, just so people don't get too complacent.

Agents then use a "classification handbook" to classify DIF-selected returns for a closer look. The returns that are selected are then screened according to the importance of the DIF score and the items in question on the return. The IRS will look to the size of the item, its character, and any evidence that you were trying to confuse or mislead the Service in how you reported the item. It will check whether you put it on a schedule that would lead to lesser tax (for instance, Schedule C versus an itemized deduction) and the relationship between the questioned item and others on the return. This is a judgment call, depending on the experience of the reviewer.

The IRS also has a research arm, the Compliance Research Information System (CRIS).

That covers the great majority of audits. Others get started for a variety of reasons. Maybe you suffered through one audit and the revenue agent thinks the same issues will recur in other tax years. Maybe someone who holds a big-time grudge has told the IRS about hidden assets or hidden income. (Informers can earn rewards of up to 10 percent of the amount the IRS collects.) Maybe your corporation has been examined, and as a result the IRS now wants to look at your related personal return. The IRS also information-matches the 2 billion+ forms it gets every year, such as Forms W-2 and 1099. Or, your local Area Director may initiate a compliance project. Lucky you, if you get snared in this one.

Whatever the source, whatever the reason, once you get that notice, you're stuck with an audit until it is finished.

Not all Audits are Created Equal

The IRS conducts three main types of audits: the correspondence audit, the office audit, and the field audit.

> Fun Fact: For many years, the IRS inflicted a special, research-purpose audit on about 50,000 to 150,000 taxpayers, called the Taxpayer Compliance Measurement Program. One was scheduled for 1996 until people got so upset that Congress stepped in to call a halt.

The Correspondence Audit. This type of audit is simple, straightforward, and usually painless. Like an injection. With a big needle. In a sensitive part of your anatomy. The IRS finds an apparent error in your return and writes you a letter. In most cases, there is nothing to fear from a correspondence audit. Did you put down the wrong number from your W-2? Forget income from Form 1099 (for nonwage income such as interest and dividends)? Claim children you don't have as dependents? The correspondence audit clears this up. Did you take a clearly unallowable deduction? File using the wrong filing status? Make a mistake on your IRA contribution? Claim a questionable refund? Relatively simple questions like these are easily handled by mail. The IRS writes you, notes the issue, and asks for a response. Or, if it's a clear error, IRS just makes the adjustment and sends you notice. Example: arithmetic errors, or claims for payments you made but IRS did not receive.

Heed its deadline or get an extension. If you don't, the tax machine will grind on, sending you a follow-up request, then a "thirty-day letter," and finally a Notice of Deficiency. If you fail to respond to the Notice of Deficiency, the IRS will assess the error as it sees it. You then have a legal bill you usually cannot fight except by paying it first and going to court.

Even a lowly correspondence audit can hide nasty traps. For example, the IRS watches out for alimony compliance, child support refunds that should be paid to another spouse, erroneous refunds, tax credits, and a host of other errors that its computers can detect electronically. Some of these can balloon into big fights, between you and the IRS or between ex-spouses. So the rule is, pay attention and respond to these correspondences audits. Since these audits are conducted almost entirely by mail, you won't see an IRS representative. But you may speak to one by telephone in a few cases. That's not the usual rule, but sometimes a phone call helps to clear up the issues. Do not hesitate to call the IRS, even in a correspondence audit, if that phone call will solve the problem.

<u>Office Audit and Field Audit</u>. Now let's escalate. Your return has a bigger error. It contains an issue the computers can't handle. You have unreported income, or you simply scored too high in the IRS' audit lottery. Then your return is selected. Someone in the service center where you filed it physically mails that return (along with the returns of many other lucky taxpayers) and the usual cover sheets to the local IRS district office that will handle your case.

Then the fun begins. An officer in that district office has to decide which returns to examine, and whether you get "office audit" treatment or the royal attention of a revenue agent (field audit). The local office can't audit every return it receives, or even those it selects for a closer look. Many are therefore "closed on survey." Someone looked at the return and decided it lacked sufficient dollar or issue appeal to bother with. As to the rest, well, they have won/lost the audit lottery.

An examiner assigns some returns for <u>office audit</u>. This is an audit conducted in the IRS' office. It is usually reserved for issues the selecting officer deems complicated or significant enough to look at, but not so heavy-duty as to merit a full field audit. It's a judgment call. Usually a Tax Auditor conducts an office audit. She sends you a letter asking for or making an appointment, noting the questionable items and requesting certain records. You gather the records, bring them into the office, and discuss the issues. Office audits have their own perils.

On the income side, tax auditors are trained to spot unreported income by performing indirect checks on the amount of income you reported on your return. They love to dive into cash businesses, and they salivate at the mere mention of "gross receipts." They will ask you many questions: "How did you get your gross receipts number? Have you checked it against other records? Does it square with your checking accounts, personal and business?" They ask you where you got your money - from gifts, loans, or inheritance? They ask about your lifestyle. They check your personal return against your main assets and liabilities. If you lifestyle is Jaguar but your income is Volkswagen, be prepared to explain. Tax auditors also question unusual or very large deductions. Since many taxpayers are poor record keepers, auditors have a turkey shoot with many business and personal deductions. In fact, the poorest record keepers are usually people who say or think, "I can keep sloppy records. The IRS can never prove my figures are wrong." That taxpayer is in for a nasty surprise when he finds that the burden of proof is on him, not the IRS.

> <u>Helpful Hint</u>: The well-known "reversal of the burden of proof" in the 1998 tax reform act is more illusion than reality. It started out strong but was watered down in Congress. Now, under the version that became law, you will have to carry your burden of proof in order to get a reversal, and that was the law anyway even before the reform act.

So if you have very sloppy records, the IRS will often disallow your deductions for "lack of substantiation," then penalize you for negligence because you kept sloppy records. People who run cash businesses are especially at risk in this type of audit.

The field audit is the final type of common audit the IRS conducts. This is a full-blown examination of any and all items on a taxpayer's business and/or personal return. The revenue agents who conduct these audits are often certified public accountants. Even when they're not, they've had years of training inside or outside the IRS. Revenue agents focus on many of the same issues that an office audit might address, but they are more thorough. Also, the dollar amounts at stake and the complexity of the issues are usually higher both on the income and the deduction side. Examples might be home office deductions, hobby losses, or complicated business deductions. They might also address capital gains and losses, income from the sale of residences, and pension and retirement issues.

Here is a recent list of fourteen of the most commonly audited and appealed issues, on a nationwide basis:

1. gross income
2. trade or business deductions
3. deductions for losses
4. bad debts
5. depreciation
6. net operating losses
7. capital expenditures
8. taxability of a corporation on distribution (of assets)
9. taxable year of inclusion (that is, in what year is an item of income properly taxed?)
10. taxable year of deductions
11. last-in, first-out inventories
12. allocation of income and deductions among taxpayers
13. taxes of foreign countries and U.S. possessions
14. definition of gross estate

"Getting to Know You" – IRS Style

The revenue agent normally selects the site of the audit. Unless the choice is unreasonable in time or place, his choice prevails. Still, if the presence of a revenue agent would harm your business, the agent normally makes alternative arrangements, such as an isolated room or an off-site location. Quite often, the taxpayer's accountant is the buffer between the taxpayer and the auditor. The accountant can usually work out an acceptable time and place of examination.

How the Revenue Agent Works

Revenue agents work out of groups of six to eight, usually one or two groups in each local office. Their boss is a “group manager.” The group manager's boss is a branch chief. If you don't like the agent you get, you can't request another. But if you have a communication problem or personality conflict, don't hesitate to call the group manager. You have the right to fair and courteous treatment, and if you are not getting it, like a true American you should complain. In fact, the IRS now includes training in taxpayers' rights as part of its routine.

According to a recent "Fact Sheet," 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 yourself or an authorized representative
- A right to appeal disagreements, both within the IRS and before the courts

The revenue agent works steadily and methodically. She often prepares a list of documents to examine, using an IRS form called an Information Document Request. IDRs can go on for two to three pages (in simple audits) and can ask for five, ten or more items. Agents often freely discuss the issues they are focusing on if you ask them. You can tell a lot about what the agent is thinking just by looking at the documents she wants.

Having the records available and in good shape is a good idea. Taxpayers who keep sloppy records usually wind up paying more in taxes. But records carry their own perils. You, the taxpayer, know where the bodies are buried: the unreported income, the erroneous deductions. The agent does not (at least, not yet). So the agent's questions may range widely. Many taxpayers then panic because their returns contain ordinary, garden-variety mistakes. Still, there is no reason to be afraid unless you have truly evaded your taxes and the agent's documentary net threatens to expose your crime. If you have something to hide, discuss that issue with a tax professional before responding to the IDR. The revenue agent also has specialists available. Examples might be art appraisers and industry specialists. She can request help in any specialized area where she does not feel completely comfortable.

Can the Agent Really Get All Those Records?

Current law says yes. The agent's authority to examine is almost unlimited. A rule of thumb is that the agent is authorized to request any record that ***is or may be relevant*** to the examination. That agent has the authority to assure himself that the law has not been violated, as well as to find out where it has.

Revenue agents wield other powers, too. They can (and often do) expand the audit to other years, both before and after the year at issue. Revenue agents can examine any "related" returns, such as partnership returns and corporation returns where your individual income tax return is under examination. Those inquiries can open more issues for the corporation, partnership, shareholders, and partners. The agent can refer a case to the Criminal Investigation Division if she suspects fraud. She can propose increases in your taxes and thereby thrust the burden on you to prove her wrong. She can also propose penalties, as to which you again have the burden of proof in most cases. Although these seem like very powerful tools, each is fully authorized by law.

What – More Audits?

One special type of audit (now banned, but other versions exist) is called the Taxpayer Compliance Measurement Program (TCMP) audit. Under the former TCMP Program, about every three years, the IRS selected about 50,000 to 150,000 returns for a line-by-line, item-by-item examination. These TCMP audits were excruciating for taxpayer and auditor alike. In such an audit, you may be asked to verify every item on your return. For example, you may have to bring in birth certificates to verify the existence of children you claim as exemptions. The agent can demand a copy of your marriage license to show "married, filing jointly" status. The agent can require you to show every mortgage payment, receipt for a charitable deduction, or telephone bill for your business. The IRS uses these audits for research purposes to refine the DIF scoring system. These days, the TCMP audits have been shelved because of adverse Congressional reaction. However, don’t count on this attitude lasting forever.

How else can the Service bother you? In many interesting ways that are technically not audits but feel like them anyway. A common example is an employment tax investigation. The IRS may claim that the people you use as “independent contractors” are legally your employees, making you liable for their employment taxes. If your business fails to pay its payroll taxes, you as an officer or director might be liable personally for a portion of these taxes. That tax results from an investigation as well. Or, one of the worst nightmares: concluding you have committed tax fraud, the agent refers your case to the Criminal Investigation Division. That's in part an audit, too, but it is also a high-level criminal investigation extremely different from a normal audit because the special agent wants to throw you in jail.

Tip: Beginning in early 1999, the IRS may not use “financial status” or “economic reality” audits to determine unreported income unless it has a "reasonable indication" that there is a likelihood of such unreported income. This may mean the agent needs an independent source before fishing in this area.

Agents can look at your lifestyle to see whether you live beyond your means. They look at net worth, significant assets, net equity, and business affairs. They search for other assets such as boats and fancy cars. They often perform an analysis called a "cash T" to see whether you are spending more than you are apparently bringing in. Someone who lives well beyond his means can often explain the discrepancy (inheritances, loans, and so on), but in many cases, the lavish or visible lifestyle means the taxpayer has been evading taxes by failing to report all income. So, if your spending habits are too lavish, watch out. High-profile people like this tend to become visible targets.

Here are some of the topics from a recent lifestyle audit list:

Selected IRS "Economic Reality" Questions

1. What real estate do you own and when was it acquired? Monthly rent? Do you manage or do you have a management company?

2. Did you make any improvements to any of your real estate? What was done, how much was it, and how was it paid for?

3. How many autos do you own? What are they? What is the payment?

4. Do you own any large assets (over $10,000) besides auto and real estate? What is it, where is it kept? Is it paid for? If not, what is the payment?

5. Did you sell any assets? If so, what, to whom, and how much?

6. Do you ever take cash advances from credit cards or lines of credit? How much and how often?

7. What cash did you have on hand in the audited year, personally or for business, not in a bank-at your home, in a safe deposit box, hidden somewhere?

8. What is the largest amount of cash you had at any one time in the audited year?

9. Did you deposit all paychecks into the bank? What account?

10. Do you have a safe deposit box? Where? What is in it?

11. Were you involved in any cash transactions of $10,000 or more?

12. Employee business expenses: What meals are being deducted? Provide appointment calendar receipts, business purpose, and business relationship for all expenses.

And these questions are just the start. The agents have wide discretion, so far uncurbed by courts, to ask questions about your lifestyle. You must respond unless you invoke the privilege against self-incrimination, the attorney-client privilege, physician-patient, spousal, or some other applicable evidentiary privilege.

Requesting Audit Reconsideration

What if you simply can't get your act together during the audit and the IRS machine grinds out an assessment? You may request "audit reconsideration." Audit reconsideration is like stopping a train after it has left the station because you just found your ticket. It's a great way to have your case reconsidered, even when you've been given a prior opportunity.

You are entitled to audit reconsideration in many cases, but not all. For instance, you can ask the examination division to reconsider your case if you have new information suggesting the IRS' assessment is excessive. Reconsideration may be available if the IRS made a computational error, you didn't get notice of the proposed adjustment in time, or you simply didn't have enough time to substantiate your position. Ask for reconsideration if you didn't receive the IRS' audit report or the follow-up statutory Notice of Deficiency. Finally, if you have one or more unfiled returns, you can almost automatically get audit reconsideration by filing true original returns. The Service has broad discretion to reconsider and abate any assessment that is too high (or increase one that is too low) even after an audit has been closed.

The mechanics of your request are simple. Address a letter to the regional service center, the Collection Division, or even the Office of the Taxpayer Advocate. State that you are requesting “audit reconsideration.” An amended return with a cover letter will do. In your letter or amended return, note the issues you are questioning and the grounds for abatement or adjustment. Attach a copy of the affected tax return and the IRS' audit report if it is available. Also enclose all documentation you can find to support your position.

The IRS has a long list of required information, depending upon what issue you select. For example, if you ask for an additional exemption for a dependent, the Service wants to see items such as school, medical, or other records to determine residence, a record of income, or a copy of the birth certificate. The IRS publishes "substantiation requirements" for many other items, such as retirement accounts, alimony payments, medical and dental expenses, auto expenses, and entertainment. Your request is routed to the IRS service center. If it is accepted, the service center sends it to your local IRS office, where your friendly revenue agent or tax auditor reopens your case. Then, you're back in the IRS audit loop.

What's on the Horizon

The IRS is always looking for new and different ways to audit the American public. Over the past few years, it has invented something called the Market Segment Specialization Program (MSSP), a fancy name for audits of entire industries at a time.

These MSSP guidelines are available on the IRS’ website, www.irs.gov. The MSSP guidelines are guided tours of what the agent will be looking for, so they are extremely valuable if they apply to your industry or business. They are good checklists, because they will tell you where you may have erred or where to be careful in your record keeping. In that sense, they are often guides to better business practices.

So far, the Service has identified more than ninety industries or issues for this special audit status. These include law firms, accounting practices, bed-and-breakfasts, the construction industry, and many others. Then, the agency devises an entire audit strategy that applies to every audit it conducts in each of these groups.

The IRS also publishes Audit Technique Guides which assist the IRS agent in examining your business.

What Can the Agent do to You?

When the agent finishes his audit, what happens? Actually, nothing. Strictly speaking, the agent can only recommend some action, really a choice of four possibilities:

1. No change. The agent found no errors, or only minor ones not worth pursuing. He writes a No Change Report, and sends you a letter advising you that the examination resulted in no change to your return.

2. Agreed case. The agent found errors and proposed more taxes (or a refund), possibly penalties. (Interest is added automatically by law.) You agree with all the changes or choose not fight them. The agent writes a Revenue Agent's Report and asks you to sign it. In this report you agree to the immediate assessment of the taxes. If you agree and sign, you soon get a bill from the IRS for the extra taxes, penalties, and interest.

3. Unagreed case. You and the agent could not resolve any of the issues. He reports the entire audit as "unagreed." He sends this Revenue Agent's Report to you or your tax representative. It has a cover sheet, a summary page reciting exactly what items the agent is increasing or decreasing, and by how much. The report explains each item. The summary sheet sets out how much tax the agent proposes. Normally it contains a calculation of penalties and interest.

4. Partially agreed case. You agree with the agent on some issues, but not all. This hybrid case is split. The agent prepares a partial agreement form, and writes the remaining issues as "unagreed."

> Helpful Hint: Before the second Taxpayer Bill of Rights (1996), the IRS could abate interest only in the case of a "ministerial error," e.g., the final bill got stuck in a desk drawer for a month or years. Now, you can also request interest abatement for "managerial" errors. For example, let's say the IRS assesses a tax without ever giving notice of the proposed tax liability. That would be a managerial error for which interest might be abated. You can also now go to court to review the IRS' refusal to abate interest.

If all or part of the audit is unagreed, the agent then sends you a "thirty-day letter." This formal letter advises you of the proposed changes and gives you thirty days to agree or disagree. If you don't agree, you may want to appeal. Nothing in the law grants you the right to an appeal within the IRS, but the agency found a long time ago that internal appeals often settle cases. In fact, it has an entire branch devoted to these appeals, the Office of Appeals.

People often ask whether the agent has the authority to settle an issue that is in conflict over the facts or law. Usually, he does not. His job is to call an issue one way or another, not to settle an issue based on litigating hazards. Appeals officers have this authority. If you write the IRS within the 30-day deadline that you want to appeal, the agency will not assess the tax. Instead, it sends the case to the Office of Appeals. See below, this Guide, on how appeals should be handled.

If you do nothing? Remember one of the rules of IRS survival: Doing nothing usually (not always) hurts you. In this case, the IRS sends you a formal letter called a Notice of Deficiency. Unlike the thirty-day letter, this Notice of Deficiency is required by law before the IRS can assess a tax. The notice is a formal proposal that you owe more taxes. It gives you ninety days (not three months) to file suit in the United States Tax Court to contest the notice, if you decide to do so. See Guide: Taking the IRS to Court. Filing suit in the tax court stops the IRS from assessing the tax it had proposed, at least until the case is resolved. But if you miss the ninety-day deadline by a day, an hour, or a minute, the IRS makes the assessment against you several weeks later and sends a bill.

At that point, there is little you can do but pay the bill (or possibly seek an "offer in compromise.") If the bill is wrong but you simply missed the deadline, you can still file a claim for refund or possibly request audit reconsideration. The court case, an agreed assessment, or an unagreed assessment ends the audit process that started when your return was "selected for examination."

Your State Tax Bill is Not Far Behind

These days, the states need ever more money to run their programs. They also need stronger enforcement mechanisms to ensure they reap the fields of green within their borders. Everyone who owes a federal tax should consider whether he will end up owing a state tax as well. States are no longer paper tigers when it comes to tax enforcement. They also gain strength every day. The general rule is for IRS to share your audit information with the state where you file your state return. Most if not all states (and DC) have a rule that keeps the statute of limitations open for more state taxes if you have an increase in your federal tax bill.

You Can't Keep Secrets

State-federal cooperation has been a feature of our federal system since the first days of the republic. The states and federal government continue to cooperate very closely when it comes to taxes. One area they share is information, lots of it. The IRS and many (in some areas, all) state governments have signed a series of protocols, called Information Sharing Agreements, of which the public is largely unaware. The first type of sharing agreement is for tax information. The exchange goes both ways. The IRS tells states what you earn. States tell the IRS what you have reported to them. They also share refund information, and, of course, states are required to send you an IRS Form 1099 when you get a state tax refund.

The states and the IRS also share employment and sales tax information. The reporting cycle is every eighteen months to three years. For example, the federal government wants to know how much your business is reporting to the state for sales tax purposes so it can check this against the amount you reported on your federal return. Cheating usually shows up when you report more gross sales on your state sales tax returns than gross income on your federal income tax return.

The states and the IRS also share employment information. They exchange data on your employees, so you can't tell the state you have "employees" and call them "independent contractors" for federal tax withholding purposes. The IRS shares the results of income tax audits with your state's department of taxation. State laws require that you amend your state income tax return if you owe more after a federal audit. The same laws also suspend the statute of limitations on assessment if you owe more state taxes as a result of a federal audit. So, even though more than three years have passed, the state can still assess more state tax as a result of your federal audit.

Often, the states have computer programs to generate a bill to you whether or not you file an amended state tax return after your federal audit. Some states also cooperate with the IRS to investigate or audit you. For instance, suppose a state investigates your business to see whether your workers are employees or independent contractors. The choice makes a big difference in your state unemployment tax. It makes an even bigger difference to the withholding and Social Security taxes you must pay to the IRS. The state can share the results of this investigation with the IRS. As electronic filing and computerization of federal and state tax records become more common, we'll be seeing much more of joint audits and joint collection.

Nonfilers need to be hyper-alert to these features of state-federal cooperation. The nonfiler who owes taxes to the federal government almost always owes state taxes as well. The state taxes may be only 1 percent to 10 percent of the federal total, but they are still important. So the nonfiler should file state tax returns when he files delinquent federal tax returns.

All states with tax laws – and that's ALL states (even those like Florida with no *income* tax) – have vigorous enforcement tools as well. These laws have criminal penalties for violating state tax statutes of all varieties-income, employment, sales, and so on. Moreover, states are enforcing these statutes more diligently and regularly than at any time in the past. Their methods include arresting people for failing to pay taxes, prosecuting for evasion or nonfiling, closing delinquent businesses, and similar strong medicine. The criminal investigation divisions of the states and the IRS also share information after they complete their investigations. States have civil seizure powers comparable to those of the IRS, including levying on wages and seizing bank accounts. Tax refunds are also a prime target. Each year, states millions in tax refunds and send them to the IRS.

Caution: The IRS' Refund Offset Program has been in place for many years to collect things like debts to federal agencies, overdue child support, tax liabilities, and even future IRS taxes. The statute has a priority scheme. Beginning with refunds payable after December 31, 1999, the IRS has enhanced powers to collect these refunds, but the states must also give notice to you of their intent to ask the IRS for your refund.

The states have asked the IRS to return the favor with federal refunds, though so far it has not. Still, the IRS does collect some child support payments from tax refunds. It sends those monies to the states that have signed up for this program. So, if you owe a federal tax, always think through whether you also owe comparable state tax. Make arrangements to pay or compromise that tax as well.

On the happier side, states are working ever more closely with the IRS to make tax life simpler. For example, there is a push toward joint federal-state electronic filing, that is, filing both federal and state returns at one time and in one place. Eventually, this idea will become standard practice.

States also have authority to compromise a tax you owe. The leniency or strictness of these programs runs the gamut from reasonable to impossible, but the authority is there. Call your state tax department for information. Often the states don't publicize their compromise authority out of fear people will flood them with requests and stop trying to pay their current and past-due taxes. Each state is a sovereign when it comes to taxes; you must act accordingly. The key to survival is to anticipate the state tax liability. Check whether it can be reduced or compromised and then address the state tax problem before it surprises you. States also declare "amnesties" from time to time. Inquire about those as well.

Time is (Not) on Your Side – Statutes of Limitation in Tax Matters

Anyone who has ever missed a deadline-and that's most of us-knows you can lose valuable rights you would otherwise have exercised. That principle holds true ten times over in tax matters. Statutes of limitation in tax cases dissolve millions of tax claims each year, on the taxpayer's side and the government's. In most cases, there is nothing you can do about a missed deadline. The law is that hard-and-fast. Here are the most common deadlines and their extenders, and a few hints on how to avoid a statute of limitations problem.

Deadlines When the IRS Comes After You

The most common statutes of limitation the IRS must obey are those dealing with the assessment and collection of taxes.

<u>When you file your return</u>. Filing your federal income tax return triggers the well-known three-year rule. The IRS has three years to assess more taxes, whether by audit or other adjustment on its computer system. But audits often last beyond the three years. Some do not even start until two years into the limitations period. So the IRS often asks for extensions. Give careful thought to each one. The downside of refusing is that the IRS will simply stop its audit and immediately assess the tax or send you a Notice of Deficiency. That action will force you to go to Tax Court to prevent a proposed assessment from becoming a formal bill. The IRS sometimes, but rarely, misses these deadlines. So you are usually better off agreeing to the extension. In most cases, in practical reality, you have no other good choice.

Tip: You have a legal right to refuse an extension, or to limit its reach. Try to limit that extension, possibly to one tax year, or to certain issues the IRS has already examined. Try to avoid giving an open-ended extension. Read the extension language carefully. Ask the agent to explain its fine print.

If you file an amended tax return within sixty days before the three years runs out, the IRS legally gets more time to audit, an additional sixty days after receiving the amended return. For instance, if you file an amended return on the last day within the three-year period, the new deadline would be sixty-one days later.

The basic three-year rule on assessments is subject to many exceptions. Two are mentioned above: (1) you extend by agreement and (2) the IRS issues a formal Notice of Deficiency proposing more taxes. That Notice of Deficiency is not a bill; it is only a formal proposal. Issuing that notice suspends the period of limitations on assessment until ninety days runs or you file a petition within the ninety days and the US Tax Court resolves your case. Some other exceptions to the three-year rule are as follows.

The six-year rule. The IRS has six years to assess a tax if you omitted 25 percent (or more) of gross income from a tax return. This rule protects the Service in these high-dollar cases. It also alerts the Service to be very thorough about other tax years in which you may have omitted income.

The "forever" rule. Some taxes are forever, that is, subject to no statute of limitations. Such is the case with civil tax fraud. Tax fraud consists of filing a false return with intent to evade the tax, or willfully attempting to evade the tax. (Criminal tax fraud must be prosecuted within six years from the date the crime was committed-usually the date the fraudulent return was signed.)

There is also no statute of limitations on assessment where you do not file a return at all.

So Here are the General Rules:

1. Read your audit rights and be familiar with them.
2. Be businesslike and cooperative with the IRS agent.
3. Prepare well for your audit by reviewing your return and the documents requested.
4. Always tell the truth to the auditing agent.
5. Always fight for whatever deductions you believe are legitimate.
6. Consider amending your state tax returns if you pay more to the IRS.

2

Avoiding an Audit

Making Your Return "Audit-proof"... The Importance of Keeping Good Records… Organizing Your Tax Records… Prepare for a Painless Tax Season

Would you like to ensure that the IRS never selects your return for audit? Who wouldn't? There is one surefire way: Don't file one. Not an option for most, but the next best thing is to file one with average gross income (subject to withholding), average deductions or the standard deduction, no partnerships, no fancy shelters, and no tax losses. Even returns like that have some chance of audit, though small.

The tax audit is an over-feared fact of modern life. Mathematically, you have less than one chance in one hundred of being audited, and most audits are routine correspondence audits with the IRS Service Centers. Even in full field audits, all it will cost you is money (tax, possibly penalties, possibly interest). But nonetheless, people fear audits too much.

At the opposite extreme, would you like to ensure that your return is in fact audited? Take big tax losses, operate a business in cash, and keep sloppy records. Don't report income you earn from third-party payers (who report it to the IRS), and take unusual or extremely large deductions. Most returns fall between these two extremes. We don't want to sacrifice a valid deduction, even if it's large or unusual. But we're concerned that taking such a deduction waves the audit flag.

> Helpful Hint: You can get these average deduction statistics from the IRS' website (irs.gov, then search on "IRS Data Book") or even by calling (202) 622-4000, the IRS' Public Affairs Office in Washington, D.C. Even some local offices may have these statistics.

The fact is that no magic formula can make a return audit-proof. And, like it or not, much of our economic life-like paying deductible mortgage interest, earning income, and so on-finds its way to a tax return no matter what the numbers turn out to be. All income and deductions must be reported, and reported truthfully. If those facts mean you have a higher chance of audit, there is usually little you can do. Still, there is some room for maneuver even within these confines.

1. Keep deductions within the averages. Each year, the IRS publishes the average deductions (depending on income) people claim for each major category on Schedule A (Itemized Deductions) of the individual tax return: mortgage interest, charitable contributions, state and local taxes, medical expenses, and miscellaneous deductions. You

probably won't earn many audit selection score points if your deductions are within these averages. True enough, you spend what you spend, and if you are entitled to the deduction, you should take it. Moreover, you risk the charge of filing a false return if you omit a valid deduction for the purpose of evasion. A missed deduction also costs you money. Still, you can legally time some deductions or arrange your affairs to bring yours within the averages.

For example, sometimes you can legally delay payment of a state income tax until January 1 of a new year. Or, if it helps keep your deduction within the average, you may accelerate the payment to the current year. You might decide to prepay some interest on a mortgage, defer paying some interest, pay down principal to obtain a lower rate, or refinance to obtain an adjustable rate mortgage with its lower interest payments in the first year. You may decide to accelerate or delay medical expense payments, or do the same with charitable contributions and miscellaneous expenses. Bear in mind that all of these timing strategies may cost you money; a deduction delayed to a later tax year means you pay more tax this year (though less in a later year). Also note that each of these "timing" strategies must be legal to start with – each on its own merits; if after that they have a desired income tax effect for you as a by-product, that is normally OK.

2. <u>Report all third-party payor income</u>. Report all W-2 wages and Form 1099 income, no matter how small, on page 1 of the return and Schedule B, C, D or other schedules. If your bank sends you a Form 1099 for interest income of $1,000, but you really only earned $500, try to convince the bank to issue a corrected form before you file your return. Similarly, report income from every other third-party payor: your employer, union, state tax department (for an income tax refund), and a host of others. One way to check whether you have actually received all 1099 forms is to go through your bank account at the end of the year. Identify all deposits as wages, dividends, interest, rebates or refunds, insurance reimbursements. Then decide whether each is required to be reported as gross income.

    <u>Helpful hint</u>: Not sure of all those forms? Ask the IRS. Call 1-800-829-1040 to obtain a transcript of all third party payments that have been reported to the IRS for you. Ask for "wage and income" information.

    Caution: Delaying income payments until the following year could cause a big headache. For example, if you receive a big check on December 1 but delay deposit until January 2 of the next year, that could be construed as tax evasion.

3. <u>Use the right forms</u>. The IRS loves forms. It has hundreds from which to choose each year. It devises new ones all the time. Using the wrong form often results in at least a notice inquiry. The notice inquiry asks about your income or deduction item. If you put it on the wrong form, normally you need only put it on the right form or send an explanation, and that is the end of the matter. But sometimes using the wrong form triggers the interest of an agent. For example, farmers use Schedule F to report their income and expenses (deductions). You may get audit selection points if you use this

schedule. If you suffered a loss, perhaps the agent may conclude your farming activity was only a hobby, causing disallowance of the loss. Similarly, Schedule C, for sole proprietors, and Schedule E, for partnership income (among other types), probably attract more attention.

According to IRS statistics, more than 99% of wage income is correctly reported, but with respect to net income earned by unincorporated businesses (such as Schedule C proprietorships), an incredible 70% or more is not correctly reported.

In particular, Schedule C attracts IRS interest. Sole proprietors often deal in cash. If yours is a cash-intensive business such as jewelry dealer, car salesperson, boat dealer, pawnbroker, dry cleaner, or restaurant operator, you probably earn more audit selection points for that occupation alone. Such occupations make it more likely that you or your employees are part of the underground economy, by some estimates a $2 trillion per year shadow economy that escapes federal taxation. So the choice of how to characterize and name your business is important. But the name must be accurate; using a misleading name to avoid audit scrutiny could be a criminal false statement. If you run a pawnshop, you can't call it a bank.

4. Operate a noncash business. Since cash-based businesses are inherently subject to error or abuse, they invariably attract more than the usual IRS attention. Use checks, credit cards, bank deposits, and anything else that generates a true record of your income and expenses. After all, in a tax audit, you, not the IRS, have the burden of proof. Some cash businesses try to have it both ways. They keep meticulous records reporting some of their cash, but other cash slips mysteriously through their fingers and into someone's wallet. The IRS has ways of finding this, including using industry averages, net worth examinations, and undercover techniques in criminal investigations. So reporting less than the average for businesses of your type may well trigger an audit. For example, if dry cleaners usually report gross income of $500,000 per year and yours reports $250,000 in a high volume area, this may be an audit trigger. In any case, it may cause an agent to look more closely if your return is selected for some other reason. The same can happen if you claim too much by way of deductions in a cash business.

5. Use only employees, not independent contractors. For years, the IRS has fought a running battle with many industries over the tax classification of subcontractor workers. Are they employees, making the owner liable for their payroll taxes? Or are they independent contractors, responsible for their own income and self-employment taxes? From an audit selection standpoint, it's probably safer to classify your workers as employees despite the extra burden of withholding, umpteen state-level reports and returns, and filing larger payroll tax returns. This issue might arise if you have a large deduction for "subcontract labor" or a similar category of expense.

Tip: If you feel strongly that your workers are independent contractors and economically it makes sense to do so, since 1998 you have a right to go to the U.S. Tax Court to challenge the IRS' determination that your workers are employees in fact and in law. You can even ask the agent for the determination letter because you wish to go to Tax Court.

Example: The Great Big Construction Company builds residential and commercial buildings. It grosses $4 million per year. It pays wages to employees of $100,000 and $2 million to subcontract laborers. The IRS may have a program to compare these two amounts, or to compare both amounts to industry averages, and thereby spot the issue. Or, if the company is audited for some other reason and the agent looks at business deductions, he can easily spot the big disparity between subcontract labor and regular employees. Still, for competitive reasons, or paperwork-burden reasons, many businesses continue to use subcontract labor.

6. Use a corporation, limited liability entity or partnership, not a proprietorship. Choosing a corporate, limited liability entity, or partnership form of doing business, instead of a proprietorship, may lessen your chances of being selected for audit. Proprietors tend to be more lax in their record keeping and more cash-intensive, or do other things that attract the interest of the IRS. The disadvantage of incorporating or using a partnership is that it doubles your paperwork and reporting requirements, but the net amount of tax should generally be the same. Even if you use a "C" corporation, tax planning can cut down or eliminate the double taxation that form of corporate life normally entails.

7. Watch cosmetics and arithmetic. Common sense steps: file on time, check your income and deductions, check your arithmetic. A clean, neat return is a return that avoids at least one extra pair of eyes.

    Helpful Hint: It is total folly these days for any business to operate without a high-quality computer system and accounting software. This is good business practice anyway, enabling you to keep better tabs on your income and receipts, and it certainly adds credibility to any examination by the IRS or any other agency.

8. Avoid unusual deductions or exclusions from income. Millions of people claim unusual deductions or unusually large deductions. For example, some might try to deduct the cost of a small in-ground swimming pool as a medical necessity (shown by doctors' statements). Such a deduction is extremely unusual and is quite likely to be challenged. An unusually large deduction might be one for mortgage interest of twice or three times the national average. Other examples of unusual deductions the IRS loves to hate are home office deductions, hobby losses, casualty losses, and business operating losses. These are not "unusual," in the sense that millions of people take them every year. But agents tend to see these types of deductions as subject to abuse. They examine them carefully and often. Other times you might receive money during the year that is not reportable gross income. Examples would be loans, gifts, inheritance, or awards from some lawsuits (such as personal injury). In all of these cases, the issue is always whether to claim the deduction or omit the income, and whether to disclose your choice.

Tip: The IRS' most common sanction for a disallowed deduction is to penalize you for negligence or for substantially understating your tax liability. You can try to immunize yourself against these penalties by disclosing the questionable item on Form 8275 attached to your return. You don't have to use this form if your deduction appears on Schedule A or on certain other schedules. The IRS claims that filing Form 8275 does not increase your chances of an audit, but in the real world, it often does.

9. Hire a pro. Using a professional return preparer does not, by itself, reduce your audit selection score, but it can help in a number of ways. First, the professional may spot a troublesome deduction or omission of income that could have triggered an audit. Since the professional also does this for a living, common mistakes on the return are less likely. If for no other reason, a second pair of eyes that are not your own (or Uncle Ted's or Aunt Alice's) can objectively review the tax return for errors and trouble spots. Many businesses use professional return preparers as a matter of routine. They also make frequent use of payroll services to pay payroll taxes and prepare payroll tax returns. Both of these techniques are well-advised. While quality among commercial payroll services varies, the competent ones can be a godsend to a busy executive. Payroll tax compliance, a soft spot in many businesses, are often the first places the IRS looks. Once it looks there, it has a license to look elsewhere. So using a payroll service can often avoid that first inquiry from a curious agent.

10. Keep your evidence. Audits don't always escalate from zero to one hundred in less than thirty seconds. An agent may question only one or two items on a return and be satisfied you have your evidence lined up and ready to go. By contrast, nothing tweaks an agent's curiosity more than evasive answers, sloppy records, or inconsistent and unpersuasive evidence. So, if you are tempted to take an unusual deduction, keep all of your records and evidence together, ready to go in case they're needed. Tax audits are a fact of life and always will be, even if for only a small percentage of taxpayers. So the goal of minimizing your chances of audit should not lead to extreme conservatism on your tax returns. Even the IRS encourages you to take every deduction to which you are entitled. While you don't want the nagging threat of an audit to rule your life, taking care to keep records and prepare your return carefully can minimize the chances of your becoming personally acquainted with an IRS revenue agent.

"They Don't Eat Much"

Record keeping, for business or tax purposes, is almost a world unto itself. People have all kinds of ideas on what records they must keep, and for how long. Surprising as it may seem, with a few narrow exceptions that do not apply to most people, the tax laws impose no legal requirement to keep any specific types of tax records. Of course, you will certainly want to. The IRS encourages accurate record keeping, and good records are essential to know how you're doing financially. But the only "law" is a general one that requires you to keep records the tax regulations require. And, strictly speaking, for most people those regulations require only that you keep records that are "sufficient to establish the amount of gross income, deductions, credits" for your tax returns. Translation: Keep whatever records you need to support your tax return.

At the end of this chapter is a handy guide showing suggested record-retention periods. How long to keep them? Again, federal law specifies general no time period to retain checks, receipts, or other records. The only hint is to keep records "so long as the contents thereof may become material in the administration of any Internal Revenue law." Translation: Keep them as long as you or the IRS may need them. What good would a tax rule be without exceptions? Some specific requirements apply to farmers, certain types of wage earners, corporations that use computerized records extensively, and exempt organizations (mostly charities). Also, if you've been a poor record keeper in the past, the IRS can specify in writing that you have to keep checks, receipts, or other specific types of records.

Even when the tax regulations are more specific, such as the requirement to keep books of account, they are also vague, stating only that the books of account must be kept accurately but in no particular form. Your books just have to be organized well enough to enable an IRS agent to examine them and make sense of them.

This vagueness is understandable. The IRS cannot possibly keep up with even the known types of records that people generate, much less new ones periodically invented. The agency has enough trouble keeping up with its own records. And a regulation that spelled out exactly what records to keep would be self-defeating-so quickly outdated it would be impossible to administer. (Actually, it would be a windfall for taxpayers if the agency tried. You could argue that since the IRS didn't tell you to keep a check for this or a receipt for that, you don't have to.)

And, of course, the burden of proof in tax examinations and most tax cases in court is on you, the taxpayer. So although the regulations don't say you must keep specific records, it is wise to do so.

The Importance of Keeping Good Records

Many businesspeople look on record keeping as a necessary evil, a chore to be avoided or delegated. Thousands adopt the attitude, "I must be making money, just look at my sales" just before their ship sinks. If businesspeople who thumb their noses at record keeping realized how critical good records are, they would treat them with the same importance as White House visitor logs. For example, you can never know accurately whether you are making money, and how much, unless you know your income and expenses – accurately.

> Example: In one case, Marshall, owner of a small business, was in a cash crunch at the end of the year. It seemed impossible; sales had doubled and expenses had certainly not come anywhere near doubling. His internal bookkeeper had recently left, so one Monday he decided to take a look at her work. By Friday, he needed $150,000 to meet payroll, tax payments, and other expenses. The bank balance was $5,000. He looked at the bookkeeper's accounts receivable files. To his horror, the bookkeeper had failed through ignorance or oversight to bill $200,000 of work. Some was never billed, some was marked as "paid" when it was not;

> other files were too confusing to understand. Marshall painstakingly reconstructed every file, called his customers, and saved the day. But it cost him countless hours of agony, some tax penalties, and plenty of interest on undeposited receipts that were overdue.

A second reason to keep good records: it avoids costly penalties and allows you to take normal business discounts vendors often allow for quick payment. You can also avoid late-payment penalties, interest charges, and IRS charges for late payment of payroll taxes. Many other tax penalties also can be avoided. This kind of control is impossible without good record keeping.

Third, in this era of instant-everything, your business must be lean and mean. No one has extra money to throw around at unnecessary expenses. You can't have an accurate picture of expenses-where to cut or where to add-without accurate and timely records. It is no exaggeration to say that for many businesses the difference between profit and loss is the control over expenses and income that comes with good record keeping.

Fourth, lenders are impressed with accurate long-range (over three years) record keeping. It shows a mastery of your business; it implies accuracy; it instills confidence. In fact, institutional lenders such as investment bankers and commercial banks will demand not only *good* records, but also *audited* records. Your CPA cannot start to audit your records unless you give her an accurate set and a system for keeping records that works into the future.

Fifth, good record keeping builds credibility in every area of your business. It shows you are on top of things. Customers and vendors have more confidence in everything else you say about your business.

Sixth, if you want to sell your business, multi-year accurate, financial statements are a must. It's hard to play catch-up after five or six years of neglect. Many buyers want audited financial statements, or at least ones that are "reviewed" by a certified public accountant.

Seventh, think about going public. It's the dream of many businesspeople. You become instantly rich and retire to the beach of your choice. You have no hope of taking a company public without audited financial statements, which means they must be well organized and accurate from the start.

What Records, for How Long?

In the absence of detailed requirements, be guided by common sense and good judgment. Here are some guidelines for the most common types of records that people create and use.

1. <u>In general</u>. A good rule of thumb is to keep any tax-related paper a minimum of four years.

   The IRS is big on electronic storage of records. Its Revenue Procedure, 98-25 (March 16, 1998) is an excellent start on what records to keep, and how to keep them.

These records would include proof of Schedule A items: medical expenses, taxes, interest, contributions, and miscellaneous deductions including unreimbursed employee expenses. For example, if you claimed deductions on your individual return, keep the receipts, canceled checks, check registers, and so on, at least four years. That's because a deduction taken on January 1, 2009, is not reported to the IRS until April 15, 2010 (at the earliest). The IRS then has at least three years to audit the return and assess more taxes. But people who trash their records at 12:01 a.m. on April 16 three years after they file their return take an unwise, needless tax risk.

Many events, some unexpected, can extend the normal three-year period of limitations, and then you are stuck-unable to meet your burden of proof-if the IRS audits your return. What are some of these events? It may sound strange, but, from time to time, strictly by accident, the IRS loses tax returns. The IRS sends a polite letter: "We don't have any record of your return." After picking yourself up off the floor, you write back, "What do you mean? I sent it in!" The IRS responds: "Prove it." Since you didn't send the return by certified mail, return receipt requested, you can't prove you filed it. But… you have a copy! It's even dated, and it bears your signature. "Not enough," says the IRS. "Re-sign and redate the copy, and send it in." So you send in a copy of the return you did file, signed and dated anew. The IRS audits that return and proposes more taxes. So there you are, more than three years after you filed your original return - without records.

Another example: You trash your records at the three-year mark, confident to a moral certainty that the return is totally correct. But you forgot about some income you earned because you never got a Form 1099. That extra income was more than 25 percent of your gross income. The law says if you omit more than 25 percent of your income, the IRS has six years, not three, to audit your return. If the IRS accuses you of civil fraud, there's no statute of limitations on assessment at all! It may assess a new tax "at any time."

2. Your home. Keep records on your home, such as purchase documents and improvement records, until four years after you sell it, or until you die, whichever comes first. Be able to prove what you paid for the home, purchase expenses, improvement costs, and any other adjustments to your cost basis. Under current law, some of the profit on the sale of a residence is excluded from tax. Still, home records are important. Some people can't qualify for full deferral. Some taxpayers sell other real estate such as investment property. Still others go through a divorce and divide the marital properties, including the home. Here it's crucial to keep all records relating to your purchase, as well as records for any additional money you put into the home over time.

3. Stocks, bonds, and other investments. Keep records on these until you sell them, plus four years. When you sell these assets, you report the profit or loss on your next tax return. Profit or loss is the sales price minus the cost, so you need to know the cost of the property, known as "basis." You also need to report when you bought and sold the stock, the expenses of sale, and whether it is a capital asset. Let's say you bought one hundred shares of Consolidated Widgets, Inc., in 1990. You sell them in 2010. You report that sale on April 15, 2011, and pay tax on the profit. If the IRS ever questions what you paid for the stock, you'll need your twenty-year-old records to prove the basis. Then add four years to April 15, 2011, to get to April 15, 2015. That's a total of twenty-five years of

record keeping. Still, records don't eat much, so storing them costs little. If you own investment property such as real estate, keep records of capital improvements (big-ticket items or repairs that can't be deducted right away). These add to your basis, decreasing your profit and therefore your tax when you sell. They also serve as a record of your basis for depreciation.

4. Business records. The technical requirements for keeping records on travel and transportation expenses, entertainment, meals, gifts, and lodging are so extensive that they virtually defy description. Entire forests have been decimated to make the paper on which these requirements are printed. Despite the volume of rules, we're all required to follow them. How long to keep records? Again, the rule of thumb is four years at a minimum because the statute of limitations on business audits is generally three years after the return is filed. This guideline applies whether you report your business profits on an individual return (Schedule C) or whether you are a shareholder in a small corporation and receive dividends from that corporation.

5. Tax returns. Keep your tax returns forever. True enough, their usefulness may diminish after four or more years, but you'd be surprised how many unanticipated needs you will have for old tax returns. And don't count on the IRS to find an old return for you. The agency keeps these returns for only about six years.

   Tip: To get a copy of your return, use Form 4506, Request for Copy or Transcript of Tax Form. There is a charge, but no charge for a copy of Form W-2. If you have not kept your tax returns, it is worth the investment to get copies of all that are available. Then simply keep them in a paper or electronic file marked, "Tax Returns." This goes for all kinds of tax returns, including personal property, gift tax, and estate tax returns. If the IRS does not have your return, ask for a "literal transcript" of your account. That stretches back even more than 6 years, sometimes 10 or 15. It still contains valuable information that may give you the answers you need.

6. Gifts. Keep records of gifts you receive for as long as you hold the gift, plus four years. When you sell the gift, you many need to prove the donor's basis (or cost), as well as the market value and any gift tax the donor paid on it.

Organizing Your Records During the Year

By far the biggest problem tax practitioners face when dealing with the IRS is the failure of clients to act like pack rats. If people would only save paper, they would save millions in taxes and professional fees. Life would be easier for the audited taxpayer, and, believe it or not, the IRS would also be happier, or more inclined to give you a break on your audit or collection problem. A few simple rules will help in most situations.

RULE 1: SAVE PAPER OR THE ELECTRONIC EQUIVALENT

Unfortunately, people throw away valuable documents every day. Receipts, checks, notices, bills, you name it. Billions of dollars of tax-saving evidence winds up in landfills or incinerators, much of it impossible to reconstruct. Even when you can reconstruct it, for example a bank statement from the bank's microfilm or electronic records, it's expensive, time-consuming, and frustrating. Besides, when you ask “the bank,” by the time you ask, it has merged two or three times and now where are your records?

So, why not just keep the records you may need? It's easy, and you need not be the world's most organized person to keep your records in good enough shape so that preparing for tax season or an audit is a breeze. Note that banks keep on-line records of your account for only limited time periods, after which the bank can and often does “purge” the record. Even so, banks get bought and sold all the time; you often will encounter major problems in getting your records from Bank B that just bought Bank A where you had your accounts.

Many people use the "shoebox" approach. They throw everything in a big pile and hope to sort it out at the end of the year. (Some people actually use a shoebox.) Actually, the shoebox approach is a very serviceable method if you don't end up with a room full of them at the end of the year. If you have that many records, you'll have to be more organized during the year. You might try the "modified shoebox" approach. At the beginning of the year, take an envelope or file and mark it "Taxes 2014." Into that folder go all tax-related documents, as you get them during the year. That means you decide as you get a document whether to keep it and put it in the file. Use this test: "Is it possible that I might need this piece of paper at the end of the year for taxes?"

Even better, save your records electronically. Excel, pdf and other data storage formast are your friends.

For example, you'll need your check register; most people keep this with their checkbook or the electronic version. Medical records, real estate tax bills, records of charitable deductions, possibly bank statements, receipts for other deductions-all of these can go into your "modified shoebox." As you write checks during the year, note on the check and the check register what the payment is for and whether it may be deductible. The personal accounting software uses “categories” and often even has a “tax related” checkbox. Use some type of memory aide, like an asterisk, a check mark, or "deduct" to remind you at the end of the year that the checks for doctor visits or the contribution to the church are deductible. Do the same even with the more obvious ones like mortgage, real estate taxes, state income taxes, and unreimbursed business expenses. When you pay bills electronically, use the “notes” section of the payment screen.

That's really all most of us need to do. For most people, records won't be so voluminous or complex during the year that you will need to organize them any better than this. Then, at tax time, it's only a short step to separate your expenses to prepare your return.

RULE 2: BUSINESS AND PERSONAL – NEVER THE TWAIN SHALL MEET

Sole proprietors (unincorporated business) report their business income and expenses on Schedule C of their individual Form 1040. For proprietors, an absolute, hard-and-fast rule is never to mix business and personal expenses. Use two checking accounts: one business, one personal. Many people will object, "But it's not required that I keep separate accounts." True, but you are 100% better off if you do. When you need personal money during the year, write a check from the business account to the personal account. Cumbersome? Somewhat, but well worth the pain and suffering if the IRS ever questions your Schedule C deductions. Also, it saves monumental time and effort when tax return preparation time comes around.

You'll be certain all your business expenses are in fact business-related and deductible on Schedule C. Of course, keep all business records for at least the four years, as discussed above. For corporations and partnerships, the "separation" rule is usually less of a problem because these entities have a separate legal existence, and therefore are required to maintain separate bank accounts and records.

RULE 3: THE COMPUTER IS YOUR FRIEND

Nowadays, excellent software is available for people who computerize their personal and business lives. There are programs for calendars, scheduling, tax return preparation, organizing records, filing, you name it. These programs can be a good discipline tool. Any good one will feature "one entry" to generate a cash receipts and disbursements journal, general ledger, balance sheet, income statement, bank reconciliation, or other financial report. Probably the best advice is to keep your business and personal finances on computer, not on paper done by hand. And back up your data onto a disk, or online facility. Also, remember the computer adage, "Garbage in, garbage out." The data you enter should be complete and accurate for the computer to do any good. A printout that looks pretty is not necessarily accurate. Some people sit at a computer every day to log in their business or personal expenses, receipts, and checks. Others do it on a weekly or monthly basis. But if you have the discipline, by all means go ahead and use that computer. At the end of the year, a push of the button generates your financial history and tax life.

Preparing for Tax Season

Now the year is over; it's January 2. You've recovered from New Year's parties (and you'll deduct the allowable expenses). The faster you file your return, the faster you'll get that tax refund. Let's explore some easy steps on what to do if you don't use a computer. These guidelines apply whether you use a paid return preparer or prepare the return yourself.

What to do with the inch-thick pile of records you've been keeping all the past year? A good rule is: Use the "envelope" method. Start out with about twenty empty envelopes for your personal return and your business return (Schedule C). Using last year's return as a guide, mark the backs of these envelopes with your tax categories, taken from the lines and categories you will use on the return itself. For example, one envelope could be marked "W-2 Income." Another could be marked "Form 1099 Income." On the deduction side, mark envelopes such as "Medical," "Taxes," "Contributions," and so forth. Make sure no paper is an orphan.

What about your checks and check registers? Separate these expenses for tax purposes by any method that works for you and is traceable. One method is to go through the check register and make a list of the check amounts for all deductible expenses. Then separate the items on that list into their respective "envelopes." Tally them, then transfer the totals to your return. If you use a home computer, the software available today will quickly separate all of your deductible expenses by "category." Tax return software practically does everything. All you do is enter the number and select an expense category.

The final rule is: Start early. January 2 if you can. You'll have most of your tax records available even then because you've been filing them in the "modified shoebox" all year. You'll have to wait for your W-2, Form 1099, or Schedule K-1, but at least your other records will be in good shape and available. A tax-related record-keeping guide can be another big help. Many excellent guides are available in bookstores and office supply stores, or are included in software programs. Some focus on personal records, others on financial records, yet others on tax records. Tax record guides will likely be more comprehensive than you need; they try to cover everyone's case. Don't be deterred. Instead, select the categories or organizational aids from those books that apply to you. You'll find that the same categories recur, year after year. A word of hope: Keeping and organizing your tax records for a painless tax day is not heavy lifting. Once you get the hang of it, it's easy, though rarely fun. You'll find yourself designing variations of a record-keeping program, personal hints that make record keeping and reporting easy for you. Customizing is the key. And once your methods are in place, they'll keep you tax-comfortable year after year.

This chart suggests how long you might wish to retain tax-relevant records. There is no hard-and-fast rule. Opinions differ among practitioners, but you will generally find broad agreement on the following items.

7. Keep these records forever: tax returns, federal and state, all home purchase and improvement records, records of gifts (cash or noncash) by and to you, deeds, birth certificates, financial statements and business accounting records such as general journals, general ledgers, balance sheets, and cash receipts and disbursement journals

8. Keep for seven years: canceled checks, deductible expense records, receipts, contracts of employment and other contracts, other tax-related records such as forms 1099 and W-2 and credit card statements

9. Retain until sold, plus four years: stock certificates, brokerage statements reflecting sales of securities, purchase and sale documents for any other large asset, such as a car or home.

10. Keep for four years: all other tax-related documents

Summary of Tips

1. Pay attention to detail. Try to make your return as accurate as possible, the first time.
2. Never fail to take a deduction to which you are entitled.
3. Consider hiring a professional to prepare your return, or to check it after you prepare it.
4. Pay laser beam attention to keeping accurate records.
5. Use a computer wherever possible to organize your records and prepare your tax returns.

3

Appealing a Bad Audit Result

Don't Play Dead if You "Lose" an Audit…
Preparing Your Appeals Protest…The Appeals Conference…
The Brave New World of the "Innocent" and "Injured" Spouse

Tax audits and other tax investigations can often be frustrating or futile. By training, IRS agents see many issues in black-and-white terms. Either you prove your deduction, or you do not. It's therefore reassuring to know there is an appeal you can file without having to go to court. This is the function of the Office of Appeals. Founded in 1925, this office exists for the sole purpose of settling your tax case, if possible. Its mission is to craft the right settlement based on "litigating hazard," that is, the chance the IRS might lose if the case went to court and an actual trial were held. Appeals Officers have the authority to concede issues, to sustain the case agent's findings, or to split issues. Only in rare cases involving issues of widespread impact and importance will the Appeals Officer lack discretion to seek a settlement. This chapter guides you on this very important function of the Internal Revenue Service, a function that is becoming more encompassing every year.

In fiscal 2013, the Office of Appeals received 123,000 cases and closed 131,000. At that time, it had 59,000 pending.

Where the Cases Come From

Each IRS district has one Office of Appeals staffed by a group of Appeals Officers. Sometimes there are satellite or branch offices. Six main types of cases filter up to the Office of Appeals.

First is the income tax audit. If you and the revenue agent (or tax auditor) can't agree on every issue in your case, the agent writes a report on the unagreed issues and sends it to you. That report is known as a "thirty-day letter." You have thirty days to agree, disagree, or do nothing. If you agree, you sign it, date it, and send it back. Doing nothing allows the IRS to conclude the agent was correct and bill you accordingly. If you disagree, you appeal to the Office of Appeals simply by filing a "Protest." Appeal rights apply to any item the revenue agent adjusts, whether tax or penalty (in rare cases, interest).

> Helpful Hint: Interest can be contested in some cases, such as a long, drawn out audit where the IRS, not you, caused the long delay. Some interest stops by law after a certain audit or appeal period. The IRS also has limited discretion to abate

some interest where the IRS is at fault because it made a "ministerial" or "managerial" error. If you lose on this issue, you can appeal the loss to the U.S. Tax Court. However, in the real world such appeals are rare and taxpayer wins even rarer.

File the Protest within the thirty days or any extension you obtain before the thirty days run out. Ask for this extension from the IRS office that issued the thirty-day letter, usually the revenue agent's office. Once you file the Protest, the audit machinery grinds to a halt until your appeal is considered and resolved. That could be a minimum of two months, but appeals lasting many months are not uncommon. Of course, interest on your eventual tax bill continues to accrue.

You are allowed to bypass Appeals after an audit by requesting a “notice of deficiency.” That notice allows you to petition directly to the US Tax Court. If you decide to sue the IRS in tax court (See Guide: Taking the IRS to Court) you can still get appeals office consideration since Appeals never had a chance to settle the case. Some people use this tactic to put pressure on the IRS to settle.

The second main source of Appeals cases is employment tax investigations of two types: Trust Fund Recovery Penalty and employee-independent contractor cases. In a Trust Fund Recovery Penalty investigation, the revenue officer investigates who is responsible for a corporation's failure to pay its payroll taxes and recommends an assessment of personal liability against the officers the agent finds “responsible” for the corporation’s default. Each officer has the right to protest the recommendation to the Office of Appeals before the assessment can be made official. Appeals in trust fund cases are usually on a 60-day deadline.

In employee-independent contractor investigations, the revenue officer examines corporations that classify workers as independent contractors. These corporations don't withhold taxes; instead, they furnish Forms 1099 at the end of the year. Quite often the IRS concludes these workers are employees, making the corporation liable for the workers' payroll taxes. The corporation has the right to protest such a finding to the Office of Appeals before the IRS assesses the tax.

The third main source of cases is appeals from the denial of penalty abatement. A late return, an insufficient estimated tax payment, a late payment, and many other types of penalties are assessed directly by the IRS' regional service centers. You may contest these penalties at whatever level the IRS recommends or imposes them. If you get no relief, you can appeal the denial to the Office of Appeals.

Fourth, if your offer in compromise to settle a big back tax bill is rejected, you may appeal the rejection to the Office of Appeals.

Fifth, you may file a refund claim for taxes you overpaid in the past. If it's rejected, an appeal lies to the Office of Appeals.

Finally, the Office of Appeals has been given responsibility to review a number of collection-type cases. Under the 1998 tax reform act, the Office of Appeals now reviews a pre-levy protest (called a Collection Due Process Hearing), and other proposed or completed collection actions.

Preparing Your Protest and Your Case

An appeal is made by filing a “Protest.” There's no official, complicated form; it's just a letter you send to the office that proposed your tax. The Protest has seven parts. You'll find a sample or “template” in the 30-day letter you receive from the tax auditor. Of the seven parts, four are of the fill-in-the-blank variety: your name, other identifying information, the office that issued the letter, and the tax periods. The heart of the Protest consists of parts five, six, and seven. In these three sections, the task is to tell the Appeals Officer the findings with which you disagree (part five), the facts (part six), and why the agent was wrong based on the law and the facts (part seven).

Keep part five brief. Consider stating, "The revenue agent erred in disallowing my deduction of $1,000 for a wheelchair for my dependent aging mother." Or, "The revenue agent erred in characterizing a loan from my Aunt Josephine as unreported income." Number each such summary point so as to negate, point by point, the corresponding items in the Revenue Agent's Report (if you disagree with them).

In the next part (six), tell all the facts underlying the issues you are protesting. You need not protest every issue; in fact, often people change their minds after reading the Revenue Agent's Report and decide not to protest even though they disagreed. But as to the issues you wish to fight, recite all the facts in detail, and prepare to prove them.

Tip: Some practitioners disagree with this general strategy, preferring to hold their fire until they meet face-to-face with the Appeals Officer. They file a "bare-bones" Protest, reciting enough to preserve your right to appeal the issues but not so much to show all your cards. This strategy may be appropriate in some cases, but in general, taking a strong, well-supported stand right away has a better chance of achieving a good settlement.

State the facts logically and cogently. Avoid opinion and hyperbole. Assume the Appeals Officer knows nothing about your case but learns quickly from a cogent presentation. (The officer will in fact have read the Revenue Agent's Report in advance, and carefully.) So, begin at the beginning if that will make your factual statement complete and understandable within its four corners. Next, prove your facts. Most people assume they already did that at the agent's level, so they'll use the same proof at appeals. But be on the lookout for even more evidence. In fact, new evidence at the appeals level often gives the Appeals Officer the justification she needs to settle your case. Appeals Officers can and do consider evidence that would never make it past the front door of a courtroom: hearsay, third-party information, and anything else that appears to be relevant. In fact, the more third-party information you can bring to the table, the more credible your case.

Tip: Sometimes, an Appeals Officer will say something like, "Well, your Protest states nothing new, no new facts or evidence, from the revenue agent’s report. Why should I change the result?" The answer to this (assuming you in fact have no new evidence) is that the agent was simply wrong, either in his recitation of the facts or in his legal conclusions from those facts. Appeals Officers should not consider the revenue agent’s report to be presumptively correct, but should consider the whole case afresh.

Above all, include and rely on your own testimony. After all, you, the taxpayer, have the most intimate knowledge of the tax-relevant facts. Whenever you can, put the evidence in writing, under oath. Sometimes an agent or Appeals Officer objects to your statements of fact, even under oath or penalty of perjury, as "self-serving." Of course they are; that's the whole idea-to help yourself. What the agent really means by that phrase is that your statements lack credibility because you have a natural bias in your own favor. That also may be true. However, your statements under oath are subject to the penalties of perjury and are fully admissible in any court if given as live testimony. That's good enough for a judge or jury; it should be good enough for the IRS. So don't be reluctant to use your own statement, bolstered by your oath.

Part seven is the statement of law. Here, your tax representative can help or write the section for you if she is familiar with the law. If you represent yourself, a statement of the law is still required, so consider performing your own legal research. Still, the process is very informal. You need not file a Supreme Court-style brief with citations to cases, rulings, and other authority, though solid research like that adds credibility. But you do have to say what the law is. Bear in mind that the Appeals Officer is always well-versed in the law governing your issues. In fact, she will sometimes assist you in your research if you ask and indicate a willingness to do copying, legwork, and other tasks. When you have the law firmly in mind, write it in this section as best you can, and then apply the facts to those legal rules.

An example might be something like this:

> <u>Example</u>: My Mother Rose is seventy-five years old, barely ambulatory, and lives with me. I am her sole support, and I claim her as a dependent on my return. I provide more than one-half of her support in terms of food, clothing, shelter, and other necessities. She has no income of her own. She is not married. Last year, she underwent total hip replacement on the right side and needs a wheelchair to get around the house. Since I work for a living, she needs the wheelchair to feed herself and stay out of bed. Dr. Smith Jones prescribed a wheelchair for her last year, and I bought it. A letter from Dr. Jones and a copy of his prescription are enclosed. The wheelchair cost $2,000. A copy of the sales slip and my check are enclosed. Of that cost, I deducted $1,600 because of the 7.5 percent floor on medical expense deductions. However, the agent disallowed this deduction. The rule on medical expense deductions is that such an expense is deductible if medically necessary for a dependent's condition. Here, the facts show that the wheelchair was in fact medically necessary for my mother. Therefore, the agent's conclusion to the contrary was in error.

At the end of the Protest, include the following statement above you signature: "Under the penalty of perjury, I have examined the foregoing statement of facts in the foregoing Protest, together with all exhibits, statements, and other documents referenced therein, and to the best of my knowledge and belief, it is true, correct, and complete."

"Face to Face" Time – The Appeals Conference

Your next stop is the conference. The Appeals Officer normally sends a preliminary letter letting you know she has the case, will review it, and will call you for a conference. Sometimes these letters set a conference date. Confirm or change it immediately (a phone call will do). To prepare for the conference, review your Protest thoroughly. Also review the Revenue Agent's Report and all your files to have them firmly in mind. Keep looking for other evidence. In fact, Appeals Officers will give you ample opportunity to gather more evidence even after the conference. Then, on the appointed day, go to the Office of Appeals. (Some appeals conferences are handled by telephone only.)

Appeals conferences are very informal. You go in, sit across the desk from her, and begin to talk about the case. No one records the conference. You may take notes, as will the Appeals Officer, where appropriate.

> Helpful Hint: If you are unsure about the facts, or what the agent had written about a particular issue, ask the Appeals Officer. They are usually forthcoming with information and documents in their own file. The agent may not have let you know all the facts they rely on to deny your deduction. The Appeals Officer will have that at her fingertips.

Your task is to convince the officer that the agent's mistake should result in a full or partial concession by the government. In theory, the Appeals Officer's role is to be neutral. She weighs the evidence for and against the revenue agent's position and comes to some compromise based on the hazards of litigation. Many Appeals Officers try to act with neutrality; others unintentionally slide into defending the revenue agent against your attacks. This slippage is a danger and one major reason why your Protest and demeanor at the conference should be fact-based, businesslike, and firm. Moreover, the Appeals Officer has heard it all before-all the facts, all the law, all the name-calling. This does not mean you should downplay the agent's mistakes. Hit them all. Showing how wrong the agent was, and how contrary to the facts, goes a long way toward obtaining a good result.

The appeals conference proceeds issue by issue until there is no more left to say. The Appeals Officer might indicate she is willing to concede some issues. On yet others, she may say the agent was right and she will sustain the finding. On others, she may need more information. It often helps to ask what additional facts she would need to accept your position. She may suggest evidence you might be able to gather, and, if so, she will give you reasonable opportunity. Then go get that evidence and send it to the Appeals Officer as quickly as possible. She will give you a deadline and reasonable extensions if you ask for them in advance.

The end of this process is the Appeals Officer's report. If all has gone well, she writes an "agreed report," formalizing the final settlement on all issues. She then sends it to you for signature. A tax bill or tax refund follows. If you can't agree on all issues, try to agree on most. "Unagreed" issues are written up in a Notice of Deficiency, also known informally as a "ninety-day letter." This is the formal letter the law requires the IRS to send you before it assesses your tax. You then have two choices. If you do nothing, the bill soon arrives. To forestall that bill, you may file a petition in the United States Tax Court to contest the remaining unagreed items.

The appeals process can be lengthy, but it's usually fairly simple to get through. Moreover, it's your one chance at reasonable expense to get a better result than you obtained from the revenue agent. There's little harm in trying and much to be gained.

Sample Protest

Internal Revenue Service Collection Division
500 N. Capitol Street, N.W.
Room 3207
Washington, D.C. 20221
Att: Ms. Jones

Re: Penny Pencil, 000-00-0000; Wonder Widgets, Inc., EIN 00-0000000

Dear Ms. Jones:

PROTEST

Protest is hereby made of the proposed assessment of Trust Fund Recovery Penalty with respect to Penny Pencil. The following information is submitted in support of this Protest.

1. Name, Address, Social Security No.

Penny Pencil
1 Main Street
Anytown, USA 11111

SSN: 000-00-0000

2. Conference.

A conference relating to this Protest is hereby requested.

3. Date and Number of Letter.

Letter dated July 26, 1995; Letter 1153(DO)(Rev. 3-93)

4 Tax Periods.

3rd quarter 1993; 4th quarter 1993; 1st quarter 1994

5. Findings Disagreed With.

The revenue officer erred in determining that Penny Pencil was a person responsible for the failure of Wonder Widgets, Inc., to collect, account for, and pay over the withholding and Social Security/Medicare taxes of the employees of Wonder Widgets, Inc., for the above periods, and that Penny Pencil willfully failed to ensure that these amounts were paid over.

6. Statement of Facts.

[Here state all facts to support your case.]

7. Statement of Law.

The Trust Fund Recovery Penalty may be imposed under IRC 6672 only if two separate requirements are fulfilled. First, the person must be under a duty to "collect, truthfully account for, and pay over" the withheld taxes, that is, he or she must be a "responsible person." IRC 6672 imposes liability only upon the person or persons who are actually responsible for an employer's failure to withhold and pay the government, that is, the person who is under the duty to perform the act, and not necessarily the individual who is nominally charged with disbursement of the funds. White v. United States, 372 F.2d 513 (Ct. Cl. 1967); Turner v. United States, 423 F.2d 448 (9th Cir. 1970).

The second element, willfulness, requires that the responsible person shall have intentionally, deliberately, voluntarily, or knowingly failed to pay over the withheld taxes. White v. United States, supra. Mere negligence in failing to ascertain facts regarding the tax delinquency is insufficient to constitute willfulness under IRC 6672. Bauer v. United States, 543 F.2d 142 (Ct. Cl. 1976).

Under these standards, I am neither responsible nor willful for the following reasons. [State additional grounds.] In view of these cases, I should not be deemed a responsible person. By contrast, the evidence in this case shows that others may have been the responsible persons. Also, I had no knowledge that the taxes were unpaid until the time period when the business closed.

For the foregoing reasons, the proposed assessment of the Trust Fund Recovery Penalty against me should not be sustained.

Under the penalties of perjury, I have examined the foregoing statement of facts in the foregoing Protest, together with all schedules, exhibits, and attachments, and to the best of my knowledge it is true, correct, and complete.

Sincerely yours,

Penny Pencil
[end of Protest]

"But I Just Signed Where He Told Me": The Innocent Spouse and the Injured Spouse

One audit issue is of special importance – "the innocent spouse."

> Example: Emily and Ernest were married in 1940. Emily had only a high school education. Ernest handled all of the family's finances. Emily took care of the house, using the couple's joint checking account to pay for groceries, utilities, and the mortgage. Emily also raised two daughters. Of course, the couple filed joint federal income tax returns. Meanwhile, Ernest and his brother formed a partnership to open a store. He never discussed the store's business with Emily, nor did Emily visit. To prepare the couple's joint tax return, Emily gave their reliable accountant a list of household expenses, then simply signed on the dotted line. Things went well for years, then Ernest passed away. The IRS audited the couple's joint returns and assessed more than $40,000 in taxes for three years. Without Ernest, Emily found herself alone: solely and completely liable for all of these taxes. They did not live lavishly; there were no expensive fur coats, luxury yachts, trips to Bermuda, or private schools. Emily always did as Ernest asked, keeping faith with her husband and his professional accountant-advisers. Yet, because she signed the joint returns, she was held liable for all of the tax.

Congress felt there ought to be some remedy for situations like this, so in 1969 it passed the "innocent spouse" statute, a part of the Internal Revenue Code. If you meet the tests, you get complete absolution from all tax, penalties, and interest that you otherwise guaranteed by signing a joint return.

> Very Important: The IRS Reform and Restructuring Act of 1998 made substantial changes to the innocent spouse provisions. In particular, it allows qualifying spouses to "split" the liability, so that they pay taxes only on their income. See below.

Meeting the tests of the innocent spouse law is difficult. Still, it can be done; many do it each year. You can go it alone, but you are almost always better off having professional help to prove this issue.

To file your innocent spouse claim, use IRS Form 8857.

When You May Claim to Be "Innocent"

You may raise the innocent spouse defense almost anytime in the tax process, but the issue usually arises during an audit. The agent finds a hidden bank account, or the extra taxes arose because one spouse was arrested for drugs or gambling and the IRS found unreported income.

A corporation's president is charged with extra income because the corporation paid personal expenses, or one spouse is responsible for an unallowable deduction. These events and myriad others could result in an increase in taxes. Then the "innocent" spouse claims, "I had no idea my husband [or wife] had all this extra income [or had taken unallowable deductions]."

The defense also can arise during a divorce. In the divorce decree, the husband (or wife) commits to pay the taxes for past years when the couple filed a joint return. The IRS audits those returns, or finds some other reason to propose more taxes. The wife (or husband) can claim innocent spouse at that time. Finally, we also see the issue in garden-variety collection situations. Here, the IRS is trying to collect past-due taxes reported on joint returns. Often one spouse will raise the innocent spouse defense.

> Myth-debunked: Note that the innocent spouse defense is not available unless the IRS proposes more tax than what is shown on the joint return (except for "equitability" determinations; see below).

Proving You Are Innocent

Proving innocent spouse status is arduous even under the best of circumstances, and sometimes a spouse is not eligible no matter how unfair the overall situation. Let's explore how a spouse can establish "innocence." The proof has five elements, some easy, some difficult.

First, you must have filed a joint return for the tax year involved. This item seems simple enough-either you signed or you didn't. But sometimes a wife denies the genuineness of her signature on the return. Then the fight starts. The husband claims she in fact signed, or that he signed her name with permission. Even where one spouse doesn't sign the return at all, the IRS sometimes argues that the facts show the spouse *intended* to file a joint return. If so, by law it's a joint return. The second requirement is that there be an "understatement of tax" attributable to erroneous items of one spouse.

Tip: Under pre-1998 law, the understatement of tax had to be "substantial," and the items had to be "grossly" erroneous. These were two big hurdles that many taxpayers could not overcome. The 1998 tax reform act eliminated them, making innocent spouse more widely available, especially to lower income spouses.

Watch the details: there must be an *understatement* of tax on the return. This means that you are stuck with anything you reported on the return as the true tax. You may be innocent, if at all, only as to *extra* taxes the IRS proposes.

> Example: Jack and Jill were married for ten years. When Jill signed their joint returns, Jack said, "Don't worry, dear, I'll pay the taxes." He always promised he would, but the IRS never knocked on the door. When they divorced in 1995, Jack promised again to pay all taxes due on past returns, $50,000 in total. The divorce became final. Jack moved to Elk Breath, Montana, and Jill was left in the IRS' target zone, struggling as a single mother to support three children, all under the age of five. Innocent spouse? No! Maybe Jill can get relief in other ways, such as urging that collection would be a hardship. But she is not an innocent spouse under this part of the law. She signed all the returns, and there was no understatement of tax. The return stated exactly how much tax was owed. It simply was not paid.

The third legal requirement is that the spouse must not have known, nor had reason to know, of the understatement of tax. This rule does not mean you can sign the return in blank or not read it all. You can't hide your head in the sand and expect to get tax relief. Instead, the requirement is to show you acted with "reasonable prudence."

For example, if you reviewed the return but relied on your husband, wife, CPA, or lawyer to prepare it correctly, that could be reasonable prudence. But if you put your left hand over your eyes and scribbled your signature with your right, that's not. It's also not reasonable prudence if you ignore obvious warning signs that something is wrong or too good to be true. A spouse who lives in a million dollar home knowing her husband earns $20,000 a year is probably not "innocent." Maybe a spouse's suspicious behavior could put you on notice; maybe your lifestyle is way above your earnings. Possibly there are unusual or inconsistent warning signs, such as long, unexplained absences from home, lavish gifts, erratic behavior, or sudden changes in lifestyle or net worth. The agent and the IRS will seize on any of these to show you should have known that there was something wrong with the tax return you signed.

Tip: If you can’t argue for complete relief, argue for partial relief, on the grounds that the innocent spouse did not know how big the understatement was; therefore, innocent spouse relief should be available as to one item, or a portion of an item. For example, suppose that husband told wife he omitted $100,000 of income, but the real omission was $1,000,000. Wife may claim innocent spouse with respect to $900,000 of income.

The fourth requirement is that, under all the circumstances, it would be inequitable to hold you liable for the understated taxes. "Inequitable" generally means "unfair." This is a catchall requirement that limits relief to the truly needy. The rich and famous of the world do not usually qualify. If life was hard when you signed the return, but life is great now, there's no unfairness in holding you responsible for past taxes. Still, the law makes an explicit exception for normal support. So, if your spouse supports you with food, clothing, and shelter within normal amounts, not lavishly or extravagantly, the government cannot claim you failed the "inequitable" test by that fact alone.

> Example: One case shows how far this argument will stretch. Lucy and Larry were married. Larry started a business raising and selling radishes. He was so successful that he built a house on ten acres, complete with swimming pool, tennis court, clubhouse, and airplane landing strip. Thirty years later, Lucy and Larry divorced. She got $225,000 each year as guaranteed income, plus the house, clubhouse, swimming pool, and tennis court (apparently, Larry kept the landing strip). Two years later, the couple remarried each other. For three years, Larry gave his wife $15,000 per month, plus two Mercedeses and trips in the airplane. Naturally, they had a getaway in Florida during the winter growing season. However, the winds of love blow hot and cold. They divorced a second time, this time permanently. As a parting gift, Lucy got $4.28 million as alimony. Of course, the IRS then came into the picture, proposing massive taxes on the couple's jointly filed returns.
>
> Lucy said, "I am an innocent spouse." The IRS said, "You've got to be kidding. Just look at your lavish lifestyle, including your $15,000 a month allowance, new cars, European

> vacations, race horses, a full-time maid and gardener, two homes, and a clubhouse, swimming pool, and tennis court. You must have known that Larry was underreporting his taxes, and besides, it's certainly not unfair to hold you liable." Believe it or not, the court sided with Lucy. "One person's luxury may be another's necessity," said the court. She was rich before the returns were filed, she was rich during the years in question, and she was rich afterward. Nothing in her lifestyle would have put her on notice that anything had changed.

The fifth requirement is that you make an "election" to invoke innocent spouse status within 2 years after the IRS begins to collect against you. This one is easy to fulfill but also easy to forget. The IRS no longer is enforcing this 2-year rule, but it's best to meet that deadline anyway.

Despite occasional wins like the Lucy case, in the real world agents are extremely reluctant to believe your claims of innocence, or even to credit sworn testimony to that effect.

> Helpful Hint: Even if you fail the innocent spouse tests, and can't make an election under the new 1998 law to have "separate liability," the law allows the IRS to grant relief from liability by taking into account all the facts and circumstances and finding that it is "inequitable" to hold you liable. While this may seem repetitive, it evidences Congress' intent that innocent spouse relief be granted generously and liberally, even if it does not exactly meet the statutory requirements.

Often, you must prepare to go to court to prove innocent spouse status. But courts are often skeptical about granting relief, and the cases are inconsistent from courts of appeal around the country. Your case must be excellent to prevail. The best way to prove you're an innocent spouse to the IRS or a court is to assemble a catalog of evidence and present it to the IRS or to a court if necessary. First, prepare your own affidavit. Tell your life story, focusing especially on the years of trouble with your spouse. Common to these cases are long, sad stories of spouse abuse, psychological and physical domination, alcoholism, drug abuse, and other dysfunctional behavior. Wives who are abused and dominated by their husbands can often be "innocent spouses." It is common sense that if one spouse dominates the relationship, he or she can take charge of the taxes, and the return comes out wrong without the other spouse's knowledge or consent.

It's also very common for innocent spouse cases to arise out of family businesses. One spouse, let's say the husband in this example, runs the business with an iron hand. The other spouse minds the home and children, participates in community activity, and has minimal involvement in the business. Then, when the IRS proposes more tax, the wife claims innocence because the husband ran the business and refused to keep her informed of income or tax-related matters. It's common to hear, "My husband ran the business. He refused to let me participate in it. I trusted him to file the returns, and we had the accountant to help get it right. When I asked him about the return, he would just say "Sign here" and not ask any questions." While sometimes this can be a convenient excuse, quite often it is the truth.

Your "life history" affidavit should be long and detailed. Include everything. Show how the other spouse's personality, bad habits, or ways of doing business meant that you could not know that the taxes were understated. Demonstrate the unfairness of holding you liable for the other spouse's errors.

Second, begin to assemble third-party witness statements. Evidence from people with no ax to grind on your issue is always credible with the IRS and the courts. If your three best friends knew of your spouse's alcoholism, drug abuse, or domineering nature, have them write affidavits. Bankers may have known of his secretive business habits. Counselors and friends can testify about the personalities and financial habits they observed.

Third, gather objective evidence. This would include bank statements, notices, business records, and anything else on paper that supports your case. You will be amazed at how much support you can find once you start to look with this issue squarely in mind.

Fourth, get help. Find a friend or ask a professional whether your case is good and how it can be improved. Then follow up. Ask the revenue agent or tax auditor for as much time as you need to put the evidence together. Cite helpful court cases. These are available in the professional literature, but you may need some help finding them.

Fifth, don't give up. Statistically, you will lose your claim at the agent's level. You may then appeal to the Office of Appeals or go to court. If the case comes up after the assessments have been made, consider requesting audit reconsideration. Finally, ask the Office of Taxpayer Advocate for help. Make your innocent spouse case to that office if you never had sufficient opportunity to prove your case to the agent. Even if that office does not sustain your innocent spouse claim, it may refer your case back to the examination division for reconsideration. The officer may decide that your case is so worthy, and enforced collection would be so unfair, that it will stop the Collection Division anyway under the "hardship" rules.

Use Form 8857 to claim innocent spouse relief. Assemble and organize your evidence in any way that makes sense. You may choose separate exhibits with exhibit numbers, or simply bundle it all altogether. Write a cover letter to the agent setting forth all the facts and asking for innocent spouse relief. Be sure to keep a copy.

The 1996 Taxpayer Bill of Rights also helps a bit on the collection side. Let's say you can't prove innocent spouse status, or you've settled your innocent spouse claim somewhere in the middle. You therefore still owe taxes, but, in the meantime, what has the IRS been doing to collect against your ex? Now, an agent must tell you whether she has tried to collect, the general nature of her efforts, and how much has been collected. These facts may put some pressure on the agency to spread the burden of these joint taxes.

Separate Liability Election

The IRS Restructuring and Reform act of 1998 also enacted a very important innocent spouse relief provision for divorced or separated spouses. It is important because it does not depend on the IRS; you can invoke it on your own. Under this new law, you may elect to be taxed separately from your spouse if you were no longer married or were legally separated, or you are not living in the same household as the other joint return filer during the past 12 months. You can make this election up to 2 years after the date the IRS begins collection activity. But if you had "actual knowledge" of the items giving rise to the tax deficiency, you are not eligible. Moreover, if you and your spouse engaged in a fraudulent scheme to transfer assets, this election does not apply. If you make this election, your tax liability is generally figured on a "married filing separately" basis, although there are a number of fine details and exceptions to this rule.

The Injured Spouse

The "injured spouse" concept has nothing to do with "innocent spouse" status. It's a fancy name for a spouse who did not receive his or her fair share of a joint refund. These cases arise quite often in the aftermath of a divorce or separation. One spouse has two-thirds of the income and has paid two-thirds of the taxes through payroll withholding, but does not receive two-thirds of the refund. In fact, the injured spouse may receive nothing. So, the IRS devised a form to file by which you can receive your proportionate share. Form 8375 and its detailed instructions explain how to file your claim. Basically, you are entitled to get back your share of a joint refund, based on your proportionate share of the tax you and your spouse paid together. You can file an injured spouse claim anytime before the IRS issues a refund. It's usually best to do so with the tax return itself, or right afterward. Sometimes you can get back money from years past if the IRS has not issued the refund. But once the refund has been issued, you can't get it back except from the other spouse.

To Summarize

1. Be fully aware of your right to appeal adverse audit results.

2. Prepare your appeal logically and according to the IRS' forms.

3. Prepare for your appeal, and be businesslike in your presentation and relations to the Appeals Officer.

4. If you are an innocent spouse, be aware of the 1998 law which makes relief easier or allows you to elect separate tax liability treatment.

About the Author

Robert Nath is nationally recognized as an authority on tax matters. He holds degrees from Yale, the University of Pennsylvania, and Georgetown University. After clerking for a federal judge, Mr. Nath litigated tax cases for 8 years with the Tax Division, U.S. Department of Justice. Since 1984, he has been in private practice advising taxpayers, accountants, and attorneys on tax procedure and controversy matters, as well as representing them before the IRS and in court in tax collection, audit and tax litigation matters.

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