

# Executive's Tax & Management Report

Wealth-building strategies plus  
late-breaking tax news

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## Dealing With the IRS After an Audit

By Ray Moore

**I**n last month's issue of EXECUTIVE'S TAX & MANAGEMENT REPORT, we discussed what to do in preparation for and during an IRS audit [see *What to Do When the IRS Comes Calling*, April 2007, at 6]. Now, we'll consider the next step—what to do if you have been audited and you disagree with the results. You have several options available to you to try to resolve the matter within the IRS.

### Pay the Tax

Simply paying the tax might not seem like the best response. In some cases,

however, it is the cheapest way to end the dispute.

If the questionable items are small, it might make the most sense to just follow your head and not your heart. That is, you may know that you are right, and that you really shouldn't have to pay the tax that the auditor says you owe, but the amount may be too small to incur the fees associated with going forward.

For example, if the IRS auditor says you owe \$1,500 in tax, and it will cost you \$5,000 to question it,

## Proposed Regs Address Artificially Generated Foreign Tax Credits

**P**roposed regulations recently released by the IRS and the Treasury would disallow foreign tax credits for foreign taxes purportedly paid in connection with certain artificially engineered, highly structured transactions.

Foreign tax credits are aimed at providing relief to U.S. taxpayers from double taxation of their foreign source income. However, transactions addressed by the proposed regulations are structured in such a way that a U.S. taxpayer voluntarily subjects itself to foreign tax when an ordinary business transaction generally would result in little or no foreign tax paid by the taxpayer, according to the IRS.

"The proposed regulations complement the vigorous enforcement efforts of the IRS to identify and, in appropriate cases, to challenge the tax benefits claimed in these foreign tax credit generator transactions under principles of existing law," said IRS Chief Counsel Donald L. Korb.

The IRS learned of the significant impact of these transactions from members of the Joint International Tax Shelter Information Centre (JITSIC), an information exchange arrangement under which the United States, the United Kingdom, Canada and Australia exchange information on tax avoidance schemes. ■

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the sensible thing to do is pay the tax. The exception to this rule is if this is a recurring item, one that potentially will increase over time or flow through a number of returns. In those situations it is important to get the issue resolved up front. Protesting the small item now could save large amounts in the future.

### Manager's Conference

The first step you can take to protest the auditor's findings is to request a conference with his or her manager. The worthiness of such a conference should be determined on a case-by-case basis. In most cases, a conference at the manager level is not worth the fees incurred.

Like the auditor, the manager cannot weigh the hazards of litigation with regard to an issue; he or she is bound by the published authorities of the IRS (such as revenue rulings, revenue procedures, notices, *etc.*). In addition, a manager may feel a need to support the findings of the auditors.

The only time I usually request a conference with a manager is when I feel that the taxpayer is being denied his or her rights, such as not being allowed to have a conference with the auditor to discuss the findings in the exam or where an auditor was being threatening or abusive to a client (*e.g.*, threatening audits of other returns or related taxpayers if the client did not agree to the demands of the auditor).

If you have met the manager previously and feel that he or she offers a "cooler head" than the auditor, then a request for a manager's conference could be in order. By engaging a knowledgeable CPA with significant audit experience, you can benefit from the CPA's familiarity with the manager in prior examinations. Then the CPA can advise you as to whether or not a conference with the manager will be worthwhile.

### Appeals Protest and Conference

In most situations, an Appeals protest and conference is the best choice as the next step in the process of disputing an IRS auditor's findings. Appeals is separate from the IRS' auditing group. In fact, the Internal Revenue Restructuring and Reform Act of 1998 prohibits communication between an Appeals Officer and the auditor who handled your examination or with anyone else within the IRS, if such communication would appear to compromise Appeals' independence with respect to the matters being appealed.

The Internal Revenue Manual (IRM) includes, as part of the Appeals mission, "... considering protested cases, holding conferences, and negotiating settlements in a manner which ensures ... settlement of contested cases—on a basis fair to both the Government and the taxpayer—to the end that the greatest possible number of nondocketed cases are closed in that status and the greatest number of docketed cases are closed without trial." In other words, Appeals is required by law to maintain its independence from the audit process, and it is charged internally with settling disputes if at all possible as opposed to having the case go to trial.

As a practical matter, I have always found Appeals to give a fair review of the case, and I have never personally had to take a case past Appeals to get what the taxpayer considered to be a fair settlement (or at least, a settlement where the cost of going forward was more than the unsettled disputed amount).

In order to maximize your potential for achieving a favorable settlement at Appeals, there are certain procedures that should be followed. If the tax involved is less than \$25,000, you can fol-

low the procedures for “small case requests.” Protests involving higher dollar amounts—and those involving partnerships or S corporations—require a written protest.

The small case request only requires that you file a “... written request that asks for Appeals consideration, indicates the changes the taxpayer doesn’t agree with and why the taxpayer doesn’t agree” (IRM 8.6.1.1.4.1). However, even though this protest is less formal than that required for a “written protest,” it is often better to prepare a full protest of the issues with which you disagree.

The only information the Appeals Officer has on your case is the information prepared by the IRS auditor during your examination, which includes the Revenue Agent’s Report (RAR) and copies of your tax return. Obviously, the RAR represents the auditor’s viewpoint in the areas with which you disagree. By preparing a more formal report, following the guidelines set out in the IRS’ Publication 5, *Your Appeal Rights and How to Prepare a Protest if You Don’t Agree*, you put your side of the story in front of the Appeals Officer. The Appeals Officer can then review your reasoning and the basis for your position with regard to the issue at the same time he or she is reviewing the position prepared by the auditor.

The importance of a quality written protest cannot be overemphasized. The Appeals Officer will likely spend more time reviewing the written protest than any other documentation you submit.

In fact, I have even gone into an Appeals conference to find that the Appeals Officer had barely skimmed through the RAR. We were able to go through our written protest, item by item, laying out why we were right and the IRS auditor was wrong in her position, and ultimately

receiving a settlement favorable to the taxpayer.

Although it is not required, I recommend including in a written protest your position on every item in the RAR, including any adjustments with which you agree. The reason for this is two-fold:

1. It makes it clear to the Appeals Officer exactly which items you are disputing (sometimes there may be similar items within a single examination, some of which you agree with and some you don’t).
2. It shows the Appeals Officer that you are not being unreasonable in your positions; if an error was made, then you show that you agree with the adjustment.

For example, I once handled an appeal for a client that had prepared its own tax returns in-house prior to becoming a client of our firm. The client’s controller had mistakenly reversed an entry on the tax return, increasing the amount of a deduction rather than eliminating it (an item that was not deductible for tax purposes until paid, but was accrued on the financial statements when incurred). As a result of this error, the client had deducted \$200,000 on the return in error. (The deduction for financial statements was \$100,000, and the deduction for tax should have been \$0. The error increased the deduction by \$100,000 instead of reducing it by \$100,000.) This was purely a mechanical error on the part of the controller. So, in the Appeals protest, we indicated our agreement with the auditor’s adjustment on this item. Then, when we protested other areas, the Appeals Officer had seen that we do not just routinely protest every item raised in the examination - that we had a basis for the positions that we were challenging.

As stated above, Appeals is charged with settling all of the cases that they can. They have the authority to consider the “hazards of litigation” in their proposed settlements. Unlike the auditor, they are not bound to follow to the letter every IRS pronouncement. The one exception to this is for published positions that are favorable to the taxpayer. Appeals is required to follow any “... technical advice memoranda issued by the National Office where the technical advice memoranda are favorable to the taxpayer...” [IRM 8.1.1.3.2.1.B.] In other words, they can accept a taxpayer’s position, even if this position is contrary to the IRS’ published position on an issue.

While there is no rule of thumb regarding how much of a disputed amount can be resolved at the Appeals level, I have seen cases where the final settlement was as little as one percent to two percent of the originally protested amount. Similarly, I have seen the Appeals Officer allow as much as 60 percent to 80 percent of a disputed item (*e.g.*, one that requires a specific form of documentation under the tax law) without requiring any additional documentation from the taxpayer—simply based on the Appeal Officer’s analysis of the hazard of litigation (*i.e.*, the possibility that the IRS would lose the issue in court).

One final point with regard to the appeal process: ensure that the CPA working with you on your appeal is knowledgeable and experienced in this area. The taxpayer rarely meets personally with the Appeals Officer. All communication is usually between the CPA and the Appeals Officer. The issues being protested usually involve interpretations of the tax law or the application of the law to a specific set of facts. Having a

competent advisor who is knowledgeable both in the tax law and in the appeals process can help you achieve a favorable result at the Appeals level.

### **Unresolved Issues**

If you go through the appeals process and still have unresolved issues, then you have to decide whether to agree and pay the tax or pursue further routes available to you. As was the case with the audit, if the alleged amount owed after your appeal is less than the cost associated with further action, you should probably pay the tax. However, if the tax is a significant amount, and you think

you have a strong rationale for the position taken on your return, then you can pursue additional action through the courts.

In next month's issue of EXECUTIVE'S TAX & MANAGEMENT REPORT, we will discuss the alternatives available to a taxpayer who desires to continue to dispute a proposed adjustment through the court system.

### **Summary**

If you disagree with an auditor's proposed adjustments to your tax return, a protest to Appeals usually is the best course of action. Appeals is mandated to both remain independent of the audit

process and to settle as many cases as it can. One of the reasons that approximately two-thirds of the tax cases that go to trial are decided in favor of the IRS is because Appeals usually resolves in the taxpayer's favor those issues for which the taxpayer has a strong position. With competent professional representation, you can usually reach a satisfactory settlement of your case at Appeals.

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