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## IRS Examination and Collection Functions

### -A Basic Overview

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*Editor's Note: This is the first of a two-part article discussing IRS examination and collection activities.  
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It is a moment that taxpayers dread – a letter from the IRS, and it is not a refund check. Instead you have just received a letter from the IRS informing you that there is an issue with your tax return or that you owe additional tax penalties or interest. Each year the IRS sends a multitude of letters and notices to taxpayers. These letters can range from the simple (such as a notice identifying a mathematical error on the return) to the complex (such as a notice that the return has been selected for an audit). A comprehensive discussion of the substantive and procedural implication associated with the various notices a taxpayer may receive from the IRS is beyond the scope of this article. However, this article will provide a basic overview of the examination and collection functions of the IRS.

#### Examination of Tax Returns.

Returns are selected for examination for various reasons. A return may be selected for examination on the basis of computerized screening. The IRS operates a computer program referred to as the Discriminant Inventory Function System ("DIF"), which assigns a numeric score to each return as it is processed by the IRS. The higher the DIF score the greater the return error potential; thus, the greater the chance the return will be selected for examination. A return also may be selected for examination on the basis of income document matching, which attempts to reconcile information received from third-party documents (such as Form 1099 or a Form W-2) with the information on the taxpayer's return. Returns also can be randomly identified for audit on the basis of information received from various sources (newspapers, informants, etc.) or due to items identified by the IRS as susceptible to taxpayer abuse.

Once a taxpayer has been notified that an audit of the return is underway, the examination usually will take one of three forms: (1) an audit by correspondence where the IRS sends the taxpayer a letter asking the taxpayer to send supporting documentation by mail; (2) an audit to be conducted at the IRS office closest to the taxpayer's residence; or (3) a field audit where the Revenue Agent will travel to the taxpayer's home or place of business to review records. The audit by correspondence tends to be the least complex and least intrusive audit method, while the field audit typically signals a more complex and more intrusive examination of the return.

According to the 2007 IRS Data Book, which describes activities conducted by the IRS for the 2007 fiscal year, there were 179,419, 771 returns filed for the 2006 calendar year. Of the total returns filed for 2006, 1,550, 992 were selected for examination by the IRS. The greatest majority of the returns selected for audit (1,384, 563) were individual income tax returns. Of the 1,550, 922 returns selected for audit, 449,215 were handled as field audits (including examinations conducted at an IRS office) and 1,101,707 were handled as correspondence audits.

Whether the audit is conducted by correspondence, at an IRS office, or as a field audit, the taxpayer typically receives an initial contact letter from the IRS identifying the tax years at issue, the IRS



representative conducting the audit, the issues on the return that are under examination, and the type of audit being undertaken. The letter will identify the date and time of the appointment with the Revenue Agent or provide the date by which the taxpayer must respond in writing. This letter usually is

accompanied by an Information Document Request (“IDR”), which is used by the IRS to request specific information from the taxpayer for use in examining the items on the return.

The taxpayer and the taxpayer’s representative should begin preparing a response to the initial contact letter as soon as possible to assess the merits of the positions taken on the return, to identify whether there may be exposure for prior years, and to discuss the overall audit defense strategy. Audits are about facts. The Revenue Agent’s chief function during the audit is to accumulate evidence for the purpose of evaluating certain items on the tax return. The evidence can take many forms, including the taxpayer’s own testimony, books and records, and documents obtained from third parties. Section 7602 of the Internal Revenue Code provides that, for the purpose of evaluating the correctness of an item on the tax return, the IRS is authorized to “examine any books, papers, records, or other data which may be relevant or material to such inquiry.” Section 7602 also authorizes the IRS to issue a summons to the taxpayer, employees, officers and directors, or others in possession of information related to the return.

Depending on the facts in a given case, the taxpayer and the taxpayer’s representative may need to discuss potential criminal exposure during the audit process. The Internal Revenue Code contains numerous provisions imposing criminal sanctions on taxpayers for certain conduct, commonly referred to as tax fraud. A taxpayer may face criminal prosecution for failing to file a return, filing a false return, or failing to pay a tax. Moreover, if the taxpayer provides a false statement to the Revenue Agent during the audit, this can constitute a separate crime under the Code. The IRS Criminal Investigation Division (“CID”) investigates taxpayers who willfully or intentionally violate their duty to file a correct tax return or pay a tax. According to the IRS website, CID initiated 1,780 criminal investigations in 2007 under the General Tax Fraud Program. Of the 1,780 investigations opened, 1,127 cases were referred for prosecution.

Once the examination of the return has been concluded, the taxpayer will receive a “30-day letter” along with an examination report setting forth the proposed changes to the return and any resulting deficiency in tax. The examination report

may also propose additional penalties and interest depending on the issues examined during the audit. Once the taxpayer receives the 30-day letter, he or she can either (1) agree with the proposed changes and pay any additional tax, penalties or interest or (2) disagree with the proposed changes and exercise his or her right of appeal.

The letter sent to the taxpayer at the conclusion of the audit is referred to as a “30-day letter” because it triggers the beginning to as a 30-day period within which the taxpayer may administratively appeal the Revenue Agent’s findings to the IRS Appeals Office. The taxpayer invokes the Appeals Office’s jurisdiction by filing a protest setting forth the taxpayer’s position on the facts and law. If the taxpayer fails to respond to the 30-day letter, the taxpayer will lose their right to have a less costly administrative hearing and will be forced into a position of litigating any issues that arose during the audit.

If a taxpayer does not respond to the 30-day letter, or if the case cannot be settled with the IRS Appeals Office, then the IRS will issue a 90-day letter to the taxpayer. The 90-day letter is commonly referred to as a Notice of Deficiency. The 90-day letter provides the taxpayer with a 90-day period within which to file a petition with the appropriate federal court seeking judicial review of the findings contained in the audit examination report. If the taxpayer fails to respond to the 90-day letter, the IRS will assess the additional tax, penalties and interest. The taxpayer’s only remedy at that point is to pay the assessed tax, penalty and interest and file a claim for refund.

Many taxpayers believe that hiring a tax attorney to represent them before the IRS during an audit will signal to the IRS that there is a problem with the return or that doing so will cause the IRS to more closely scrutinize the return. From the standpoint of achieving the best result for the least cost, however, each phase of the audit offers a greater opportunity to the taxpayer than the one that follows. In general, the audit is more important than the administrative appeal to the IRS Appeals Office, the appeal is more important than the trial, and the trial is more important than the judicial appeal. The more complicated the facts and the legal issues in a given case, the more desirable it is to have a qualified tax attorney representing the taxpayer at the earliest possible state before the IRS.

The next installment of this article will examine the IRS collection function and the various ways in which a taxpayer can address an unpaid tax liability.