

IRS Audit Procedures

What to do when your client gets the “call”

Definitions and other useful Information

1. Income Tax Audit. Hell for those unprepared. Synonymous with performing painful delicate surgery on oneself without anesthetics while suffering from uncontrollable shaking and tremors.
2. National Office The IRS head office located in Washington. It is from the National Office that issues of procedure and ruling requests are sent and acted upon The IRS National Office is comprised of the offices of the Commissioner and Deputy Commissioner, Chief Financial Officer, Chief, Management and Administration, Chief, Strategic Planning and Communications, Chief, Taxpayer Services, Chief Compliance Officer, and Chief Information Officer
3. Regional Offices The four Regional Commissioners administer the IRS field functions within each region. 7 At the office of each Regional Commissioner, there is an office of Regional Counsel under whom there is a Regional Director of Appeals, who supervises the Regional Appeals Offices within the region. The work of the Appeals function is performed in Appeals Offices headed by Chiefs, who report to the Regional Director of Appeals. An Assistant Regional Commissioner (Examination) supervises the examination functions within the region, and provides planning, evaluation and coordination support for the districts within his region.
4. Service Centers The four regions are served by 10 IRS Service Centers, each headed by a Director, who is responsible to the Regional Commissioner. The service centers are

primarily responsible for the IRS' mass processing of tax returns, the selection of tax returns for IRS audit, and in-office audit of returns by its Compliance or Examination Division.

5. District Offices The four regions are subdivided into 33 districts, each headed by a District Director, with local offices throughout each district. Within each District Director's office there is an Examination Division which performs most of the audit functions and procedures. The District Director oversees the collection, taxpayer service, examination, problem resolution and criminal investigation programs of the IRS as established by the National and regional offices. The District Director is responsible for determining the correct tax liability, assessing such liability, and scheduling and certifying refunds, and civil and criminal tax investigations. Under each Director is an Examination division headed by a Chief. This Division conducts examinations (including returns referred to the District by the Service Center) of all kinds of returns (other than those relating to employee plans and exempt organizations), claims for refund, and offers in compromise based on doubt as to liability for taxes.⁹ The examination program includes classification of returns for office or field examination, participation with special agents of the Criminal Investigation Division in investigating tax fraud, and the provision of technical support for year-round taxpayer services.
6. Circular 230 This is the IRS publication dealing with the practice in front of the IRS by attorneys and accountants as well as the procedures involved in such practice. If you plan to deal with the IRS at all you need to become familiar with Circular 230.

7. Form 2848 Declaration of Representation and Power of Attorney. Without this form the IRS will not speak or deal with you with respect to a tax matter of your client. Always have at least 3 copies of this form signed by your client as the Service has a tendency to lose them.
8. Form 870 Consent to the Extension of the Statute of Limitations. A taxpayers consent to extend the statute of limitations beyond the applicable period in order to allow the Service time to complete its audit or send the matter to Appeals.
9. Collections That part of the District Office which handles the collection of taxes which have previously been assessed.. Most of the IRS personnel assigned to Collections are not nice individuals who tend to be slightly psychotic.
- 10 Audit Division That part of the Regional, Service Center of District office dealing with the audit of a Taxpayers return. Usually those individuals conducting an audit are Revenue Agents. Most of these Revenue Agents are not as psychotic as the agents dealing in Collections mostly because they are smarter. However, calling them smarter than their brethren in Collections is “damning with faint praise”. Most Revenue Agents involved in a field audit are vary paranoid people who hold Oliver Stone out as a prophet and see shadows everywhere. Although they may have families, their families refuse to acknowledge their existence.

- 11 Criminal Investigative Division Also known as CID. If you have a client who is being investigated by CID you have a **BIG** problem and you (and especially your client) need the help of a good criminal tax lawyer. CID investigations are usually conducted by IRS Special Agents. **These are not nice people!! They are also usually very smart.** Special Agents usually come in pairs like most bad things (I know it is threes). If at an initial meeting with the IRS there are 2 agents involved you should immediately suspect something and ask whether there is a CID investigation ongoing or whether a referral to CID has occurred.
- 12 Appeals. That part of the District office which is designed to resolve most tax disputes at the District Office level. It functions independently of Audit and resolves over 90% of all tax disputes. Typically Appeals will get a case assigned to it after a taxpayer had filed a protest to a Thirty Day Letter or after a taxpayer has filed a Petition with the United States Tax Court.
- 13 Thirty Day Letter. Notice sent to a taxpayer at the conclusion of an audit. It gives the Taxpayer 30 days to agree with the finding of the auditor or submit a written protest to the office of the District Director requesting that the matter be sent to Appeals. The time period for filing the protest may be extended by the audit office (and usually is) if requested by the taxpayer or his or her representative.
- 14 Ninety Day Letter Also known as a Statutory Notice of Deficiency. This letter is issued if the taxpayer does not respond to a Thirty Day Letter or if a matter sent to Appeals

remains unagreed to after the Appeals process. It is issued from the District Office via Certified Mail. The 90 day period (150 days if you are out of the Country) may not be extended. In order to contest your liability you must file a petition with the United States Tax Court within this 90 day period. Failure to file a Tax Court Petition will result in an assessment of the Tax proposed in the Ninety Day Letter.

15 United States Tax Court The separate court set up under the Executive Branch to decide tax disputes. All decisions of the Tax Court are appealable to the Court of Appeals for the Circuit in which the Tax Court tried the case.

How is a Return Selected for Audit?

A. Selection of Returns for Audit

1. In General

The primary objective of the IRS in identifying returns for examination is to promote the highest degree of voluntary compliance. The primary objective of the classification of returns is to ensure that returns with substantive issues and the highest yield are selected for examination. An annual examination plan is developed by the National Office in consultation with regional and district offices, and used, to establish nationwide audit plans for determining the number and type of returns to be selected in order to accomplish the audit plan. Various methods and procedures for identifying and selecting individual and

corporate returns for examination are employed by IRS to achieve such results. Tax returns are selected for examination by computer or by manual identification. Manual identification involves making tax returns available for classification by other than computer identification (e.g., amended returns, claims for refund or information returns). Returns that are classified by computer as having audit potential may also be manually screened to identify issues for consideration and set the scope of the examination, and to accept as filed those returns initially computer classified, but do not warrant examination. During the classification/screening process, returns are identified and classified for examination by service centers or district offices, and are further identified for the kind of audit to be performed (i.e., correspondence audit, office audit or field audit). With respect to returns classified for district office audit, significant issues are also identified.

2. Methods of Selection

a. Discriminant Function System (DIF)

The Discriminant Function System (DIF) is a mathematical technique used by IRS to classify income tax returns as to examination potential. Under the DIF system, individual returns are divided into different audit classes, each with its own DIF formula. Nonbusiness return audit classes are based on total positive income shown on the return; business returns are separated into classes based on total gross receipts. Weights are assigned to certain return characteristics in accordance with a DIF formula which varies with each audit class; the weights are then added together to obtain a composite DIF score for the return processed. Generally, the higher the score the greater the potential for a significant tax change on audit. In addition to assigning DIF scores to most returns, the computerized processing identifies income tax returns which have special features or characteristics that

may require special handling. The IRS refers to these returns as "specials," which include automatic examination returns, returns requiring prompt examination under Section 6501(d), unallowable items returns, Joint Committee cases, and returns showing foreign business transactions.

. Taxpayer Compliance Measurement Program (TCMP)

The Taxpayer Compliance Measurement Program (TCMP) is a research program for measuring and evaluating taxpayer compliance characteristics through specialized audits of individual income tax returns. Results from the TCMP audits are used to develop the basis for changes to the DIF formulas and update the variables used in determining the DIF score. TCMP program returns are selected at random for examination and must be examined through a detailed field audit in order to obtain the required information. Results of the examination are tabulated and analyzed at the National Office and the DIF formulas updated with the information developed.

Note: The IRS has suspended the TCMP program indefinitely due to budget constraints.

c. Other Methods

(1) Claims for Refund or Credit

Upon receipt of claims for refund of previously paid taxes, IRS screens the original return to determine whether an examination should be made to substantiate the basis for the claim before payment is made.

(2) IRS Initiated Examinations

Examinations may be initiated by IRS on the basis of information received from informants or other IRS audits or programs (e.g., matching information documents such as Forms 1099), or by specific IRS compliance programs (e.g., certain exempt organizations, income

tax preparers, etc

(3). Screening and Classification of Returns

Upon receipt at a service center, income tax returns are sorted by type (i.e., individual, corporate, fiduciary, etc.), a document locator number (DLN) is recorded on each return and on any check or money order accompanying the return. The amount of the check or money order is compared to the tax due, and the return is checked for form and execution, including the presence of all necessary schedules and other required information, such as W-2 forms. Any omissions, errors or defects are resolved through direct correspondence with the taxpayer. In the first stage of computerized analysis, all individual returns are classified under the DIP system. In the second stage, DIF returns with the highest scores are made available to the Examination division for manual screening. Certain returns are classified by DIF scoring as low priority audit returns capable of being examined through correspondence audit. These returns are referred to as "CORR returns. Although DIF scores indicate examination potential, tax examiners must manually screen returns to identify issues in need of examination and to eliminate those returns where audit is not warranted. 122

Classifiers also determine the type of examination (office audit or field audit) and the scope of examination to be conducted. 123 Individual returns are generally identified for examination by either revenue agents or tax auditors, depending upon the complexity of the issues involved and the degree of auditing skills required to perform the examination. Corporation returns are identified for examination by revenue agents only. The screening process also includes the preparation of a classification checksheet that is attached to each return identified for office examination by a tax auditor. The checksheet lists significant items to be considered and whether the examination should be conducted by correspondence

or office audit. Returns are identified for correspondence examination where information concerning questionable items can readily be furnished by mail and there are indications on the return the taxpayer can effectively communicate in writing. Individual returns identified for office interview examination typically contain issues which require an analytical approach and which require individual judgment to direct verification of records. After tax returns have been selected for audit, the taxpayer may still avoid being examined by reason of a "survey" either before or after assignment to the examiner. A case may be surveyed by the group manager before assignment to an examiner if no examination is warranted or if the number of returns assigned to the group exceeds the number which the group can timely examine and process. A return can be surveyed after assignment by the examiner himself if, before contacting the taxpayer, the examiner believes an examination would result in no material change in tax liability. In either case, survey of the return results in no contact of the taxpayer (i.e., no audit) and acceptance of the return as filed. The screening process also includes the preparation of a classification checksheet that is attached to each return identified for office examination by a tax auditor. The checksheet lists significant items to be considered and whether the examination should be conducted by correspondence or office audit. Returns are identified for correspondence examination where information concerning questionable items can readily be furnished by mail and there are indications on the return the taxpayer can effectively communicate in writing. Individual returns identified for office interview examination typically contain issues to an analytical approach and which require individual judgment to direct verification of records. After tax returns have been selected for audit, the taxpayer may still avoid being examined by reason of a "survey" either before or after assignment to the examiner. A case may be surveyed by the group

manager before assignment to an examiner if no examination is warranted or if the number of returns assigned to the group exceeds the number which the group can timely examine and process. A return can be surveyed after assignment by the examiner himself if, before contacting the taxpayer, the examiner believes an examination would result in no material change in tax liability. In either case, survey of the return results in no contact of the taxpayer (i.e., no audit) and acceptance of the return as filed.

Types of Audits

. Service Center Audits

1. In General

Service center audits are conducted almost entirely by correspondence and telephone contact with the taxpayer. Returns which disclose issues not covered by the specific Service Center audit programs are transferred to the district office for screening and audit. Also, if it is determined that the taxpayer is incapable of effectively communicating in writing, or if the taxpayer requests a personal interview, the case is forwarded to the district office for examination.

2. Service Center Audit Programs

Returns are selected for service center correspondence examinations through the following specific audit programs:

- Unallowable Items
- Multiple Filer Examinations

- Matching Information Returns
- Alimony Compliance
- DIF CORR Program
- Claims
- Federal-State Cooperative Program
- Social Security Form SSA-7000 Program
- Married Persons Filing Separately
- Mathematical or Clerical Error Abatements
- Estate and Gift Tax
- IRA Contribution Limits
- Credit for the Elderly
- Self-Employment Tax
- Substitute For Return Refusal-to-File Cases
- Erroneous Refunds
- Alternative Minimum Tax
- DATC/ASTA
- Qualified Personal Service Corporations
- Taxable Gain on Sale of Residence
- Improper Zero Bracket Amount
- Monitoring Age 65
- Child Support Refund Offset
- Invalid S Corporation Elections
- Return Preparers

- Questionable Refunds

3. Audit Procedures

All service center examinations are conducted by correspondence. The service center sends the taxpayer an initial contact letter requesting information, or explaining corrections to the return along with a solicitation of the taxpayer's agreement to the corrections. The letter specifies the telephone number and name of an IRS contact person. The letter also contains a self-addressed return envelope for response and return to the service center Examination Branch. The possible responses of the taxpayer to the initial contact letter include: (a) agreement to the correction in tax liability; (b) a request for additional explanation of the correction; (c) an explanation by the taxpayer of the items questioned; (d) a request for an interview; and (e) no response or non-agreement. If the taxpayer agrees to the correction, the case is closed. A taxpayer's signature on the initial contact letter may be accepted as an agreement at any stage of the process. Cases in which the taxpayer remits the correct amount but does not sign the agreement are considered as agreed. If the taxpayer requests additional explanation by the IRS, the service center sends a letter within 30 days responding to the taxpayer's question and requesting a correction or agreement. If the taxpayer's reply contains an explanation of the item in question, and if the explanation is satisfactory, the return is accepted without change, and the taxpayer is sent an appropriate no-change letter. If the explanation is not satisfactory, a preliminary notice (a "thirty-day letter") advising the taxpayer of the proposed tax change and appeal rights is prepared. If the IRS needs any additional information after receipt of the taxpayer's explanation, the service center sends a letter to the taxpayer explaining what is required. If the taxpayer's second explanation does not provide sufficient basis for a definite determination by correspondence, the return is

transferred to the district office. If the taxpayer requests an interview (or if the IRS determines that an interview is necessary because the taxpayer cannot effectively communicate in writing), the service center transfers the case to the district office for an office interview and the taxpayer is notified of the transfer. If the taxpayer does not agree or does not respond within 30 days of issuance of the initial contact letter (60 days if the address is outside the United States), the next step is generally the issuance by the Service Center of a thirty-day letter. The thirty-day letter serves as the cover letter for an examination report. If the taxpayer requests an interview or an Appeals conference as a result of the thirty-day letter, the return is transferred to the appropriate district office for necessary action. 151

/Footnote/ 150IRM 4(13)14.1:(1) (10-20-93).

/Footnote/ 151IRM 4(13)14.1:(3) (10-23-93).

If the taxpayer fails to respond to the thirty-day letter, or if the initial contact letter is received by the taxpayer but the subsequent thirty-day letter is returned undeliverable, a notice of deficiency (a "ninety-day" letter) is issued at the expiration of the 30-day period.

152 A request for an interview or hearing with the Office of the Regional Director of Appeals after issuance of the statutory notice of deficiency is forwarded to the appropriate district office.

C. IRS District Office Audits

1. In General

District office audits can take the form of a correspondence audit, office audit, or a field audit. The determination of which type of audit to conduct is made based on the complexity

of the return, and which type of audit is most conducive to effective and efficient tax administration. IRS examiners are required to follow certain standards when examining returns:

- All large, unusual, or questionable items should be considered, including balance sheet and Schedule M items, income, deduction, credit, or classified items, and the scope of the examination should be limited or expanded to the point that all significant items are considered for the correct determination of tax liability.

- Inquiries should be made for unreported income, including consideration of internal controls for all business returns, the type of taxpayer, and the taxpayer's standard of living. Indirect methods should be used when appropriate.

- Package audit procedures should be followed, including consideration of prior and subsequent returns, related returns, and compliance items such as employment tax returns.

- Issues should be examined to the extent necessary to provide sufficient information to determine the substantially correct tax, including conducting adequate interviews, the use of adequate exam techniques, consideration and development of indicators of fraud, and sufficient development of the issues.

- Examination conclusions should be supported by a correct application of the tax law.

- Penalties should be considered and applied correctly.

- Workpapers should document the examination audit trail and techniques used, and IRS report writing procedures should be followed.

Note: Effective on July 22, 1998, under §7602(e), added by §3412 of the 1998 IRS Reform Act (P.L. 105-206), the IRS cannot use financial status or economic reality examination techniques to determine the existence of unreported income unless it has a "reasonable indication" that there is a likelihood of such unreported income.

In the audit, the examiner covers all "significant items" necessary for a correct determination of the taxpayer's tax liability. In deciding whether an item on the return is "significant," the examiner considers the following factors:

- The comparative size of the item (e.g., a \$6,000 expense item out of total expenses of \$30,000 would be significant, but not if total expenses were \$300,000);
- The absolute size of an item;
- The inherent character of the item (e.g., airplane expenses claimed on a plumber's Schedule C);
- The beneficial effect of the manner in which an item is reported (such as expenses claimed on a business schedule rather than as an itemized deduction);
- The evidence of intent to mislead (such as misleading or incomplete schedules); and
- The relationship with other items on a return (e.g., no dividends reported when Schedule D shows sales of stock).

2. Correspondence Audits

Correspondence audits are generally limited to individual tax returns and typically involve simple issues that lend themselves to resolution through direct verification from records that can be mailed to the IRS. Such issues include itemized deductions, child care expenses, interest penalty on early withdrawal of savings, IRA contributions, and self-employment tax. Most correspondence audits are performed by IRS Service Centers. District offices handle such audits in very limited circumstances, such as when a taxpayer requests that the audit be handled by correspondence rather than an office visit.

3. Office Audits

Returns selected and classified by the service center for office audit generally involve issues

that may be too complex to be resolved by mail but not complex enough to warrant a field audit. Office audits are used to handle such issues as unusual or large itemized deductions, dependency exemptions, travel and entertainment expenses, and income from rents or royalties. Office audits are usually conducted by office interview but may be conducted by correspondence if requested by the taxpayer and the examiner determines that the required information can readily be supplied by mail.

a. Initiation of Audit

An office examination is initiated by mailing a letter or telephoning the taxpayer. The taxpayer is informed that his tax return is being examined and is usually requested to furnish certain information and/or records by bringing them to an IRS office. Publication 1 (Your Rights as a Taxpayer), Notice 609 (Privacy Act Notification), and Notice 782 (Information on Tax Examinations) must be included with every initial contact letter or given to the taxpayer at the initial office interview. If a taxpayer fails to respond within the specified time limit to the initial contact letter, a no-response audit report is prepared by the examiner.

In most cases, the examination is held at the IRS office closest to the taxpayer's home. The taxpayer, however, may request that the office examination be held at a location other than the IRS office, e.g., where the taxpayer is physically unable to travel.

In some cases, the IRS may use field examination techniques subject to supervisory approval. Aside from third party contacts, field examinations are normally conducted at the taxpayer's place of business or other location where the books and reports pertinent to the examination are located or maintained. Requests by taxpayers for field examinations are generally not granted by the IRS unless the taxpayer's books and records are too voluminous

to bring to an IRS office, or other circumstances exist that clearly indicate that the examination cannot be satisfactorily completed otherwise.

Note: In connection with some office interview examinations, the IRS may visually inspect the taxpayer's place of business or personal residence. Such inspection may be beneficial in helping to give the IRS a better indication as to the size and nature of the business, business volume, etc., and may assist in resolving some issues. In making visual inspections, however, tax auditors are instructed not to infringe upon the privacy of the taxpayer and not to take photographs. 169

b. Procedures and Techniques

Some returns selected for office examination require planning, research or analysis by the examiner before contacting the taxpayer. For returns requiring pre-contact analysis, the tax auditor identifies the issues to be examined. The scope of the examination of a return not requiring pre-contact analysis is prescribed on the classification checksheet attached to each return by the service center and identifies the significant items to be considered by the examiner. However, the examiner may expand the scope to include other significant items derived from information secured during the examination.

Gross receipts are generally required to be examined in all cases, but the extent of the examination is a matter of judgment on the part of the auditor. On nonbusiness returns, the taxpayer is questioned concerning possible sources of income other than those reported. On business returns, the examiner is instructed to evaluate existing internal controls over gross receipts. In addition, the taxpayer is generally questioned with regard to sources of income, standard of living, purchases of assets, cash balances on hand and in the bank, payments on loans and receipt of borrowed funds. Based on the answers to these questions, if the auditor

has reason to believe that the taxpayer may have unreported income, alternative methods such as the bank deposits method may be employed by the examiner to verify receipts. If the examination reveals a material understatement of income in a given year, the examination may be expanded to subsequent or prior years and may possibly be referred for criminal investigation.

4. Field Audits

Business returns and individual returns with complex or financial or business activities are assigned to IRS revenue agents for examination rather than the less-skilled tax auditors.

Field examinations are normally conducted at the taxpayer's place of business or location where the books and records are maintained.

a. Initiation of Audit

The examiner contacts the taxpayer by letter or telephone to make an appointment for the time and place to start the examination. If the taxpayer requests that IRS notification be made through his representative, the examiner will do so.

The time and place of the examination are fixed by the IRS; efforts are made, however, to schedule times and places that are reasonable based on a balancing of convenience to the taxpayer with efficient tax administration. In the case of a small business, the IRS will not conduct an examination at such location if doing so would interrupt business operations or essentially require the taxpayer to close the business. This does not, however, preclude the IRS from visiting the taxpayer's business location or residence to establish facts that can only be established by a direct visit (e.g., an asset or inventory verification). A taxpayer can request that the examination not be conducted at his place of business. Such request should

be made in writing. At the beginning of an examination, the examiner should ask whether the taxpayer has any questions regarding the audit process, regular selection procedures and appeal rights, etc. Publication 556 (Examination of Returns, Appeal Rights, and Claims for Refund) is furnished to interested taxpayers. The examiner should also include Publication 876 (Privacy Act Notification) with the contact letter or to give it to the taxpayer at the initial personal contact. Any request made by an examiner for information of a nature which may be considered by a taxpayer as confidential must be prefaced with complete personal identification and the reason the information is desired. Note: The IRS will often assure the taxpayer that examination of the taxpayer's return does not suggest a suspicion of dishonesty or criminal liability. However, the agent has no authority to assure a taxpayer that his books and records will be used solely for civil purposes. If a taxpayer insists upon such assurances, the agent may discontinue his examination and report the matter to his group manager.

b. Procedures and Techniques

As the first step in a field examination, the examiner usually makes a pre-contact analysis of the return to determine which items should be examined. The revenue agent determines the scope of the audit, and has authority to expand the examination beyond the significant items identified on the checksheet or eliminate others. Examiners are generally instructed to pursue the examination to a point where he can conclude that all items necessary for a substantially correct determination of tax liability have been considered. Among other items, gross receipts are probed in the case of individual returns and returns of small corporations having assets below \$1,000,000 regardless of whether the taxpayer maintains a double entry set of books. On nonbusiness returns, the taxpayer may be questioned concerning possible sources of income other than those reported. If the return contains a

Schedule C or F, such schedules will be verified to the extent deemed appropriate by the examiner. On all types of business returns, the examiner evaluates existing internal controls over receipts. On individual returns the taxpayer may be questioned with regard to sources of income, standard of living, purchase of assets, balances of cash on hand and in the bank, payments on loans and receipts of borrowed funds. If the examiner has reason to believe that the taxpayer may have unreported income, alternative methods such as the cash transaction, T account, sources and application of funds, bank deposit analysis, or net worth analysis may be employed to verify receipts. 190 Effective on July 22, 1998, §7602(e), added by §3412 of the 1998 IRS Reform Act (P.L. 105-206), prohibits the IRS from using financial status or economic reality examination techniques to determine the existence of unreported income unless it has a "reasonable indication" that there is a likelihood of such unreported income.

Conclusion of Audit

1. Possible Outcomes of Audit

There are four possible outcomes to determinations made by the examiner on audit of a return, and his efforts to obtain the taxpayer's agreement as evidenced by the signing of a Form 870 (Waiver of Restrictions on Assessment and Collection), as follows:

- (i) No change -- The examiner proposes no change in the taxpayer's tax liability.
- (ii) Agreed -- The examiner proposes adjustments to the taxpayer's tax liability and the taxpayer agrees to sign a waiver with respect to all of the adjustments.
- (iii) Unagreed -- The examiner proposes adjustments to the taxpayer's tax liability and the taxpayer does not agree to sign a waiver with respect to all adjustments.
- (iv) Partially Agreed -- The examiner proposes adjustments to the taxpayer's tax liability and

the taxpayer agrees to sign a waiver with respect to some of the adjustments, but not to others.

Comment: The ramifications and consequences of the four possible outcomes are discussed below. In many cases, the course which the taxpayer adopts is dictated by the taxpayer's intentions. If the taxpayer does not intend to concede the tax liability, the taxpayer's representative will probably decide procedural questions with reference to the ultimate forum considered most favorable for disposition of the case (i.e., the Tax Court, the U.S. Court of Federal Claims, or a federal district court).

a. No Change Cases

If the examiner proposes no change in the taxpayer's liability, the tax liability shown on the return is accepted by the IRS as filed, and the taxpayer is so notified. 236 The no change report constitutes a final administrative determination of tax liability, and the case is closed. The case will not be reopened to try to change the taxpayer's tax liability, except under the limited circumstances described in the IRS' policies regarding the reopening of closed cases. From the standpoint of the taxpayer, his own determination of tax liability has been accepted by the IRS. Nevertheless, if the taxpayer subsequently decides that he incorrectly determined his tax liability and overpaid his tax, he may still file a claim for refund with the IRS.

b. Agreed Cases

If the examiner proposes adjustments to the taxpayer's liability, the basic choice for the taxpayer is whether he wishes to contest the adjustments. If the taxpayer does not wish to contest the adjustments, he should sign the Form 870 and pay the deficiency, thus closing

the case. By signing the Form 870, the taxpayer waives his right to a notice of deficiency and thus permits the IRS to immediately assess the tax. Signing the Form 870 waiver effectively precludes the taxpayer from contesting the adjustments by filing a petition in the Tax Court. If the taxpayer wants to contest the adjustments but does not wish to avail himself of the IRS appeals procedures or litigation in the Tax Court, he can sign the Form 870, pay the tax, and then file a claim for refund. After the examination is closed by signing the Form 870, the IRS will not reopen the case to assert additional changes in the tax liability of the taxpayer, except in limited circumstances.

c. Unagreed Cases

If the examiner proposes adjustments to the taxpayer's tax liability and the taxpayer wants to avail himself of the appeal procedures and/or file a Tax Court petition, a Form 870 should not be signed. The IRS will issue a "30-day letter" to the taxpayer. Receipt of such a letter permits the taxpayer to file a protest with the IRS Appeals office within 30 days. If the taxpayer does not file an appeal, or is unsuccessful in the appeals procedure, a "90-day letter" (i.e., a notice of deficiency) is issued to the taxpayer; the taxpayer can then file a petition for redetermination with the Tax Court before assessment of the deficiency is permitted.

d. Partially Agreed Cases

If the examiner proposes adjustments and the taxpayer is unwilling to sign Form 870 with respect to all of the adjustments, the examiner will request that the taxpayer execute a waiver covering some of the proposed adjustments. If the taxpayer signs a waiver of restrictions, the taxpayer may avail himself of the appeals procedures within the IRS and/or

petition the Tax Court for a determination concerning the proposed adjustments not covered by the waiver of restrictions. With respect to the proposed adjustments covered by the waiver of restrictions, the IRS will assess a deficiency and collect from the taxpayer the tax attributable to the proposed adjustments covered by the waiver of restrictions. The taxpayer may subsequently take the position that the proposed adjustments covered by the waiver of restrictions were incorrect and file a claim for refund for the tax paid with respect to such proposed adjustments, or, if there is Tax Court litigation, request that the Tax Court determine the correctness of the proposed adjustments covered by the waiver of restrictions.

Processing of No-Change and Agreed Cases

Generally, when the examination of a return results in no-change in tax liability, the taxpayer or his representative is notified that the reported tax liability is accepted by IRS without change (although a copy of the examination report is not ordinarily furnished to the taxpayer).²⁶⁸ In agreed income, estate and gift tax cases in which changes in tax liability are made, a taxpayer is furnished with a copy of the examination report (except for fraud or penalty cases in which criminal prosecution is recommended). Also, the taxpayer will be furnished a copy of an agreed no-change report involving a rejection of a refund claim, or a no change report in which audit adjustments affect subsequent years and IRS wants to notify the taxpayer or secure his agreement to such adjustments.

Copies of examination reports in regular agreed income tax cases are furnished to the taxpayer by the examiner at the conclusion of the examination.

However, in all other agreed income, estate and gift tax cases, the copy of the report is sent to the taxpayer after the case has cleared Quality Review. In regular agreed income tax cases where the taxpayer received a copy of the report at the conclusion of the examination,

when such a report clears the QM Staff, the taxpayer is so notified by appropriate form letter.

5. Processing of Unagreed Cases

a. Procedures Before Thirty-Day Letter

In an office audit, if the taxpayer disagrees with the proposed changes, either by letter or in person at the originating office, the group manager, if practicable, will discuss the disputed adjustments with the taxpayer in a further attempt to resolve the issues and obtain the taxpayer's agreement. 273 If after a discussion with the group manager, the taxpayer is still not in agreement, he will be informed of his appeal rights. If the taxpayer orally requests an Appeals hearing, the case is sent to Appeals. If at the conclusion of an interview examination, including any interview with the group manager, the taxpayer does not request an Appeals hearing, a thirty-day letter is issued. Upon receipt of a taxpayer request for an Appeals hearing in response to the thirty-day letter, the case is sent to Appeals.

In a correspondence examination, if the taxpayer's response indicates a disagreement and he requests an Appeals hearing, the case files are reviewed by an examiner to consider any additional information submitted that may allow the issues to be resolved at the examining level. If the additional information indicates that further development is warranted, the examiner will continue the examination. If the examiner concludes that further correspondence action should not be taken, the examiner will attempt to arrange a personal interview, and the same procedures are followed as in an office examination. If the taxpayer declines an interview, the case is forwarded to Appeals.

If the taxpayer does not respond to the thirty-day letter, the IRS attempts to contact the

taxpayer by telephone or other means to learn what course of action he intends to take. The IRS will issue a notice of deficiency without delay if the taxpayer indicates that he does not intend to take any action. The same applies if the taxpayer cannot be contacted. If the thirty-day letter is returned undeliverable, even though the initial contact letter was not returned, the IRS will try to ascertain a current address. If the taxpayer's correct address is ascertained, the correspondence is readdressed and mailed. If a current address is not obtained, the IRS mails the deficiency statutory notice to the taxpayer's last known address..

b. Thirty-Day Letter

In unagreed income, estate and gift tax cases (except for those cases involving criminal or fraud cases involving criminal prosecution and transferee liability), the taxpayer is furnished with a copy of the examination report and advised of his rights to appeal. The IRS issues a preliminary letter commonly referred to as a "Thirty-Day" letter for this purpose. The thirty-day letter requests that the taxpayer sign and return a waiver of restrictions on assessment (Form 870) if the taxpayer agrees with the findings; asks the taxpayer to submit any additional evidence or to request further discussion with an examiner; or exercise his appeals rights. The thirty-day letter informs the taxpayer that, failing to do any of the foregoing, the case will be processed on the basis of the proposed adjustments within thirty days and a notice of deficiency issued. A thirty-day letter is issued in tax change cases and in no-change cases involving fully disallowed claims for refund. Thirty-day letters are sent by ordinary mail except when the IRS considers it necessary to use certified mail. If certified mail is used, the IRS requests return receipts. 281 In the case of a joint return, the documentation of separate residences is noted in the transmittal letter of the examiner's

report, and a duplicate original of the thirty-day letter is mailed promptly to the other spouse at the address indicated. A copy of the thirty-day letter with enclosures is normally mailed to the taxpayer's representative if there is a document on file authorizing him to receive such communications. Thirty-day letters are accompanied by: (i) a copy of the examination report (excluding the transmittal letter or report of a confidential nature); (ii) an appropriate waiver form; (iii) Publication 5 (Rights of Appeal and Preparation of Protests for Unagreed Cases); and (iv) Publication 586A (The Collection Process -- Unagreed Accounts) or Publication 594 (The Collection Process -- Employment Tax Accounts).²⁸⁴ In addition, the Taxpayer Bill of Rights requires that the 30-day letter include a simple and non-technical explanation of the taxpayer's rights during an audit, the procedures for appeals, refund claims, taxpayer complaints and procedures IRS may use in assessing and collecting taxes.

When prepayment credits shown on the return are changed, the examination report accompanying a thirty-day letter will disclose separately the increase or decrease in income tax liability and the adjustment to prepayment credits. The accompanying waiver will show the net additional tax or net overassessment after the proposed change to tax liability is adjusted by the change in prepayment credits.

c. Response to Thirty-Day Letter

(1) Extension of Time

Thirty-day letters allow the taxpayer 30 days to request appeals consideration of the case, but the district director, upon request by the taxpayer or his representative, may grant extensions of time where facts and circumstances warrant. As a matter of IRS policy, extensions are granted under reasonable circumstances such as the following:

- The taxpayer retains a representative and he demonstrates a need for more time to prepare a meaningful protest.
- The taxpayer retains a new representative.
- Sickness or injury of the taxpayer or representative.
- Issues are complex, requiring considerable legal research or delving into records of prior years.

No extension is supposed to be granted unless the taxpayer makes the request in writing and states the reason why additional time is needed. Since many requests are made by taxpayers over the telephone, the IRS will grant an extension orally to be confirmed in writing upon the receipt of the written request. / If the statute of limitations will expire within 150 days and the granting of an extension will not leave sufficient time to adequately process the case, any extension is contingent on securing a consent to extend the statute of limitations on assessment. When an extension is granted, the protest due date should be stated.

Extensions are normally granted for no more than 30 days unless a sound, specific reason is advanced for more time.

(2) Agreement

If an agreement is received in response to the thirty-day letter, the case is closed under the agreed case closing procedures. If there is partial agreement, but no protest is received, the case file will await either protest or default.

(3) Protest

If the taxpayer submits a written protest and/or requests Appeals consideration, the case file and written protest are transferred to the Appeals Office serving the district office. A protest will generally be reviewed within seven calendar days of receipt to determine whether the

protest is adequate, whether the case requires further development by the examiner, whether the examination report should be modified and whether the written protest includes the necessary information. When a protest is inadequate, the protest is returned to the taxpayer for perfection.

d. No Response to Thirty-Day Letter

(1) Issuance of Notice of Deficiency

If the taxpayer fails to respond to the thirty-day letter a notice of deficiency is issued subject to all of the following conditions:

- it reasonably appears that the taxpayer or his representative received the thirty-day letter or, if not received, that a reasonable effort was made to have it delivered;
- the thirty-day letter could not be delivered because the taxpayer moved and left no forwarding address or the taxpayer is temporarily away and is not expected to return within a reasonable period of time (or has not returned after a reasonable extension of time is granted);
- follow-up action was taken without success; and
- the notification required by Section 534(b) in cases involving alleged unreasonable accumulation of earnings and profits has been issued.

Note: If a taxpayer who previously indicated his intent to file a protest fails to do so within the time allowed, the district office issues a letter to allow an additional 15 days within which to file the protest.

Protest Requirement

Upon receipt of a 30-day letter, the taxpayer obtains Appeals consideration by filing a protest and, in some cases, submitting a formal written protest. A written protest is not

required in any office examination case. Where the total amount of proposed additional tax, penalties, or claimed refund for any taxable period exceeds \$10,000, however, a formal written protest is required to invoke Appeals jurisdiction. A written protest must be filed with the District office within 30 days from the date of issuance of the 30-day letter. The IRS will grant extensions of time to file in certain situations.

Circumstances under which the IRS will grant extensions, include:

- A taxpayer retains a representative who needs more time to prepare a meaningful protest;
- A taxpayer retains a new representative;
- The taxpayer or his representative is ill;
- The case involves complex issues, requiring considerable legal research or factual development. To receive an extension, the taxpayer should file a written request with the district office before the expiration of the 30-day period. If the statute of limitations will expire within 150 days, the extension is contingent on the taxpayer extending the statute of limitations on assessment. 517

/ There is no official IRS form for submitting protests, but the protest must contain the following information:

- (i) A statement that the taxpayer wants to appeal the findings of the examiner to the Appeals Office;
- (ii) The name and address of the taxpayer;
- (iii) The date and symbols on the 30-day letter;
- (iv) The tax periods or years involved;
- (v) An itemized schedule of the adjustments with which the taxpayer disagrees;
- (vi) A statement of facts supporting the taxpayer's position in any contested factual issue;

(vii) A statement outlining the law or other authority on which the taxpayer relies; and

(viii) A declaration under penalties of perjury that the statement of facts is true to the best knowledge of the taxpayer(s). The following language is acceptable for this purpose: Under penalties of perjury, I declare that the facts presented in my written protest, which are set out in the accompanying statement of facts, schedules, and attached statements, are to the best of my knowledge and belief, true, correct and complete.

If the taxpayer's representative prepares or files the protest, the protest must also contain, in addition to a duly executed power of attorney, a declaration indicating whether the representative prepared it and whether the representative knows based on own knowledge that the information in the protest is true. The protest letter is filed with the district director, in duplicate, and forwarded to the Appeals Office.

Comment: A protest is in the nature of a brief, marshalling facts and arguments to persuade the Appeals officer that the taxpayer's position on the issues and questions in dispute is correct. Although the protest itself contains a sworn statement of facts, the taxpayer's representative should consider the submission of documentary and/or affidavit evidence in support of the stated facts. The protest should deal with defects and deficiencies in the examiner's report, such as improperly framed issues or misstatements of facts.

D. Appeals Procedures

1. Preliminary Review

In all non-docketed cases, the Appeals Officer makes a preliminary review of the case to determine whether the case should be returned to the District director for further development before consideration by Appeals. Circumstances that constitute grounds for returning a case include, but are not limited to: (i) the protest fails to set forth the taxpayer's

position or is otherwise seriously deficient; (ii) substantial additional information is required to resolve an important issue, (iii) the failure to secure timely consents extending the period of limitations for assessment; or (iv) significant unresolved factual variances exist between the examination report and the protest.

2. Consents Extending Statute of Limitations

In any case (other than an estate tax case) involving a deficiency in tax or additional tax in which the statutory period for assessment will expire within 60 days, Appeals will request that the taxpayer execute a consent to extend the limitations period. When less than 180 days remain in the statutory period in an estate tax case, Appeals will accept the case if there is sufficient time to consider and close the case and assess the tax. If there is not sufficient time to consider the case, the estate's representative is immediately notified, and the reason for not considering the case in Appeals will be explained. If the representative believes the case can be settled within the remaining time and desires a conference to discuss the issues, Appeals will ordinarily accept the case. Otherwise, if a consent is not signed, the case will be returned to the District Director..

3. 90-Day Cases

If, after issuance of a notice of deficiency, the district director receives a belated protest with a request for consideration by Appeals, the case will be forwarded to the appropriate Appeals office. If Appeals decides after review that consideration should be given to the case during the 90-day period, the district is so notified. If Appeals concludes that consideration should not be given during the 90-day period, the file is returned to the district, and the taxpayer promptly notified. If no settlement is needed, a letter is mailed to the taxpayer reminding him of the deadline for filing a Tax Court petition at least 15 days before the deadline

expires. Appeals may waive jurisdiction in a 90-day case to the district director who issued the statutory notice unless criminal prosecution has been recommended and not finally disposed of, or the determination in the statutory notice includes the fraud penalty. The waiver of jurisdiction is provided in writing in the name of the regional director of Appeals and operates to vest in the office of the Assistant Commissioner (International), a district director, or a service center director sole jurisdiction of the case during the 90-day period.

4. Docketed Cases

The IRS has special procedures for handling docketed cases. In general, settlement authority is divided between Appeals and District Counsel. Docketed cases are usually referred by District Counsel to Appeals unless the deficiency notice was issued by Appeals. If Appeals issued the notice, cases are also referred unless District Counsel concludes that it is unlikely that the case can be partially or fully settled within a reasonable period before trial. Cases are returned to District Counsel if there is no progress or if the case is set on a trial calendar. Cases are also returned to allow for adequate trial preparation. Appeals generally has sole authority to settle referred cases. If a case is returned to District Counsel, sole authority to dispose of the case by trial or settlement reverts to District Counsel.

Cases are usually transferred between District Counsel and Appeals so as to promote the most efficient disposition of the case. Certain docketed cases, however, are not transferred. These cases include disclosure cases, exempt plan/employee plan declaratory judgment cases, and cases relating to the status of government bonds.

6. Appeals Conferences

Appeal attempts to schedule conferences on dates and at places reasonably convenient to taxpayer and representatives. Proceedings before Appeals are informal. 533 Testimony

under oath is not taken, although matters alleged as facts may be submitted in the form of affidavits, or declared to be true under penalties of perjury. Taxpayers may represent themselves or designate a representative to act for them. Appeals may consider new information or evidence submitted by the taxpayer. However, appeals will refer new material to the district office for verification and comment if such material would have a significant impact on an important issue in the case or if verification by the appeals officer would be a time-consuming process. Where it appears that important new information or evidence was purposely withheld from the district office or would require extensive verification and consideration by the district office, Appeals may return the entire case to the district office and relinquish its jurisdiction. The procedures for requesting technical advice from the IRS National Office with respect to a legal issue in a case before the Appeals Office are essentially the same as those for audits. In cases involving only a few relatively simple issues, a settlement may be reached at a single conference. 536 If the Appeals officer decides that further factual development of the issue or issues is necessary, he can request the taxpayer to submit additional information -- this may necessitate a further conference. Appeals will generally give serious consideration to an settlement offer from the taxpayer on a basis which reflects the weighing of the relative merits of both parties' positions against the hazards of litigation. The IRS, however, does not settle cases based on the "nuisance value" of the case to either party. If the initial offer is made in good-faith but is unacceptable, the IRS generally provides guidance so as to provide the taxpayer with a better idea of what type of settlement offer would be acceptable. If the taxpayer reaches an agreement with Appeals, or, in the absence of compromise, the Appeals officer recommends action favorable or unfavorable to the taxpayer, the case is reviewed internally. If a decision to take

unfavorable action is approved, the taxpayer has no right to a conference with the reviewing official. If a settlement or request for favorable action is disapproved on review, the taxpayer is so advised in writing, and is entitled to a hearing with either the Appeals officer or the reviewing officer. Hearings are not provided if the government's interest would be injured by delay (e.g., in a case involving the imminent expiration of the statute of limitations)

Unagreed Cases. If, after a settlement conference has been conducted and a settlement as to the unagreed issues has not been reached, then Appeals will close the case as unagreed and return it to the District Office for issuance of a Ninety Day Letter. The Taxpayer's only option at this point is the filing of a Petition with the Tax Court or allowing the tax to be assessed, paying same and filing a claim for refund action in Federal District Court.