

33 Business Audits

■ Tab 33 Contents ■

Examination Letters	33-1
Industries/Professions Tax Centers	33-1
Websites	33-1
IRS Audit and Appeals Process (IRS Pub. 556)	33-1
Taxpayer Advocate Service (TAS)	33-1
Guide to an IRS Audit	33-2
Conduct of the Audit	33-3
Audit Strategy	33-3
Concluding the Audit	33-3
Appeals	33-4
Taxpayer Advocate Service	33-5
Internal Revenue Manual Part 4. Examining Process	33-5
Examination Process	33-5
Worker Classification	33-6
IRS Audit Techniques for Businesses	33-7
Minimum Income Probes	33-8
In-Depth Examinations of Income	33-8
Formal Indirect Methods—IRS Audit	33-9
Partnership Audit Rules	33-9
Partnership Distributions—Disguised Sales	33-10
Audit Techniques Guides (ATGs)	33-10
Industry Issue Resolution (IIR) Program	33-10
Monitoring of Authorized IRS e-File Providers	33-11

Examination Letters

30-Day Letter. A notice from the IRS giving the taxpayer 30 days to appeal the proposed adjustments.

90-Day Letter. A notice of deficiency, also called a statutory notice of deficiency, is sent by the IRS to the taxpayer by certified or registered mail. The taxpayer has 90 days to file a petition with the Tax Court.

Industries/Professions Tax Centers

For links to websites that provide industry and profession specific tax and other related information, go to: www.irs.gov/businesses/small-businesses-self-employed. Under “Information For” click on “Industries/Professions.”

Websites

<https://childcareta.acf.hhs.gov/licensing>

National Database of Child Care Licensing Regulations. Links to state agencies that regulate daycare.

<https://archive.org>

Internet Archive. Historical copy of available archived copies of a website. May be able to see how the website appeared in the year under audit.

www.bizstats.com

BizStats. Business/industry statistics and financial ratios.

www.bls.gov

U.S. Bureau of Labor Statistics. Labor economics and statistics information.

<https://farm.ewg.org>

Environmental Working Group. Searchable by individual or business name and lists payments made by the United States Department of Agriculture (USDA) to the farmer.

www.linkpopularity.com

Link Popularity. Used to identify websites with hyperlinks that are linked to the taxpayer’s website.

www.nass.usda.gov

USDA National Agricultural Statistics Service. USDA-maintained website publishing information by state and county on crop yields, production levels, and farming custom rates.

www.whois.com

Whois? Database of domain names and identities.

IRS Audit and Appeals Process (IRS Pub. 556)

Action	Taxpayer Response
IRS issues 30-day letter as result of examination	<p>Option 1. The taxpayer can request a meeting with the IRS Appeals Division. The 30-day letter will provide contact information. A formal written protest or small case request may also be required.</p> <p>Option 2. The taxpayer can take no action and wait for the IRS to issue a 90-day Notice of Deficiency. A request may be made for the IRS to issue the Notice of Deficiency so the taxpayer can proceed to court.</p> <p>Option 3. The taxpayer can pay the tax.</p>
IRS issues statutory Notice of Deficiency (90-day letter)	<p>Option 1. The taxpayer can petition the Tax Court within 90 days. A petition cannot be filed until receipt of the 90-day letter.</p> <p>Option 2. The taxpayer can pay the tax then file a claim for a refund. This keeps the case open.</p> <p>Option 3. If the taxpayer takes no action, the tax is assessed and an appeal is not allowed.</p>
Taxpayer petitions Tax Court	If the taxpayer disputes the Tax Court decision, the taxpayer may file an appeal with the U.S. Court of Appeals. No appeal is allowed if the case was heard under the Small Case Procedures.
U.S. District Court/Court of Federal Claims (after IRS rejects taxpayer’s claim for refund)	If the taxpayer paid the tax assessed with a 90-day letter, files a claim for a refund, and the IRS rejects the claim, the taxpayer can take the case to U.S. District Court or Court of Federal Claims. The taxpayer has two years from the rejection of the refund claim to sue. The taxpayer must wait to file the suit either until the claim is rejected by the IRS or six months after the claim was filed.
U.S. Court of Appeals	If the taxpayer disputes the findings of the Tax Court, the U.S. District Court, or the Court of Federal Claims, the taxpayer may file with the U.S. Court of Appeals.
United States Supreme Court	If the U.S. Court of Appeals rules against the taxpayer, the U.S. Supreme Court is the next step. However, the U.S. Supreme Court chooses which cases to hear.

Taxpayer Advocate Service (TAS)

The TAS assists taxpayers whose issues fall into one of these main categories. Final determination of assistance is made by a TAS Advocate.

Category	Reason
Financial hardship	<ul style="list-style-type: none"> Experiencing financial hardship or are about to suffer financial hardship. Facing an immediate threat of negative action. Will incur significant costs if relief is not granted. Will suffer irreparable injury or long-term adverse impact if relief not granted.
IRS system issue	<ul style="list-style-type: none"> Have experienced a delay to resolve a tax account problem. Have not received a response or resolution to the problem or inquiry by the date promised. An IRS system or procedure has either failed to operate as intended, or failed to resolve the problem or dispute with the IRS.
Fair and equitable treatment	<ul style="list-style-type: none"> The manner in which the tax laws are being administered raise consideration of equity, or impair taxpayer rights. Compelling public policy warrant assistance to an individual or group of individuals.

Guide to an IRS Audit

Cross References

- IRS Pub. 1, *Your Rights as a Taxpayer*
- IRS Pub. 556, *Examination of Returns, Appeal Rights, and Claims for Refund*
- IRS Pub. 3498, *The Examination Process*
- IRS Pub. 4227, *Independent Office of Appeals*

Related Topics

- IRS, Penalties, and Audits, Tab 15
- Accounting Procedures, page 27-11

Taxpayer Bill of Rights

IRS Pub. 1, *Your Rights as a Taxpayer*, includes the Taxpayer Bill of Rights and is sent to taxpayers when they receive IRS notices on issues ranging from audits to collections.

IRS Audit

An IRS audit is a review of an organization's or individual's accounts and financial information to ensure taxpayers are complying with tax laws and reporting the correct amount of tax.

Notification. The IRS notifies taxpayers of an audit by mail only. If the taxpayer has any questions about what is required, contact the individual reflected in the heading of the letter as the "Person to Contact."

Note: The IRS does not notify a taxpayer of an audit via telephone or email. The IRS does not initiate contact with taxpayers via telephone, email, text messages, or social media channels to request personal or financial information. This includes requests for PIN numbers, passwords, or similar access information for credit cards, banks, or other financial accounts.

Representing taxpayers. The IRS has established the following representation rights for tax return preparers.

- Attorneys, CPAs, and Enrolled Agents are the only tax professionals with unlimited representation rights. They can represent a taxpayer on matters including audits, payment/collection issues, and appeals.
- Annual Filing Season Program (AFSP) Record of Completion participants have limited representation rights. They can represent only taxpayers whose returns they prepared and signed, and only before revenue agents, customer service representatives, and similar IRS employees, including the Taxpayer Advocate Service.
- An individual can represent himself or herself.
- A corporate officer, general partner, full-time employee, or fiduciary can represent the entity that he or she is associated with.

Practice before the Tax Court. Only attorneys or individuals who have passed a written Tax Court examination are allowed to represent taxpayers in Tax Court.

Audit selection. When a return is selected for audit, it does not suggest that the taxpayer made an error or is being dishonest. Returns are chosen for audit by:

- **Computer scoring.** Returns may be selected based on comparison with statistical norms from the National Research Program (NRP).
- **Document matching.** If the income reported on the taxpayer's return does not meet or exceed the amounts reported to the IRS on Forms 1099 and W-2, the taxpayer will receive either a bill for tax on the difference or an audit notice.
- **Worker reclassification.** The IRS conducts employment audits to determine whether workers classified as independent contractors are in fact employees.
- **Other sources.** A tax return may be selected as a result of information received from other sources on potential noncompliance

with the tax laws or inaccurate filing. This information can come from sources such as newspapers, public records, individuals, and related examinations on business partners or investors.

Notice of IRS contact of third parties. The IRS must give a taxpayer reasonable notice before contacting other parties such as banks, employers, employees, or neighbors about his or her tax matters. However, the IRS is not required to provide notice of contact of third parties in cases such as:

- Pending criminal investigation,
- When notice would jeopardize collection of any tax liability,
- Where notice may result in reprisal against any person, or
- When the taxpayer authorized the contact.

Amended return. Filing an amended return does not affect the selection process of the original return. However, amended returns also go through a screening process and the amended return may be selected for audit.

Location and date. Generally, appointments will be at either an IRS office or the taxpayer's place of business (in-person audit). However, some audits are conducted via mail (correspondence audit). Appointments should be scheduled in a timely manner so the audit can be completed in the shortest period of time and to reduce interest charged if it is determined additional tax is due. The IRS tries to schedule the initial appointment within a few weeks of first contacting the taxpayer related to the audit.

Length of audit. The length of an audit varies depending on the type of audit, what the issues are within the audit, availability of requested information, and scheduling.

Extensions. Taxpayers may request an extension if more time is needed to respond to an IRS audit. The IRS will ordinarily grant a one-time automatic 30-day extension and will contact the taxpayer if unable to grant the extension request. If the taxpayer receives a Notice of Deficiency by certified mail, the IRS cannot grant additional time for submitting supporting documentation. The IRS cannot extend the time to petition the Tax Court beyond the original 90 days.

- **Correspondence audits.** For audits conducted by mail, fax a written request to the number shown on the IRS letter received. If unable to fax, mail the request to the address shown on the IRS letter.
- **In-person audits.** For in-person audits, contact the auditor assigned to request an extension. If necessary, contact the auditor's manager.

Records

The IRS will provide the taxpayer with a written request for the specific documents the auditor will want to review. The taxpayer should submit photocopies of all items during the audit, and should not submit original documents.

The IRS accepts some electronic records that are produced by tax software and may request those in lieu of or in addition to other types of records.

Generally, records must be retained for a period of three years from the date the tax return was filed, with some exceptions such as for business assets. Failure to do so may result in assessment of penalties. Records may be reconstructed if they are missing or destroyed.

Records that might be requested. Every audit focuses on specific aspects of a return but will most likely include the following items.

- **Receipts.** Present receipts by date with notes on how each relates to the business. Certain kinds of receipts can prove mileage as well as dollar amounts.
- **Invoices.** Include the name of the recipient, type of product or service, and date paid.

continued on next page

- **Cancelled checks.** Group cancelled checks with copies of the invoices they paid.
- **Legal papers.** Include a description of the case and how it relates to the business.
- **Loan agreements.** Include a copy of the loan agreement including the terms and end of year statement along with a breakdown of how the money was used.
- **Logs or diaries.** Logs can be used to show the dates and locations of travel as well as the business purpose and mileage.
- **Theft or loss documents.** Include a brief explanation of the loss including photos or video, if available, and insurance or police reports detailing the damage.
- **Employment documents.** Include payroll reports, continuing education requirements, and other employment policies.

If the IRS conducts an audit by mail, it may also require the taxpayer to fill out a questionnaire.

Organizing the records by year and type of income or expense and including a summary of transactions will speed up the process and help prevent errors or misunderstandings.

Conduct of the Audit

The IRS manages audits either by mail (correspondence audit) or through an in-person interview to review the taxpayer's records. The interview may be at an IRS office (office audit) or at the taxpayer's place of business or their accountant's office (field audit). The taxpayer will always be contacted initially by mail. The IRS will provide all contact information and instructions in that letter.

Audit Techniques Guides (ATGs). Depending on the type of business and the issues in the audit, IRS examiners may use one of the ATGs to assist them. These guides can give the taxpayer a good idea of what to expect during the audit. For a list of these guides, see *Audit Techniques Guides (ATGs)*, page 33-10.

Correspondence audit. If the IRS conducts the audit by mail, the letter will request additional information about certain items shown on the tax return such as income and expenses. If the taxpayer has too many records to mail, an in-person audit may be requested.

In a correspondence audit, the taxpayer can act on their own behalf, or have a representative correspond with the IRS. This representative must be an attorney, Certified Public Accountant (CPA), enrolled agent (EA), or an enrolled actuary. Unlike the designations listed above, an Annual Filing Season Program (AFSP) participant may also represent a taxpayer, but only for the returns that the participant signed and prepared. This person must be authorized using Form 2848, *Power of Attorney and Declaration of Representative*.

In-person audit. If the audit is conducted in person, it can take place at the taxpayer's place of business, an IRS office, or the office of the taxpayer's representative. For an in-person audit, the taxpayer is allowed to:

- Act on their own behalf. The taxpayer may be allowed to consult with their representative.
- Have someone accompany them, either to support the taxpayer's position or to witness the proceedings.
- Accompany someone who will represent them. This person must be an attorney, CPA, EA, or an enrolled actuary. Unlike the designations listed above, an Annual Filing Season Program (AFSP) participant may also represent a taxpayer, but only for the returns that the participant signed and prepared.
- Have a representative act on their behalf. The taxpayer need not attend the audit in person. This representative must be authorized using Form 2848, *Power of Attorney and Declaration of Representative*.

Audit Strategy

To prepare for an audit, the representative or taxpayer should take the perspective that he or she is auditing the return and look for anything possible to increase the tax liability on the return.

Review all issues raised in the audit and prepare documentation to support the position taken in the return and/or be prepared to accept increases in income or relinquish questionable deductions or credits. The documentation substantiating income, deductions, and credits on the return should be organized by year and by the tax item.

In response to a question, answer the specific question succinctly and honestly. Do not provide information unrelated to the question. For questions that the representative or taxpayer does not know the answer to or is unsure about, offer to get the information and provide it to the auditor.

Be prepared for several types of questions including:

- Open-ended questions framed to require a history, a sequence of events, or a description.
- Close-ended questions to obtain definitive information on dates, names, and amounts.
- Probing questions intended to pursue an issue more deeply.
- Leading questions to confirm what the examiner believes to be true.

Concluding the Audit

An audit can be concluded in one of three ways.

- 1) **No-change.** A no-change audit is an audit in which the taxpayer has substantiated all the items being questioned by the IRS and results in no changes. If the return is accepted as filed, the IRS will issue a "no-change letter," and no further action by the taxpayer is required.
- 2) **Agreed.** An agreed audit is an audit where the IRS has proposed changes and the taxpayer understands and agrees with the changes. The taxpayer will be asked to sign the examination report or similar form. If the taxpayer owes money, the following payment options are available.
 - Pay in full,
 - Apply for an installment agreement, or
 - Apply for an offer in compromise.

Payment Plans—Business¹

All required returns must have been filed and the taxpayer must owe less than \$25,000 in combined tax, penalties, and interest.

Plan Option	Fees ²
Monthly Direct Debit Installment Agreement (DDIA) ³	<ul style="list-style-type: none"> • \$22 setup fee (online). • Plus accrued penalties and interest until balance is paid in full.
Monthly non-Direct Debit Installment Agreement	<ul style="list-style-type: none"> • \$69 setup fee (online). • Plus accrued penalties and interest until balance is paid in full.
Revise or reinstate existing payment plan	<ul style="list-style-type: none"> • \$10 fee (online).

¹ Sole proprietors apply for a payment plan as an individual.

² Setup fees are higher if applying by phone, mail, or in-person. Low-income taxpayers may qualify for reduced or waived setup fees.

³ Required for balances over \$10,000.

Go to www.irs.gov/payments/online-payment-agreement-application to apply online.

For more information on offers in compromise, see *Offer in Compromise (OIC)*, page 15-6.

For more information on payment options, see Pub. 594, *The IRS Collection Process*.

- 3) **Disagreed.** A disagreed audit is an audit where the IRS has proposed changes and the taxpayer understands but disagrees

with the changes. If the taxpayer disagrees with proposed changes, he or she may request one of the following.

- A conference with the auditor’s manager,
- Fast Track Mediation, or
- The case be sent to the Office of Appeals.

Fast Track Mediation. Fast Track Mediation (FTM) is a service offered by the IRS designed to expedite case resolution. FTM may be initiated at the conclusion of an examination or collection determination. FTM is not intended to replace the manager’s conference. The mediation session is designed to help facilitate communication between the taxpayer and the auditor and help resolve unagreed issue(s).

Appeals

The taxpayer’s reasons for disagreeing must come within the scope of tax laws. For example, the taxpayer cannot appeal a case based only on moral, religious, political, constitutional, conscientious, or similar grounds. If the taxpayer does not wish to appeal the case within the IRS, he or she may take the case directly to Tax Court.

Appeal within the IRS. If a taxpayer disagrees with the proposed changes, he or she can appeal the results of the examination in the following ways.

- For examinations taking place in an IRS office, request an immediate meet-ing with the exar supervisor.
- Use mediation services offered by the IRS, see *Mediation*, above.
- Appeal to a local IRS Appeals Office.

Independent Office of Appeals. The IRS Office of Appeals is an independent office separate from the IRS examinations and collections offices. Its role is to resolve tax disputes, without litigation, on a basis which is fair and impartial to both the government and taxpayer, and in a manner that will enhance voluntary compliance. It does not undertake investigative actions on its own.

The taxpayer is not required to request an appeal before going to court, but the appeals process is less formal, less costly, and is not subject to complex rules of evidence or procedure. In addition, the taxpayer does not give up the right to go to court by going to the Office of Appeals. Services are also offered through mediation programs. These programs are designed to help taxpayers resolve disputes at the earliest possible stage in the audit or collection process.

Appeal categories. Appeals cases generally fall under one of the following categories.

- **Collection appeals.** Collection appeals resolves cases involving collection due process, offer in compromise, trust fund recovery penalties, jeopardy levies, and collection appeals program cases.
- **Examination appeals.** Examination appeals resolves general docketed and non-docketed cases generated from the IRS examination functions.
- **Specialized examination programs and referrals.** Specialized examination programs and referrals resolves a variety of specialized programs such as international issues, estate and gift tax issues, tax-exempt and government entity issues, tax computations, innocent spouse, and art appraisal services.

Requesting an appeal. A taxpayer may request an appeal by filing a written protest and mailing it to the IRS address on the letter that explains the taxpayer’s appeal rights. Before sending the taxpayer’s case to the Appeals, the IRS Examination or Collection office that made a tax assessment or initiated collection action will consider the taxpayer’s protest and attempt to resolve the disputed tax issues. If that office cannot resolve the taxpayer’s issues, the case will be forwarded to Appeals for consideration.

Small case request. A written formal protest is required to request an appeals conference unless the taxpayer qualifies under the small case request procedures. A taxpayer may submit a small case request if the entire amount of additional tax and penalty proposed for each tax period is \$25,000 or less from an examination (audit). If the taxpayer is appealing the denial of a doubt as to liability offer in compromise, the entire amount for each tax period includes total unpaid tax, penalty, and interest due. Employee plans, exempt organizations, S corporations and partnerships are not eligible for small case requests.

Petition to the Tax Court. Upon receipt of a statutory Notice of Deficiency (90-day letter), the taxpayer has 90 days to petition the Tax Court or pay the tax and file a claim for refund. If the taxpayer takes no action, the amount will be assessed and no appeal is available.

When a Tax Court petition is received within the IRS, the representative will receive a call from Appeals to try to settle the case before it goes to the Tax Court. If a petition is not timely filed, the proposed tax will be assessed, and a bill will be sent by the IRS. In that case, the taxpayer will be prohibited from taking the case to the Tax Court or otherwise appealing the case.

Small case procedure. If the disputed amount is \$50,000 or less, the taxpayer can request the case be heard under the small case procedure. This procedure is less formal than the general procedure. Cases decided under the small case procedure may not be appealed.

Practice before the Tax Court. Only attorneys and other individuals admitted to practice before the Tax Court may represent a taxpayer. Individuals who are not attorneys but would like to practice before the Tax Court must pass a written admission examination.

IRS Audit and Appeals Process (IRS Pub. 556)

Action	Taxpayer Response
IRS issues 30-day letter as result of examination	<p>Option 1. The taxpayer can request a meeting with the IRS Appeals Division. The 30-day letter will provide contact information. A formal written protest or small case request may also be required.</p> <p>Option 2. The taxpayer can take no action and wait for the IRS to issue a 90-day Notice of Deficiency. A request may be made for the IRS to issue the Notice of Deficiency so the taxpayer can proceed to court.</p> <p>Option 3. The taxpayer can pay the tax.</p>
IRS issues statutory Notice of Deficiency (90-day letter)	<p>Option 1. The taxpayer can petition the Tax Court within 90 days. A petition cannot be filed until receipt of the 90-day letter.</p> <p>Option 2. The taxpayer can pay the tax then file a claim for a refund. This keeps the case open.</p> <p>Option 3. If the taxpayer takes no action, the tax is assessed and an appeal is not allowed.</p>
Taxpayer petitions Tax Court	If the taxpayer disputes the Tax Court decision, the taxpayer may file an appeal with the U.S. Court of Appeals. No appeal is allowed if the case was heard under the Small Case Procedures.
U.S. District Court/Court of Federal Claims (after IRS rejects taxpayer’s claim for refund)	If the taxpayer paid the tax assessed with a 90-day letter, files a claim for a refund, and the IRS rejects the claim, the taxpayer can take the case to U.S. District Court or Court of Federal Claims. The taxpayer has two years from the rejection of the refund claim to sue. The taxpayer must wait to file the suit either until the claim is rejected by the IRS or six months after the claim was filed.
U.S. Court of Appeals	If the taxpayer disputes the findings of the Tax Court, the U.S. District Court, or the Court of Federal Claims, the taxpayer may file with the U.S. Court of Appeals.
United States Supreme Court	If the U.S. Court of Appeals rules against the taxpayer, the U.S. Supreme Court is the next step. However, the U.S. Supreme Court chooses which cases to hear.

Taxpayer Advocate Service

The Taxpayer Advocate Service (TAS) is an independent organization within the IRS that helps taxpayers resolve problems and recommends changes that will prevent future problems.

The TAS helps taxpayers and their representatives, including individuals, businesses, and exempt organizations, resolve tax problems with the IRS that they have been unable to solve on their own. The TAS recommends administrative changes to the IRS and legislative changes to Congress to mitigate problems or reduce taxpayer burden. This includes large-scale (systemic) problems that affect multiple taxpayers.

The TAS helps taxpayers who have been unable to resolve tax problems with the IRS in the following situations.

- The problem is causing a financial difficulty for the taxpayer or his or her family or business,
- The taxpayer or the taxpayer's business is facing an immediate threat of adverse action,
- The taxpayer has repeatedly tried to contact the IRS, but the IRS either has not responded or has not responded by the date promised, or
- An IRS process, system, or procedure is not operating as intended, causing the IRS to fail to timely respond or resolve the taxpayer's issue.

Contact TAS at www.TaxpayerAdvocate.irs.gov, or by calling 877-777-4778.

Internal Revenue Manual Part 4. Examining Process

Cross References

- IRS Pub. 3498, *The Examination Process*
- Internal Revenue Manual, Part 4, *Examining Process*

Related Topics

- IRS Penalties and Audits, Tab 15

Part 4 of the Internal Revenue Manual provides guidance for the planning, monitoring, and identification of tax returns for field examinations. The objective is to ensure that examinations are initiated based on indicators of non-compliance or on other criteria such as selection for the National Research Program.

Examination Process

Cross References

- IRS Pub. 3498, *The Examination Process*
- Internal Revenue Manual 4.10.3, *Examination Techniques*
- Internal Revenue Manual 4.10.9, *Workpaper System and Case File Assembly*

Related Topics

- IRS, Penalties, and Audits, Tab 15

Examination Techniques

Internal Revenue Manual, Section 4.10.3, *Examination Techniques*, provides details on such topics as risk analysis, interviews, tours, and examinations of taxpayer internal controls and books and records.

Overview. Auditing includes the accumulation of evidence for evaluating the accuracy of the taxpayer's tax returns. Methods for accumulating evidence include:

- Analytical tools such as analysis of balance sheets to identify large, unusual, or questionable accounts.
- Documentation of the taxpayer's books and records to determine the content and accuracy of items claimed on the tax return.
- Inquiry through interviews of the taxpayer or third parties.
- Inspection by physically examining the taxpayer's assets such as inventories or securities.
- Observation by conducting a tour of the taxpayer's business to observe daily business operations.
- Testing by tracing transactions to determine if they are correctly recorded in the taxpayer's books and records.

Risk analysis. Risk analysis is the process of comparing the potential benefits to be derived from examining the return to the resources required to perform the examination. Factors to consider for risk analysis include:

- Fraud potential,
- Materiality,
- Corollary effect of an adjustment on net operating loss (NOL) and related returns,
- Type of adjustment (e.g., permanent or timing),
- Accuracy of books and records, and
- Hours required to audit.

Methods include use of the:

- 80/20 concept to determine the substantially correct tax liability. The 80/20 concept is value added decision making that weighs the impact of comparing potential results with the investment of additional case time.
- Mid-audit decision point (50 percent rule) to perform a risk analysis at mid-point of the examination. Applies to large business and international (LB&I) cases only.

Interviews. Interviews include the initial interview, subsequent interviews, third-party interviews, and closing interviews (conferences).

Initial interviews. Initial interviews are treated as the foundation of an effective examination. The examiner is afforded the opportunity to gain an understanding of the taxpayer's overall financial picture, the business history and operations, and an overview of the taxpayer's recordkeeping procedures. Prior to conducting the interview, the examiner is instructed to review all available taxpayer information to develop interview questions that are tailored to the taxpayer, his or her business, and the examination issues that are present.

Initial interviews are to be conducted face to face whenever possible.

Subsequent interviews. Subsequent interviews are to be conducted if the taxpayer does not provide all the information requested, more detailed explanations are needed, or a review of the examinations progress is needed.

Third party interviews. Third party interviews allow the examiner to obtain testimony from third parties who can provide information that may be relevant to determining a taxpayer's liability or ascertaining the correctness of the return.

Examiners must follow third-party contact provisions prior to making a third-party contact. The taxpayer's right to privacy must be protected when contacting third-parties by:

- Obtaining information directly from the taxpayer to the greatest extent possible.
- Not obtaining information that is not necessary and relevant for tax administration or other legally mandated or authorized purposes.
- Verifying information collected from third-parties with the taxpayer to the greatest extent possible.

Closing interviews. Closing interviews are held to solicit agreement for proposed adjustments.

Who to interview. Interviews should always be held with the person having the most knowledge of the total financial picture and history of the person or entity being examined. Generally, that person is the taxpayer.

An examiner cannot require a taxpayer who has obtained representation to accompany the representative to most examination interviews. However, the taxpayer's voluntary presence at the interview can be requested through the representative to expedite the examination process.

Taxpayers have the right to representation at any time during the examination. Generally, the interview will be suspended for ten business days to permit consultation or to obtain representation.

If the representative indicates that the taxpayer will not be present for the initial interview, the examiner should confirm with the representative that he or she has first-hand knowledge of taxpayer's business, business practices, bookkeeping methods, accounting practices, and daily operations.

If the taxpayer's representative impedes or delays the examination, then the examiner may initiate procedures to bypass the representative and deal directly with the taxpayer.

Where to conduct interviews. Office examinations will generally be conducted at the IRS office closest to the location of the taxpayer. Field examinations will generally be held at the taxpayer's residence, place of business, or where the taxpayer's books and records are maintained. In the case of a sole proprietorship, a field examination will usually be conducted at the taxpayer's principal place of business.

Interview techniques. Examiners are instructed to be able to explain what will happen during the examination and explain return selection procedures, rights to representation, and appeal rights.

Question construction. Four types of questions are used during the interview.

- **Open-ended questions.** Open-ended questions are framed to require a narrative answer. Open-ended questions are designed to obtain a history, a sequence of events, or a description.
- **Closed-ended questions.** Closed-ended questions are used to identify definitive information such as dates, names, or amounts.
- **Probing questions.** Probing questions combine the elements of open and closed ended questions. They are used to pursue an issue more deeply.
- **Leading questions.** Leading questions suggest an examiner has already drawn a conclusion or indicate what the examiner wants to hear. They are used when looking for a confirmation.

Listening skills. The examiner is instructed to accurately understand the responses to questions. Listening is enhanced through:

- Making sure that non-verbal communication contributes to comfortable atmosphere.
- Listening for the meaning of words. If the taxpayer's response is unclear, the examiner is instructed to paraphrase or repeat what was said.
- Not interrupting the taxpayer and allowing a brief pause at the end of a response. The examiner is instructed to use the time to analyze the response and formulate a follow-up question.
- Maintain eye contact with the taxpayer to demonstrate interest and observe non-verbal responses.

Documenting interviews. The elements of an adequately documented interview include but are not limited to:

- Items specific to the taxpayer such as the type of return and relevant facts or circumstances.

- Sufficient depth to give a clear understanding of the nature of the taxpayer's financial history, business history, and day-to-day operations.
- Explanations of large, unusual, or questionable items and whether explanations resolve potential issues.
- Description of books and records, financial status, and an assessment of return validity.
- An explanation of the taxpayer's accounting system and accounting methods and internal controls.

Worker Classification

Cross References

- Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*
- Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*
- IRS Pub. 1976, *Do You Qualify for Relief Under Section 530?*

Related Topics

- Independent Contractor vs. Employee, Tab 5
- Payroll and Labor Laws, Tab 23

Misclassified Workers

A worker who receives a Form 1099-NEC, *Nonemployee Compensation*, instead of Form W-2, *Wage and Tax Statement*, can file Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, so the IRS can determine if the worker should be treated as an employee. If the IRS determines the worker is an employee, and not an independent contractor, the employer will be liable for employment taxes.

For more information, see *Independent Contractor vs. Employee*, Tab 5.

Voluntary Classification Settlement Program

The Voluntary Classification Settlement Program (VCSP) permits eligible taxpayers to reclassify workers as employees for future tax periods and obtain relief similar to that available through the *Classification Settlement Program* for taxpayers under examination. [IRC §3509]

See *Voluntary Classification Settlement Program*, Tab 5.

VCSP eligibility requirements. All the following must be met:

- The taxpayer is presently treating the workers as nonemployees and has consistently done so in the past.
- All required Forms 1099 have been filed for the workers for the previous three tax years.
- The taxpayer is not currently under an employment tax audit by the IRS, Department of Labor, or any state agency concerning worker classification.
- The taxpayer must be in compliance with the results of any previous worker classification audit by the IRS or Department of Labor.

Form 8952. The taxpayer must file Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*, at least 120 days prior to the date the workers are to be treated as employees.

Effects of Participation in the VCSP

If the IRS accepts Form 8952:

<i>The taxpayer agrees that:</i>	<i>The IRS agrees that:</i>
<ul style="list-style-type: none"> All workers in the affected class will be treated as employees for future tax periods. Payment is due in full when the agreement is accepted. 	<ul style="list-style-type: none"> The taxpayer pays only 10% of the employment tax liability determined for the previous tax year under the reduced rates of IRC section 3509.* No interest or penalty will be assessed on the employment tax liability. The taxpayer will not be subject to an employment tax audit with respect to classification of the affected workers for prior years.

* See *Other Employer Relief—Worker Status*, Tab 5

Author's Comment: The IRS is not obligated to accept the taxpayer's application to participate in the VCSP. State rules may be different.

IRS Audit Techniques for Businesses

Cross References

- IRS Pub. 556, *Examination of Returns, Appeal Rights, and Claims for Refund*
- IRS Pub. 3498, *The Examination Process*

Related Topics

- Sole Proprietorships, Tab 5
- IRS Audits, page 15-7
- C Corporations, Tab 18
- S Corporations, Tab 19
- Partnerships and LLCs, Tab 20

IRS Links to Industries and Professions

For links to websites that provide industry and profession specific tax and related information, go to www.irs.gov/businesses/small-businesses-self-employed. Under "Information For" click on "Industries/Professions."

The IRS has teamed with national practitioner organizations to provide information and resources for businesses. To use these resources, go to <https://www.irs.gov/businesses/small-businesses-self-employed/payroll-practitioner-partners>.

Examination Techniques

Area of concentration. The examination of a business often begins with a review of documents that may lead to a more thorough review of the actual business ledgers and journals. This is done to identify areas the examiner should focus on in the examination process.

Items being reviewed. The examiner then uses his or her professional judgement in applying the following general approaches to the examination.

- General ledger, examination approach.** The examiner will request a general ledger and an adjusted trial balance for the business. The adjusted trial balance will be reviewed for unusual account balances. During the review of the ledger, the examiner will be alert for unusual or nonrecurring items.
 - Unusual in amount.** The examiner will be alert for month-end entries of like amounts which represent large expense items which have been debited to a deferred account and spread over several months to avoid attracting attention. The total amount of an account may be unusual in amount because it appears to be too small. For example, where there is a small repair account total in a year under examination, and the

taxpayer had substantial fixed assets, the small repair total may be indicative of the practice of charging repairs to other accounts less likely to be checked.

- Unusual by source.** Source, as used here, means the journals from which the account was posted. There is a normal source pattern for most postings. Repairs or advertising expenses are generally posted from the cash disbursement journal or the purchase journal. Further investigation may be warranted if posting from a general journal source or cash receipts journal is indicated. Fixed asset credits from the cash book are unusual.
- Unusual by nature.** Examples of unusual entries and accounts include credit entries in accounts that usually contain only debits or vice versa, accounts that exist at the beginning of the year but do not exist at the end or vice versa, or a general ledger in which the nominal accounts are not closed out to the income summary account at the end of the year. These may indicate a possible bad debt write-off, an unauthorized change in accounting method, or an unauthorized charge. It is recommended that the examiner trace these accounts to the tax return to uncover adjustments to accounts that are not reflected by entries on the books.
- Net worth, examination approach.** The purpose of examining net worth is to reconcile net income per books with net income per return. Net worth of an entity consists of net worth at the beginning of the year, operating income or loss of the current year, and non-operating transactions of the current year. A reconciliation of book retained earnings is prepared as follows:

Beginning retained earnings.....	\$x,xxx
Book income/loss (Schedule M-1, Line 1).....	x,xxx
Less: distributions.....	(x,xxx)
Subtotal.....	x,xxx
Ending retained earnings.....	x,xxx
Difference.....	\$ 0

If the difference is not zero, a reconciliation will be requested. There are two possible reasons for a difference: (1) the amounts on the balance sheet are wrong so the balance sheet cannot be relied upon, or (2) an entry has been made directly to retained earnings. An entry to retained earnings has bypassed the income statement and possibly taxable income. These entries are examined to determine if taxable income is being avoided.

- Balance sheet, examination approach.** The following are representative of a few of the balance sheet techniques recommended to examiners.
 - Review cash on hand and in the bank. Review the cash disbursements journal, noting missing check numbers, and checks drawn to order of cash, or bearer. Compare deposits shown on the bank statement with the cash receipts book.
 - Review the cash on hand account to determine if there are any credit balances during the period. This may indicate unrecorded receipts.
 - Note any credit balances in the notes and accounts receivable accounts. This may indicate deposits or overpayments that could be considered additional income or unrecorded sales.
 - Determine that accrued income on interest-bearing notes or accounts has been included in income.
 - When the taxpayer calculates accrued income by subtracting beginning accounts receivable and adding ending receivables to cash collected, the examiner should consider comparing the detailed listing of receivables at the beginning of the period to the cash receipts book. Determine if beginning receivables used in the computation are the same as the ending receivables of the preceding year. This may alert the examiner to the diverting of funds.

continued on next page

- If an investment account balance is a negative amount, then the business has most likely invested in a flow-through entity. The negative amount represents the excess of deductions over the capital contributed.
- Review the computation of year-end accruals with respect to their allowability as expenses or purchases. Are accruals that are set up at the end of the preceding year reversed in the current year or were actual expenses charged against them when paid? Watch for large year-end items that have been shifted between years for the taxpayer's advantage.
- Other liability accounts may be used to improperly defer revenue to a future period. Review and analyze the composition of other liabilities with this in mind.

Minimum Income Probes

Cross References

- Internal Revenue Manual 4.10.4.3.3, *Minimum Income Probes: Individual "Business" Returns*
- IRC §7602(e), *Limitation on examination on unreported income*

Related Topics

- IRS Audits, page 15-7

Examination Techniques

Area of concentration. The IRS provides its examiners guidance for the examination of gross income. The guidance includes minimum income probe requirements for all types of returns, in-depth examination techniques, and formal indirect methods.

Identified issues. Minimum income probes are made regardless of the type of tax return filed by the taxpayer. The minimum income probes are designed as a set of analytical tests intended to determine whether the taxpayer accurately reported income.

Items being reviewed. Minimum income probes for individual business returns include:

- Financial status analysis to estimate whether reported income is sufficient to support the taxpayer's financial activities. The financial status analysis should consider all sources of expenditures identified on the tax return. Reasonable estimates for other expenses known to exist, but for which the exact costs are not known, are included in the analysis. Personal living expenses (PLE) must be estimated using U.S. Bureau of Labor Statistics (BLS) information, except where the actual amount of the expense is disclosed on the tax return.

Example: The taxpayer's total PLE based on BLS data is \$25,000. According to the BLS data, \$4,000 of the \$25,000 represents home mortgage interest. The taxpayer included \$8,000 as home mortgage interest on Schedule A of the tax return. The BLS data needs to be adjusted to account for the actual mortgage interest expense paid. Total PLE = \$25,000 – \$4,000 + \$8,000 = \$29,000.

- An interview with the taxpayer to gain an understanding of the taxpayer's financial history, identify sources of nontaxable funds, identify e-commerce activity, and establish the amount of currency the taxpayer has on hand.
- Tour the business site and review the taxpayer's website to gain familiarity with the taxpayer's operations and internal controls, and identify potential sources of unreported income.
- Evaluate the internal controls to determine reliability of the books and records, identify high-risk issues, and determine the depth of the examination of income.
- Reconcile the income reported on the tax return to the taxpayer's books and records, including a test of sales.
- Test gross receipts by tying the original source documents to the books.

- Analyze the taxpayer's personal and business bank accounts (including investment accounts) to evaluate the accuracy of gross receipts reported on the tax return.
- Analyze business ratios to evaluate the reasonableness of the taxpayer's business operations and identify issues needing more thorough examination.
- Determine if there is internet and e-commerce income activity.

Minimum income probes for corporations and other business returns are similar to the individual business returns probes but are only expanded to include the tax returns of the related owner if specific criteria are met. Minimum income probes for corporations and other business returns include:

- A complete balance sheet analysis.
- Reconciliation of Schedules M-1, M-2, and M-3.
- Evaluation of the tax returns of significant shareholders or partners (greater than 20% direct or indirect ownership).
- Interview of the taxpayer.
- Tour of the business site.
- Evaluation of internal controls.
- Test of gross receipts or sales.
- Business ratio analysis.
- Determine if there is internet and e-commerce activity.

In-Depth Examinations of Income

Cross References

- Internal Revenue Manual 4.10.4.5, *In-Depth Examinations of Income*
- IRC §7602, *Examination of books and witnesses*
- IRC §7602(c), *Notice of contact of third parties*

Related Topics

- IRS Audits, page 15-7

Examination Techniques

Area of concentration. A more in-depth examination of income will be made if, as a result of completing the minimum income probe, the examiner identified any of the following.

- Inaccurate reporting of income from known sources,
- An inability to reconcile the income reported on the tax return to the taxpayer's books and records,
- An inability to reconcile a financial status analysis,
- Unexplained bank deposits,
- The taxpayer's internal controls are inadequate, or
- Any other reasonable indication of additional unreported income.

Identified issues. In-depth examinations of income are distinguishable from the minimum income probes by their use of third-party contacts to obtain information or evidence to reconcile income issues.

Third-party contact. Third-party contact may not be initiated by the IRS before giving advance notice to the taxpayer. The IRS must actually intend to contact the third party. The IRS must also:

- Send the notice at least 45 days before contact with the third party, and
- Specify the time period during which IRS intends to make third party contacts. This time period may not exceed one year.

Third-party communication. The IRS may contact a third party in relation to various scenarios during an examination.

- If the taxpayer is not cooperative, the examiner can issue an administrative summons to the third party. The IRS has the authority to issue a summons to any person who has information for any bona fide civil tax audit, collection purpose, or criminal investigation of offense connected with the administration or enforcement of the internal revenue laws.

- The examiner is to look at all external sources of information available to search for unreported income. For example, a credit application completed by the taxpayer to secure a bank loan may reflect income consistent with the audit adjustment proposed by the examiner.
- If the taxpayer is present, the examiner may gather information from third parties via the telephone.
- The examiner may consider it necessary to interview the third party. A summary of the interview or statement made should be prepared and signed by the third party.
- Any information obtained from third parties is to be verified, to the extent practicable, with the taxpayer or representative before any action is taken.

Formal Indirect Methods—IRS Audit

Cross References

- Internal Revenue Manual 4.10.4.6, *Formal Indirect Methods of Determining Income*
- IRC §7602(e), *Limitation on examination on reported income*

Related Topics

- IRS Audits, page 15-7

Examination Techniques

Area of concentration. Formal indirect methods used to determine tax liabilities involve the development of circumstantial proof of income.

Financial status audits. If there is evidence of expenditures by the taxpayer that do not appear to be reflected in taxable income reported, the IRS can conduct an analysis to detect the source of the income. These methods are referred to as “financial status” or “economic reality” audits. The IRS is not allowed to use these methods unless there is a reasonable indication that there is a likelihood of unreported income after using other methods. [IRC §7602(e)]

Items being reviewed. The five basic formal indirect methods of reconstructing income are:

- **Source and application of funds method.** This is an analysis of a taxpayer’s cash flow and a comparison of all known expenditures with all known receipts for the period. Net increases and decreases in liabilities are taken into account, along with nondeductible expenditures and nontaxable receipts. The excess of expenditures over the sum of reported and nontaxable income is the adjustment to income. The IRS recommends the use of this method when the taxpayer’s deductions and other expenditures appear out of proportion to the income reported, the taxpayer’s cash does not flow from a bank account which can be analyzed, and the taxpayer makes it a common business practice to use cash receipts to pay business expenses. (Internal Revenue Manual 4.10.4.6.3)
- **Bank deposits and cash expenditures method.** Income is proven through a detailed, in-depth analysis of all bank deposits, cancelled checks, currency transactions, and electronic debits, transfers, and credits to the bank accounts and identification of the taxpayer’s cash expenditures. This method is based on the theory that if a taxpayer receives money, only two things can happen: it can be deposited or spent. The IRS recommends the use of this method when the taxpayer’s books and records are unreliable, unavailable, withheld, or incomplete, the taxpayer makes periodic deposits of funds into a bank account which appear to be from an income-producing activity, the taxpayer pays most business expenses by check, and the taxpayer previously used bank account deposits to determine and report taxable income. (Internal Revenue Manual 4.10.4.6.4)

- **Markup method.** This method produces a reconstruction of income based on the use of percentages or ratios considered typical for the business under examination. Use of the taxpayer’s actual markups is required, if known. Cost of goods sold is verified and the resulting gross receipts are determined based on the markup percentage. The IRS recommends the use of this method when inventories are a principal income-producing factor and the taxpayer has nonexistent or unreliable records, and where the taxpayer’s cost of goods sold or merchandise purchased is from a limited number of sources, the sources can be ascertained with reasonable certainty, and there is a reasonable degree of consistency as to sales price. (Internal Revenue Manual 4.10.4.6.5)
- **Unit and volume method.** Gross receipts may be estimated by applying the sales price to the volume of business done by the taxpayer. The number of units or volume of business done by the taxpayer may be determined from the taxpayer’s books or from third-party sources. The IRS recommends the use of this method when the examiner can determine the number of units handled by the taxpayer and the price charged per unit, and the business has only a few types of products which are sold or there is little variation in the types of services performed, and the sales price of the merchandise or services are relatively the same throughout the tax period. (Internal Revenue Manual 4.10.4.6.6)
- **Net worth method.** The purpose of this method is to determine, through a change in net worth, whether the taxpayer is purchasing assets, reducing liabilities, or making expenditures with funds not reported as taxable income. The taxpayer’s net worth is determined at the beginning and at the end of the taxable year. The difference between these two amounts will be the increase or decrease in net worth. The taxable portion of income can be reconstructed by calculating the increase in net worth during the year, adding back the nondeductible items, and subtracting the portion of the income which is partially or wholly nontaxable. The IRS recommends the use of this method when two or more years are under examination, numerous changes to assets and liabilities are made during the period, the books and records are withheld by the taxpayer, inadequate, unavailable, or not maintained. (Internal Revenue Manual 4.10.4.6.7)

Partnership Audit Rules

Cross References

- IRS Pub. 541, *Partnerships*
- Reg. §301.6221(b)-1

Related Topics

- IRS, Penalties, and Audits, Tab 15
- Partnerships and LLCs, Tab 20

Any adjustment made during a partnership audit to items of income, gain, loss, deduction, credit, or other partnership related item is assessed and collected at the partnership level. Any penalty, addition to tax, or additional amount that relates to an adjustment made during a partnership audit, is also determined at the partnership level. Any increase in tax as a result of the audit is paid by the partnership in the year the audit is finalized at the highest rate of tax in effect for the reviewed year (37% for 2024). A partnership with 100 or fewer partners can elect out of the centralized audit regime. Affected partnerships are also prevented from amending information sent to partners after the due date of the return.

See *Centralized Partnership Audit Regime*, page 20-8.

Partnership Distributions— Disguised Sales

Cross References

- IRS Pub. 541, *Partnerships*
- IRC §707(a)(2)(B), *Treatment of certain property transfers*

Related Topics

- Disguised Sale Rules, page 20-17

Examination Techniques

Area of concentration. Partners do not usually recognize gain or loss upon receiving distributions from a partnership. The opportunity to move property in and out of partnerships without possible negative tax considerations to the partners creates the potential for abuse.

Identified issues. Transactions which are essentially sales can be disguised as tax-free distributions.

Items being reviewed. Examiners are instructed to consider the following.

- Review any material distributions of cash or property to ascertain whether the distributions meet the normal distribution safe harbors. For example, if a distribution to a partner is equal to the partner's allocable share of operating income, a disguised sale would not be indicated.
- Inspect prior and subsequent years' tax returns and Schedules K-1 for evidence of a contribution from the same partner who received a distribution. Note that under the disguised sale rules, a related contribution and distribution can occur in any order. For example, a partner may receive a distribution in Year 1 and make the contribution to the partnership in Year 2.
- Review the partnership agreement, amendments, and any internal or external correspondence pertaining to the contribution and distribution.
- Determine and document the timing of the contribution and distribution.
- Review financial statements issued by the partner and the partnership. Ascertain how the transaction was reported for financial accounting purposes and note differences between the financial accounting reports and how the transaction was reported for tax return purposes at both the partnership and partner level. Schedules M-1 and M-3 may be useful for this analysis.
- If the taxpayer is relying on the debt-financed distribution exception under Regulation section 1.707-5(b), determine if the debt has been properly allocated to the taxpayer for the purposes of the disguised sale rules.
- Documents to request include:
 - Partnership agreement and any amendments.
 - Correspondence, memoranda, and other internal or external communications relating to the contribution or distribution.
 - Documents relating to the dates of contribution and distribution. Such documents might include, for example, dates the property was entered into the partnership's books and records, evidence of ownership transfer, or property tax documents indicating the date of transfer.
 - Schedule of book and tax capital accounts to determine if there is a history of normal distributions to partners, or if this is an unusual transaction.
 - Loan documents pertaining to partnership debt associated with a contribution or distribution to determine if the liabilities are qualified or nonqualified.
 - Side agreements among the partners regarding the guarantee or repayment of partnership liabilities.
 - Financial statements issued to third parties to determine how the transactions were reported for financial accounting purposes.

Audit Techniques Guides (ATGs)

Cross References

- Audit Techniques Guides (ATGs)

Related Topics

- IRS Audits, page 15-7

The IRS uses Audit Techniques Guides (ATGs) to help examiners during audits by providing insight into issues and accounting methods unique to specific industries. While ATGs are designed to provide guidance for IRS employees, they are also useful to small business owners and tax professionals who prepare returns.

ATGs explain industry-specific examination techniques and include common, as well as unique, industry issues, business practices, and terminology. Guidance is also provided on the examination of income, interview techniques and evaluation of evidence.

The following guides can be found at www.irs.gov/businesses/small-businesses-self-employed/audit-techniques-guides-atgs.

- Activities Not Engaged in for Profit (IRS Pub. 5558)
- Advanced Coal and Gasification Project Credits (IRS Pub. 5615)
- Aerospace Industry
- Attorneys (IRS Pub. 5602)
- Capitalization of Tangible Property (IRS Pub. 5712)
- Child Care Provider (IRS Pub. 5603)
- Conservation Easement (IRS Pub. 5464)
- Construction Industry (IRS Pub. 5522)
- Cost Segregation (IRS Pub. 5653)
- Credit for Increasing Research Activities (Research Tax Credit)
- Entertainment (IRS Pub. 5774)
- Equity (Stock)—Based Compensation (IRS Pub. 5992)
- Excise Tax on Indoor Tanning Services
- Golden Parachute (IRS Pub. 5975)
- IC-DISC
- Low-Income Housing Credit (IRS Pub. 5913)
- Non-Qualified Deferred Compensation (IRS Pub. 5528)
- Oil and Gas (IRS Pub. 5652)
- Petroleum Refining (IRS Pub. 5647)
- Pharmaceutical Industry Research Credit (IRS Pub. 5931)
- Real Estate Property Foreclosure and Cancellation of Debt (IRS Pub. 5550)
- Rehabilitation Tax Credit
- Research Credit Claims: Credit for Increasing Research Activities
- Retail Industry—includes grocery stores, electronic business and online retail, retail liquor sales, mobile food vendors, gasoline service stations, motor vehicle dealerships, auto/body repair, and direct sellers (IRS Pub. 5495)
- Salary Deduction Limitation
- Split Dollar Life Insurance (IRS Pub. 5962)

Industry Issue Resolution (IIR) Program

Cross References

- Rev. Proc. 2016-19
- Notice 2005-59

Related Topics

- Sole Proprietorships and Farmers, Tab 5
- C Corporations, Tab 18
- S Corporations, Tab 19
- Partnerships and LLCs, Tab 20

IIR Program Goal

The IIR program goal is to resolve frequently disputed business tax issues that affect a significant number of taxpayers.

Business Tax Issues Appropriate for IIR

The IIR program is available to all business taxpayers served by the Small Business and Self-Employed Division (SB/SE), Tax-Exempt and Government Entities (TE/GE), and Large Business and International Division (LB&I). Business tax issues appropriate for the program will have at least two of the following characteristics.

- The proper tax treatment of a common factual situation is uncertain,
- The uncertainty results in frequent, and often repetitive, examination of the same issue,
- The uncertainty results in taxpayer burden,
- The issue is significant and impacts a large number of taxpayers, either within an industry or across industry lines, or
- The issue requires extensive factual development, and an understanding of industry practices and views concerning the issue would assist the service in determining proper tax treatment.

IIR Submission Procedures

Submissions made under the IIR program will be made available for public inspection and copying in their entirety. Submissions should not include confidential or taxpayer-specific information.

Interested parties should submit issues by email to IIR@irs.gov. The submission should include:

- An issue statement,
- A description of why the issue is appropriate for the IIR program,
- An explanation of the need for guidance,
- The estimated number of taxpayers affected by the issue, and
- The name and telephone number of a person to contact if additional information is needed.

The submission may also include a recommendation of how the issue may be resolved.

Monitoring of Authorized IRS e-File Providers

Cross References

- IRS Pub. 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*
- IRS Pub. 3112, *IRS e-file Application and Participation*
- IRS Pub. 4163, *Modernized e-file (MeF) Information for Authorized IRS e-file Providers for Business Returns*
- Rev. Proc. 2007-40

Related Topics

- Electronic Filing, page 15-13

Acceptance and Monitoring

The IRS monitors providers for compliance with Revenue Procedure 2007-40 and IRS e-file rules and requirements.

Suitability. All providers, except those that function solely as software developers, must pass a suitability check on the firm as well as all principals and responsible officials of the firm prior to acceptance to participate in IRS e-file. To safeguard IRS e-file, the IRS completes suitability checks regularly on providers, principals, and responsible officials. If the results of a suitability check indicate that a firm or individual does not meet or adhere to IRS e-file requirements, the IRS may revoke or sanction the provider from participating in IRS e-file.

IRS e-file monitoring. The IRS monitors providers through review of IRS records and during visits to providers' offices and other locations where providers perform IRS e-file activities. During monitoring visits, the IRS may investigate complaints and ensure compliance with IRS e-file rules. Monitoring may include, but is not limited to the following.

- Reviewing the quality of IRS e-file submissions for rejects and other defects.
- Checking adherence to signature requirements on returns.
- Scrutinizing advertising material.
- Examining records.
- Observing office and security procedures.
- Checking tax compliance on the firm.
- Checking tax compliance on all principals and responsible officials.

In addition, the IRS may monitor providers for compliance with the tax return preparer regulations, including provisions of IRC section 6695(g), *Other assessable penalties with respect to the preparation of tax returns for other persons*, which relates to preparer due diligence requirements for certain tax benefits. These include the Earned Income Credit, the American Opportunity Credit, the Child Tax Credit/Additional Child Tax Credit/Credit for Other Dependents, and Head of Household filing status claimed on individual returns.

Revocation

The IRS may revoke participation of a firm, a principal or a responsible official in IRS e-file if either a federal court order enjoins them from filing returns, or if they are prohibited by a federal or state legal action that would prohibit participation in e-file. A type of such legal action is a federal executive order, including Executive Order 13224 (September 23, 2001), which involves prohibitions directed at individuals and entities that commit, or pose a significant risk of committing, acts of terrorism or that provide support, services, or assistance to, or associate with, terrorists and terrorist organizations.

They are not entitled to an administrative review process for revocation of participation in IRS e-file if the IRS denies or revokes a provider, principal, or a responsible official because of a federal court order enjoining filing of returns or a federal or state legal action that prohibits participation in filing of returns. If the injunction or other legal action expires or is reversed, the revoked provider may reapply to participate in IRS e-file after the injunction or other legal action expires or is reversed.

Sanctioning

Violations of IRS e-file requirements may result in warning or sanctioning principals, responsible officials, and the provider. The IRS may sanction any provider when the firm or any of its principals or responsible officials fails to comply with any requirement or any provision of any publication or notice that governs IRS e-file. The IRS may also sanction for the same reasons that it denies an application to participate in IRS e-file. Before sanctioning, the IRS may issue a warning letter that describes specific corrective action the provider must take. The IRS may also sanction without issuance of a warning letter.

Sanctioning may be a written reprimand, suspension or expulsion from participation from IRS e-file, depending on the seriousness of the infraction. The IRS categorizes the seriousness of infractions as level-one, level-two, and level-three. The firm, principal or responsible official may appeal sanctions through the administrative review process. Suspended providers and individuals are usually ineligible to participate in IRS e-file for a period of either one or two years from the effective date of the sanction, but they may reapply after resolution of suitability issues. Individuals of firms

expelled from participation may be eligible for reconsideration after five years.

In most circumstances, a sanction is effective 30 days after the date of the letter informing of the sanction or the date the reviewing offices or the IRS Independent Office of Appeals affirms the sanction, whichever is later. In certain circumstances, the IRS can immediately suspend or expel a firm, principal, or responsible official without warning or notice. When a firm, principal, or responsible official is suspended or expelled from participation in IRS e-file, all other e-file applications for which the same individuals are involved may also be subject to the same sanction.

The IRS may list in the Internal Revenue Bulletin, newsletters, or other media the name and owner of any entity suspended, expelled, or revoked from participation in IRS e-file and the effective date of the IRS action.

Level-one infractions. Level-one infractions are violations of IRS e-file rules and requirements that, in the opinion of the IRS, have little or no adverse impact on the quality of electronically filed returns or on IRS e-file. The IRS may issue a written reprimand or other sanctions for a level-one infraction.

Level-two infractions. Level-two infractions are violations of IRS e-file rules and requirements that, in the opinion of the IRS, have an adverse impact upon the quality of electronically filed returns or on IRS e-file. Level-two infractions include continued level-one infractions after the IRS has brought the level-one infraction to the attention of the provider. A level-two infraction may result in suspension from participation in IRS e-file for one or two years depending on the severity of the infraction.

Level-three infractions. Level-three infractions are violations of IRS e-file rules and requirements that, in the opinion of the IRS, have a significant adverse impact on the quality of electronically filed returns or on IRS e-file. Level-three infractions include continued level-two infractions after the IRS has brought the level-two infraction to the attention of the provider. A level-three infraction may result in suspension from participation in IRS e-file for two years, or depending on the severity of the infraction, such as identity theft, fraud, or criminal conduct, it may result in an immediate suspension or expulsion without the opportunity for future participation. The IRS reserves the right to suspend or expel a provider prior to administrative review for level-three infractions.

Administrative Review Process

The firm, principals, and responsible officials of denied applicants and sanctioned providers are entitled to an administrative review. The administrative review process can be a two-step process.

- **Step 1.** The firm, principals, or responsible officials must request an administrative review in writing by the office that denied or sanctioned them. If the reviewing office upholds the denial of the sanction, then
- **Step 2.** The firm, principals, or responsible officials may appeal the denial or sanction by submitting a written signed appeal request to the IRS Independent Office of Appeals.

Failure to request either an administrative review or appeal within 30 calendar days of the date of any denial or sanction letter, terminates the right to an administrative review or appeal.

Administrative review process for denial of participation in IRS e-file. Firms, principals, or responsible officials denied participation in IRS e-file usually have the right to an administrative review in the form of a written, signed appeal. They may fax a written response to 877-477-0567 or mail it to the address shown in the denial letter, within 30 calendar days of the date of the denial letter. The applicant's response must address the IRS' reason(s) for denial, have supporting documentation, and be signed. During this administrative review process, the denial of participation remains in effect. Upon receipt of a timely written response, the IRS reevaluates its denial of the participation in IRS e-file. The IRS may either issue an acceptance letter or a subsequent denial letter.

A firm, principal, or responsible official who receives a subsequent denial letter is entitled to an appeal. They must submit the appeal in writing to the attention of the IRS Independent Office of Appeals, by faxing a written response to 877-477-0567 or mailing it to the address shown in the subsequent denial letter within 30 calendar days of the date of the denial letter. The written appeal must contain a detailed explanation that addresses the denial, along with documentation supporting why the IRS should reverse the decision.

The administrative review process for sanctioning. Firms, principals, and responsible officials have the right to an administrative review if the IRS advises of either a proposed, recommended or immediate sanction. They can fax or mail a signed, detailed written explanation with supporting documentation as to why the IRS should reverse its decision and not impose the sanction within 30 calendar days of the date of the letter to the office that issued the letter. During this administrative review process, an immediate sanction remains in effect.

Upon receipt of a written response, the IRS reviews the appeal and issues a letter indicating whether the sanction was upheld or reversed. If a firm, principal, or responsible official receives a letter affirming a suspension or an expulsion, they can appeal to the IRS Independent Office of Appeals. The appeal must be in writing, signed, and faxed or mailed to the IRS office that issued the recommended sanctioning letter within 30 calendar days of the date of the letter. The written appeal must contain detailed reasons, with supporting documentation, to show why the IRS should reverse its decision and not impose the recommended suspension or expulsion.

Reconsideration after expulsion. Individuals that cannot participate in IRS e-file because their firms were expelled may be reconsidered after a five-year waiting period. This period begins five years from the date the firm was expelled or five years after the individual has completed rehabilitation (for example incarceration, parole, probation, or restitution). Some expulsion situations are not eligible for reconsideration.

To request consideration, fax 877-477-0567 or mail a letter to: Internal Revenue Service, Electronic Products and Services Support, 310 Lowell Street, Stop 983, Andover, MA 01810.

The individual must provide an explanation as to why he or she should be allowed to reapply and include a copy of the expulsion letter with any pertinent documents to support their position. In addition, all eligibility requirements to participate in IRS e-file must be met. The taxpayer will be notified in writing regarding the request.