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The IRS Is Regularly Auditing Taxpayers Again

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The IRS is targeting a multitude of taxpayers in the newest wave of audits, including high-income individuals, partnerships, corporations and limited liability companies. Expect an IRS auditor with a sharpened pencil who has received extensive training recently and has already worked on the types of issues expected in your audit multiple times within the last year or two.

Also, the auditor will have plenty of help from international examiners, engineers, and excise and employment tax specialists, who will be on the team or available at a minute's notice. Many times, the auditor may not tell you that she has already been in contact with other IRS counsel. An auditor who suspects fraud will engage the services of an IRS fraud referral specialist who, behind the scenes, will help the auditor to determine if a firm indication of fraud exists.

Following are a few areas with which the IRS may be concerned.

Section 263A Inventory Adjustment. Fact-intensive analysis for capturing capitalizable inventory costs allows the IRS to create large adjustments. Although the taxpayer is entitled to use "reasonable method" for allocation, this method must be reasonable relative to IRS methodologies in Section 263A regulations. Also, these methodologies are fraught with fact issues not easily resolved with Exam. A common IRS technique here is to examine the taxpayer's computations in other areas, such as the I.R.C. Sec. 199 production deduction, as a means for discrediting the reasonableness of its Section 263A computation, as the two are often not congruous.

Section 183 – The Hobby Loss Rules. Many Schedule F (farm or ranch) and Schedule C (second business) clients have several years of losses by the time the IRS audits their returns. The IRS often perceives that losses from a farm, ranch or second business may shelter or offset income earned from a taxpayer's profitable line of business. Also expect scrutiny under I.R.C. § 469 and the material-participation standards.

Accumulated Earnings Tax. The AET is a penalty tax equal to 15 percent on retained earnings of a C corporation. The AET analysis looks at the reasonable business needs and anticipated expenditures of the corporation at the end of the tax year. Anything beyond the reasonable business needs, in simple terms, is accumulated earnings subject to penalty tax. Questions dealing with AET appear in every opening audit conference for C corporation clients.

2 1/2 Month Rule for Deferred Compensation. Although only a timing issue, this element can be significant for end-of-year bonus accruals. According to the deferred compensation rules, compensation accrued at year-end that is not actually paid within 2 1/2 months thereafter is presumed to be deferred comp and not deductible until the year of payment. Overcoming this presumption is incredibly difficult, and therefore it is best to

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simply advise clients to pay accrued compensation before March 15 (based on a calendar year taxpayer).

Zero-Income Foreign Corporation Returns. The IRS has been auditing a series of small foreign corporations that filed zero-income returns. In most cases, these clients believed that filing such a return was an important protective measure regardless of the corporation's nexus to the United States. Naturally, the IRS is finding a permanent establishment necessary for taxation.

S Corporation Basis. Consistent with several recent measures designed to curb perceived S corporation abuses, the IRS is cracking down on several methods resulting in an increase to S corporation basis. The increased basis often frees up losses. The IRS still employs the traditional economic outlay analysis for testing whether the shareholder receives basis in the loans it makes to an S corporation. This analysis basically analyzes whether the loan proceeds originated from the taxpayer's pocket. This is often not the case, with the funds coming from other related entities.

Focus on the Tax Preparer. The IRS is actively looking to impose special penalties specifically on tax return preparers. New LMSB Procedures instruct examiners to determine IRC § 6694 violations in every case and further advise that taxpayer interviews should serve the dual purpose of furthering both investigations.

Family Limited Partnership Discounts. The IRS continues to target FLPs with their IRC § 2036 attacks and in-house valuation experts. For taxpayers seeking review in Tax Court, IRS has dug in its heels based on the recent Holman case and the court's finding of only a 12.5 percent marketability discount.

Foreign Accounts. In every audit, the IRS is asking about foreign accounts and transactions. All too often, a taxpayer has failed to disclose the existence of a foreign account on the Schedule B of his Form 1040 Individual Income Tax Return along with failing to file a separate FBAR (Treasury Form T.D.F. 90-1.22) disclosing the foreign account. The penalties can be severe and include civil and criminal components.

Anything Else Foreign. The IRS can be suspicious of various foreign transactions. Despite the global economy, the IRS often views transactions that occur offshore as efforts to hide income.

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