



# CLIENT TALK

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## IRS INCREASES TAX AUDITS

### IRS AUDITS FOCUS ON BUSINESSES

I attended the 2nd Annual IRS Tax Symposium at Douglass College on January 7-8, 2003. The Internal Revenue Service announced it is shifting its audit priorities to *small businesses*. Besides increasingly focusing audits on businesses, the new IRS approach is to closely examine *tax avoidance, tax shelters, and nonfiling*. It will generally go after promoters first, then look to participants in tax-avoidance schemes.

IRS and State Tax audits have concentrated on businesses and higher income taxpayers in the past and the taxing agencies are continuing to choose higher income and business returns for examination. Good computerized records help organize the *detailed documentation needed* during a tax audit.

### AUDIT AREAS

The IRS will increase resources for audits in specified areas. These include:

- Identifying and pursuing *promoters of abusive schemes, shelters and trusts*, and the participants in these tax-evasion efforts;
- *High income taxpayers* with matching programs comparing K-1 forms from partnerships and LLC with income reported by the taxpayer;
- *Structuring transactions* to lower tax with limited economic significance;
- High income *non-filers*;
- *Unreported business income*;
- *Offshore credit cards*;
- *National Research Project* where unlucky taxpayers are subjected intrusive examinations an line by line audits.

### ABUSIVE SCHEMES

The IRS is emphasizing audits on “abusive tax-avoidance schemes.” These include:

- inflated expenses
- false deductions
- unallowable credits or excessive exemptions
- making frivolous return arguments
- promoting slavery reparation claims
- abusive shelters and trusts
- and employment tax schemes.

The “Common Law Trust” and 16<sup>th</sup> Amendment non-ratification schemes, which are continuously rejected in Court, are subject to particularly harsh treatment.

### HIGH-RISK, HIGH-INCOME TAXPAYERS

High-income returns usually are more complex, and upper income taxpayers have resources to engage in passthrough entities such as partnerships, trusts and corporations. The IRS has begun to *match K-1 forms from passthrough entities*. Verifying the income on these returns requires an audit.

Starting in 2003, the IRS will use a combination of filters to identify high-risk, high-income returns. The returns selected for examination will be those most likely to have *unreported income* or “*structured transactions*.” (The IRS defines a structured transaction as one with limited economic benefit whose primary purpose is to reduce or eliminate a tax liability.)

### UNREPORTED INCOME

The IRS has created the *Unreported Income Discriminant Index Formula* (UIDIF) in its



FEBRUARY, 2003

computers to identify returns with a high probability of having unreported income. All returns will receive a UIDIF score and the traditional DIF score, which is now used to assess the probability of inaccurate information on a return.

### OFFSHORE CREDIT CARD PROJECT

Offshore credit cards are not against the law, but they do raise a **red flag** to the IRS of possible tax evasion. These credit cards provide easy access to offshore funds and accounts in tax havens where income can easily be hidden.

The IRS has taken major steps to combat tax-avoidance schemes involving credit cards issued by offshore banks. IRS agents have summoned MasterCard and Visa for a list of users from offshore banks. They will extend this to the other major cards withing the next year.

The IRS has already developed more than 1,000 cases in New Jersey for civil audits or potential criminal investigations and is expanding resources in fiscal years 2003-2004 for these cases. ***The Criminal Investigation Division is emphasizing the prosecution of unreported income using offshore accounts and credit cards.***

### NATIONAL RESEARCH PROGRAM (NRP)

**NRP** examinations are used to update the statistical research and identify reporting compliance issues for the IRS computer models. There will be 3,500 of these extensive audits in New Jersey. Approximately 140 - 200 will be a line-by-line audit. They will be very expensive for the unlucky taxpayers.

### HANDLING AN IRS AUDIT

IRS auditors, known as **Internal Revenue Agents**, and their criminal counter part, **CID** (Criminal

Investigation Division) **Special Agents** have extensive training and education. Without the assistance of a qualified tax lawyer before the audit even starts, a taxpayer is starting behind the IRS professionals.

### PREPARING FOR THE AUDIT

The first step is calling your tax and business lawyer, and alerting your accountant. You should:

- Engage a tax attorney, in addition to your accountant to represent you during the audit process.
- Gather your accounting records and all tax returns for the years being audited
- Defer all of the Auditor's questions to your tax attorney and accountant.

### DO NOT WAIT TO SEE HOW THE AUDIT

#### "TURNS-OUT" TO CONSULT A TAX LAWYER

Winning the audit requires **preparing for the audit**. Good preparation is more than simply gathering the documents demanded. Identification of the **tax law issues and factual areas of contention** require the experience and knowledge of a tax attorney. Even if a CPA or professional accountant prepared the return, the approach of the **tax attorney is to advocate for the taxpayer**. Immediately, arrange for an initial consultation to prepare for the audit.

### TAX RETURN PREPARATION

Besides QuickBooks and Peachtree Consulting and training, at the request of many of our clients, my legal assistants can **prepare** your Federal and State Business and Personal **Tax Returns**. Please call me.