Chapter Twelve

**Tax Administration and Tax Planning**

**Learning Objective 12.1 The Internal Revenue Service**

The Internal Revenue Service (IRS) helps administer the tax laws in the United States. The IRS has the responsibility to determine, assess and collect internal revenue taxes and enforces other provisions of the tax law. The IRS is a division of the U.S. Treasury Department, an administrative branch of the federal government. The IRS is headquartered in Washington, D.C., has seven processing sites and various operational offices throughout the United States. The head of the IRS, the Commissioner of Internal Revenue, is appointed by the President of the United States and must be approved by the Senate.

The IRS Restructuring and Reform Act of 1998 called for a complete reorganization of the IRS. The act required the IRS to reorganize based on taxpayer needs rather than geographical location.

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| Office | Responsibility |
| Large Business and International (LB&I) | Taxpayers with assets of $10 million or more and the International Program |
| Small Business/Self-Employed (SB/SE) | Small business taxpayers including individuals who file business forms with their tax returns |
| Wage and Investment (W & I) | Taxpayers whose primary income is derived from wages and investments and who do not file business forms with their tax returns |
| Tax Exempt & Government Entities (TE/GE) | Tax exempt and government entities |
| Criminal Investigation | Law enforcement activities |
| Office of Professional Responsibility (OPR) | Regulating enrolled agents, attorneys, and CPAs who practice before the Service |
| Whistleblower Office (WO) | Handling information that helps uncover tax cheating and providing appropriate rewards to whistleblowers |

Of these IRS divisions, the most significant to individual and small business taxpayers are the Small Business/Self-Employed (SB/SE) and the Wage and Investment (W & I) offices.

The IRS has the authority to examine a taxpayer’s books and records to determine taxes due and to summon taxpayers and make them appear before the IRS and produce necessary documentation. The IRS may also summons third parties, such as accountants, banks and brokers, for documentation.

###### Learning Objective 12.2 The Audit Process

One of the IRS’s primary functions is to audit tax returns. An office audit is typically for individuals with little or no business activity. The taxpayer takes the necessary documentation to a district office where a revenue agent reviews the information. In a field audit, an IRS agent reviews the necessary documentation at the taxpayer’s place of business or the office of a taxpayer’s accountant. A correspondence audit is conducted entirely by mail.

The IRS uses a computerized statistical sampling technique to select returns to audit. The process is called Discriminate Function (DIF) System. Using a formula, a return is assigned a DIF score, which represents the potential of improper treatment of an item on the return. The IRS also used a random selection system in past years. Other returns may be audited by information from informants, other governmental agencies, news items and associated tax returns.

After a return is selected for audit, three possibilities exist. The first is that examination may not require any changes in the tax reporting. The second is that the tax liability is changed and the taxpayer either collects a refund or pays any amount owed. The third outcome is that the taxpayer and the IRS agent do not agree and an appeal is filed. Once the appeal is begun, an appellate agent is used to examine the situation. If there is not an agreement then, court proceedings may take place.

### Learning Objective 12.3 Interest and Penalties

Interest is charged to taxpayers when there is an underpayment of taxes and interest may be paid to a taxpayer if the taxes were overpaid. The interest used by the IRS is based on the short-term federal rate. The IRS provides taxpayers with tables regarding the rates. If a taxpayer does not a file a timely return, the taxpayer is subject to a penalty equal to 5 percent of the tax due with the return for every month or portion of a month that it is late (25 percent maximum). If not filed to defraud the government, the penalty raises to 15 percent per month up to a maximum of 75 percent. Taxpayers are also subject to penalties for failure to pay the taxes due with the return. Failure to pay penalty is ½ of 1 percent of the amount due for every month or portion that the payment is late, up to a maximum of 25 percent. A 20 percent penalty for inaccurately filed returns can be levied for negligence or disregard of the rules and regulations, a substantial understatement of income tax or a substantial valuation overstatement. Fraudulent tax returns can be assessed a penalty of 75 percent. The tax laws also have several miscellaneous penalties for various taxes, such as payroll and withholding taxes.

### Learning Objective 12.4 Statute of Limitations

The statute of limitations for most returns is three years from the date filed or due date, whichever is later. Exceptions include fraudulent tax returns, a tax return that excluded 25 percent of the taxpayer’s gross income, or a return including a bad debt or worthless security.

### Learning Objective 12.5 Preparers, Proof and Privilege

Tax practitioners, including commercial preparers, enrolled agents, attorneys and certified public accountants (CPAs), complete tax returns for clients. Enrolled agents are individuals who have passed an IRS exam. Tax practitioners are subject to rules regarding the filing, processing and record-keeping of tax returns. Unlike most litigation in the United States, the burden of proof is typically on the taxpayer. The IRS Restructuring and Reform Act of 1998 has helped move the burden of proof from the taxpayer to the IRS in many circumstances. Specifically, the burden of proof is automatically shifted to the IRS when the IRS uses statistical calculations to reconstruct an individual’s income or the court proceeding against an individual involves a penalty or addition to tax. The 1998 Act also included nonattorneys authorized to practice before the IRS as having attorney-client privilege.

**Learning Objective 12.6 The Taxpayer Bill of Rights**

The Taxpayer Bill of Rights was created as a result of horror stories involving individual’s confrontations with the IRS. The set of provisions involves the taxpayer’s right to be informed about the processes of the IRS.

Learning Objective 12.7 Tax Planning

Tax planning is arranging financial affairs to minimize tax liability. The process is encouraged as long as legal methods are used. When illegal methods are used, tax planning is replaced by tax evasion, which is subject to fines, penalties and incarceration. Tax planning; however, should never outweigh the overall business goals. Additionally, all tax planning requires that taxpayers understand taxes and avoid tax traps. Taxpayers must also understand tax terminology. The average tax rate is the rate applied to the taxpayer’s income. The marginal tax rate represents the rate at which tax is imposed on the “next” dollar of income. The marginal tax rate is the most important tax rate in tax planning. Tax planning is particularly focused on timing of transactions.