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 *determines, assesses and collects* taxes and enforces other provisions of the tax law
  + Division of U.S. Treasury Department
  + Headquartered in Washington, D.C. - 7 IRS Campus Processing Sites and various operational offices throughout the United States
  + The Commissioner of Internal Revenue is appointed by the President and must be approved by the Senate.

*The IRS Restructuring and Reform Act of 1998 called for a complete reorganization of the IRS.*

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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 |
| Return Preparer Office | Registers and promotes a qualified tax professional community |
| Office of Online Services | Develops and executes strategies to update and integrate IRS Web services |

* Small Business/Self-Employed (SB/SE) serves individuals filing Form 1040, Schedules C, E, F or Form 2106
  + And all other businesses with assets until $10 million
* Wages and Investment (W&I) Division helps taxpayers understand/comply with applicable tax laws and protects public interest

The IRS can examine a taxpayer’s books/records to determine taxes due and to summon taxpayers to 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
  + Taxpayer takes documentation to a district office - revenue agent reviews
* *In a field audit*, an IRS agent reviews documentation at taxpayer’s business or accountant’s office
* *A correspondence audit* is conducted entirely by mail

The IRS uses a computerized statistical sampling technique to select returns to audit - called *Discriminant Function System (DIF*)

* Each return is assigned DIF score
  + Represents the *potential of improper treatment of an item on the return*
* A random selection system has also been used
* 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, an agent is assigned

* After audit, three possibilities exist
  1. Examination may not require any changes in the tax reporting
  2. The tax liability is changed and the taxpayer is either refunded or pays back taxes
  3. 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 if underpayment of taxes and may be paid to taxpayer if taxes were overpaid equal to the short-term federal rate + 3%

* *If taxpayer does not a file a timely return*, taxpayer is subject to a penalty = 5% of the tax due for every month or portion of a month that it is late - 25% max
* *In failure to file is fraudulent*, penalty becomes 15%per month - 75% max
* Also subject to penalties *for failure to pay the taxes due with the return* of ½ of 1% of amount due for every month or portion that the payment is late - 25% of amou7nt due max
* A 20% penalty for *inaccurately filed returns* can be levied
  + For negligence or disregard of the rules and regulations
  + Substantial understatement of income tax or
  + Substantial valuation overstatement.
* *Fraudulent tax returns* can be assessed a penalty of 75%
* Also 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 3 years from date filed or due date, whichever is later
* Exceptions include fraudulent tax returns, a tax return that excluded 25% or more of gross income, or a return including a bad debt or worthless security
* If no return filed - no statute of limitations

### Learning Objective 12.5 Preparers, Proof and Privilege

Tax practitioners, including commercial preparers, enrolled agents, attorneys and CPAs complete tax returns for clients

* *Enrolled agents* are individuals who have passed an IRS exam
* Registered Tax Return Preparer (RTRP) requiring preparers to get PTIN is *effectively disbanded* - the IRS now operates the *Annual Filing Season Program (AFSP)*
  + A voluntary tax return preparer program to encourage preparers to take continuing education
* Various penalty provisions are applicable to tax return preparers, for example failure to sign a tax return, keep of copy of prepared return or for endorsing/cashing a refund check issued to a taxpayer

Unlike most litigation in the United States, the burden of proof is typically on the taxpayer

* The Restructuring and Reform Act (IRRA) 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
  + Statistical calculations use to reconstruct an individual’s income or
  + Court proceeding against an individual involves a penalty or addition to tax
* The IRRA *extended attorney-client privilege of confidentiality in tax matters to non-attorneys authorized to practice before the IRS*

**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

* Provisions involve the taxpayer’s right to be informed about the processes of the IRS and
* Expands taxpayers’ rights and remedies when if in disputes with IRS

Learning Objective 12.7 Tax Planning

Tax planning is *arranging financial affairs to minimize tax liability*

* Encouraged as long as legal methods are used
  + Subject to fines, penalties and incarceration
  + Tax planning should never outweigh the overall business goals
    - Must recognize difference between *“average” tax rate and “marginal” tax rate*
    - Marginal tax rate is that 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, jurisdictional choices and/or entity decisions
* When illegal methods are used *tax planning becomes tax evasion*