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OUTSIDE COUNSEL

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For Whom the Bell Tolls: How the IRS Picks Audit Targets

By Bryan C. Skarlatos and Fran Obeid
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As April 15 rolls around again, every citizen faces the task of voluntarily disclosing his or her own income tax liability. Of course, the concept of "voluntary disclosure" is a misnomer because filing a tax return and paying taxes is not really voluntary. There are stiff monetary and even criminal penalties for those who fail to file a return or pay the correct amount of tax. A more accurate description of what happens every April 15 is that Americans "self-assess" their tax liability.

However, many of us don't do a very good job of self-assessing. A study conducted by the Internal Revenue Service (IRS) shows that Americans underpaid their federal taxes by $290 billion in 2001, the most recent year for which such numbers are available.[1] That figure, known as the Tax Gap, is the IRS' best estimate of the difference between the amount of federal taxes owed and the amount of federal taxes actually paid in a given year. The annual Tax Gap has grown by nearly $100 million in the 10 years preceding 2001, indicating that the level of taxpayer compliance declined significantly during that period. According to the IRS, the $290 billion Tax Gap for 2001 represents a compliance rate of just under 85 percent.[2]

The IRS polices taxpayers' efforts at self-assessment by conducting audits. Given the size of the nation's budget deficit, there is no doubt that Congress will continue to pressure the IRS to reduce the Tax Gap by collecting more taxes. Over the past few years, Congress has steadily increased the IRS' budget for audits and enforcement. The president's most recent budget for fiscal 2009 requested approximately $7.5 billion for IRS enforcement activities, an increase of seven percent over the current year's budget.[3] The proposed budget includes several new enforcement tools and initiatives, including more audits of high-income individuals and corporations, new information-matching techniques, expanded research programs and more criminal prosecutions.

Even before lawmakers began to focus on tax collections, the rate at which the IRS audited taxpayers had been on the rise. The IRS audited 0.77 percent of all individual tax returns filed in 2004, and that percentage increased to 0.98 percent in 2006. However, for individual returns that reported more than $100,000 of income, the risk of audit was much higher, rising from 1.25 percent in 2004 to 1.67 percent in 2006. The risk of audit is even higher for individual returns reporting more than $1 million of income. The percentage of such returns that were audited rose from 5.03 percent in 2004 to 6.30 percent in 2006.[4]

So, how does the IRS decide who to audit? There are many old wives' tales about why returns get selected for examination. For example, it is widely assumed that handwritten returns are audited more frequently than typed returns and that a return that is filed on the due date (e.g., April 15 or the first business day thereafter) will simply get "lost in the shuffle." Others believe that if a return is put on extension and filed as late as legally possible, the IRS will be so backlogged reviewing other returns that it won't notice the delayed return. These theories, though popular, are wrong.

The IRS has several specific procedures designed to flag returns for audit. The first review begins when the return is received at the IRS service center. The return is stamped with a document locator number that allows the IRS to identify and track that specific return as it makes its way through the system.[5] IRS employees then give the return a quick manual review to ensure that it is signed, all required schedules and forms are attached and the accompanying check matches the tax due on the return.[6]

The manual reviewers also look for certain types of returns that justify a second look. These include amended returns, gift and estate tax returns, returns with net operating losses, large capital losses, returns requesting refunds, returns reporting a foreign bank account, returns reflecting foreign business transactions, information returns with respect to controlled foreign corporations, and returns that just look suspicious because of questionable items of substantial amount. Returns that present these kinds of issues are generally more likely to be questioned by the IRS.

After the manual review, data from the return is converted to electronic format by entering into a

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computer database information such as the identity of the taxpayer, the date the return was received by the IRS and the amount on each line of the return. A program checks the return information for obvious errors, arithmetic mistakes, use of the wrong tax table, inconsistent information, and deductions or credits that exceed statutory limits. Returns that contain such errors either trigger a summary assessment notice, which is mailed to the taxpayer, or the return is designated for further review, which can lead to a more extensive audit. Additionally, a taxpayer's audit history may trigger further review of the taxpayer's return, particularly when the history indicates an intent to deceive or failure to keep adequate records.

Secret Formula

• ***Discriminate Index Function.*** After the initial manual and computerized review of the return, the return data is electronically analyzed by a top-secret formula known as the Discriminate Index Function (DIF). The DIF formula is a very closely guarded secret because it is used by the IRS to determine which returns to audit.[7] Indeed, lawsuits seeking to force the IRS to disclose the DIF formula have failed and Congress ultimately passed a law prohibiting disclosure of standards or formulas used by the IRS to select returns for audit.[8]

The DIF formula is based on taxpayer filing and reporting characteristics based on data collected during extensive audit programs known as the Taxpayer Compliance Measurement Program (TCMP) and, more recently, the National Research Program (NRP). These programs consist of in-depth audits of thousands of taxpayer returns. These audits are more extensive and detailed than most and are designed to collect data on hundreds of different return characteristics. This data is used to evaluate situations that give rise to underpayments of tax and to create baselines for different types of taxpayers and tax returns.

In essence, the DIF formula compares characteristics of particular items on a tax return, such as the ratio of charitable deductions to gross income, with statistical averages for such ratios. The DIF formula then assigns a score to the return based on whether the items on the return deviate from the statistical information.

For example, assume that the NRP data indicates that a lawyer earning $250,000 per year in the New York metropolitan area typically has between $2,750 and $3,500 of charitable deductions and $1,000 to $1,500 of unreimbursed business expenses. The DIF computer program will review a similarly situated taxpayer's return to determine whether the taxpayer's deductions for charitable donations and unreimbursed expenses fall within those ranges and, if they don't, the DIF will assign a score to the return. Based on these types of comparisons, the DIF formula classifies returns by assigning relative weights to hundreds of return characteristics and then produces an overall DIF score for each return. The overall DIF score ranks returns according to the likelihood that an examination of the return will reveal an underreporting of tax.[9]

The DIF formula also designates certain returns as "special" returns that require further review. Some examples of special returns include returns with missing or questionable Schedules C, D, E, F or Form 4797 (Supplemental Schedule of Gains and Losses); returns reporting home office expenses, like-kind exchanges, or large noncash charitable contributions; returns with international issues; nonresident returns; returns requesting large refunds; and returns reporting large amounts of self-employment income. Of course, returns reflecting certain reportable tax shelter transactions are automatically sent for screening by specially trained agents.[10]

Once a return has been flagged by the DIF formula, IRS employees further review the return to determine its audit potential, or the likelihood that an audit will reveal an underpayment of tax. During this review, examiners focus on the items that produced the high DIF score and look for things such as inconsistencies between taxpayer's occupation and the deductions reported on the return, misclassification of long-term and short-term capital gains or losses, and large deductions of items that may be personal, such as travel and entertainment expenses, insurance premiums, legal fees or bad debts.[11] Examiners will also attempt to determine whether income and deductions reported on the return provide the taxpayer with sufficient living expenses.[12]

Recent IRS budgets have increased the amount of money allocated to researching taxpayer behavior and patterns for use in the audit selection process. Accordingly, it is likely that the DIF program, or similar tools, will continue to be an important source of IRS audits.

Info Return Matching

Another primary source of IRS audits is the Information Return Matching Program. In addition to selecting returns for audit according to their DIF score, IRS computers also match information reported on a taxpayer's return with information received from information returns filed by third parties. These third-party information returns include W-2s, 1099s, 1098s, as well as information returns from partnerships, trusts and subchapter S corporations. Such third-party reports account for 80 percent of personal income received by individual taxpayers.[13]

It is easy to imagine how an IRS agent can use a form W-2 or 1099 to determine whether income reported to the IRS by the payor of the income has been picked up by the taxpayer. Further, the IRS has been known to conduct special audit programs to determine whether taxpayers in a particular industry are filing proper tax returns. For example, IRS examiners may pull forms 1065 prepared by law firm partnerships to get the taxpayer identification numbers and amounts of income allocated to individual partners. It is then a simple matter for an examiner to run the taxpayer identification numbers to determine whether the partners have filed tax returns and reported the proper amount of income.

More often than not, however, a discrepancy between a third-party information return and a taxpayer's tax return will not generate an automatic audit. Instead, the IRS will simply send out a letter advising the taxpayer of the discrepancy and requesting the taxpayer to explain or fix the problem. In 2005, the matching program resulted in the IRS making 3.5 million nonaudit taxpayer contacts, resulting in $12 billion in additional taxes and penalties.[14]

In general, it is very difficult for taxpayers to get away with failing to report income that has already been reported to the IRS. Accordingly, the IRS is seeking to increase the amount of information that third parties must report to the IRS. For example, the IRS had determined that a significant portion of the Tax Gap is attributable to taxpayer errors in reporting the amount of their basis on sales of stock. If taxpayers inflate the basis for a sale of stock, then the resulting capital gain will be lower. For this reason, Congress is considering legislation that would require brokers and other financial institutions to include taxpayers' basis in stock that has been sold on forms 1099 that are filed with the IRS.

In addition to comparing taxpayer information with third-party payor forms, the IRS can also cross-check taxpayer returns with forms required to be filed by banks and other financial institutions concerning cash transactions. These forms include Currency Transaction Reports (IRS Form 4789); Reports of International Transaction of Currency or Monetary Instruments (Customs Form 4790); IRS Forms 8300, which are required to be filed by any person who receives more than $10,000 in cash from one or more related transactions in the course of a trade or business; and Suspicious Activity Reports, which are required to be filed by financial institutions to report unusual transactions.

Related Taxpayer Audits

Many audits are also triggered by an audit of a related taxpayer. For example, an audit adjustment to a partnership or subchapter S return will flow through to the returns of the shareholders or partners. Depending on the issues involved, the IRS may also choose to initiate a full-blown audit of the partner or the shareholder. Conversely, the audit of one partner or shareholder could trigger an audit of other partners or shareholders in the same entity.

In many cases, if two taxpayers have engaged in business transactions together, the audit of one taxpayer can easily lead to an audit of the other. For example, if an audit of a small business reveals that the business made a large cash expenditure for goods or services, the IRS may follow up with the supplier of the goods or services to determine whether the receipt of the cash was reported as income. Similarly, an audit of a check-cashing business routinely leads to audits of the people who cashed the checks because the IRS is aware that the cash from the checks may not have been reported on an income tax return. Almost every transaction reported on a taxpayer's return involves another taxpayer, so it is not uncommon for an audit to spillover into an audit of a related taxpayer. These types of audits are particularly dangerous because the IRS begins the audits with significant information about the taxpayer's business dealings.

Whistleblowers

Other sources of IRS audits are whistleblowers or "squealers" who contact the IRS to turn in another taxpayer. Because the IRS has limited resources and does not have the time to track down general suspicions or dead-end leads, an unsolicited contact from an informant generally will not trigger an audit unless the informant has detailed information and some evidence of under-reporting. Thus, the most dangerous whistleblowers are people who are in a position to have firsthand knowledge of a taxpayer's under-reporting, such as an unhappy business partner; a disgruntled employee, often a controller or bookkeeper; or a former spouse.

Many informants are motivated not only by their desire to cause trouble for another taxpayer, but also by the hope of receiving a monetary reward. Historically, the IRS has been very reluctant to pay rewards to informants. However, that has recently changed. In February 2007, Congress enacted a new law that requires the IRS to pay whistleblowers between 15 and 30 percent of any taxes, penalties and interest collected from a taxpayer if the whistleblower provided information that caused the IRS to take action against the taxpayer.[15] There are some limitations on the types of cases eligible for a reward. The amount of tax, interest and penalties in dispute must be in excess of $2 million and, if the taxpayer being informed on is an individual, the individual must have gross income in excess of $200,000 per year for the years involved.[16] In the first 10 months after the new law was enacted, the IRS' Whistleblower's Office already had more than 80 cases and more are sure to follow.

There are also a number of other sources for IRS audits. Regulator agencies, such as the Securities and Exchange Commission or the Commodities Futures Trading Commission may send a report to the IRS concerning improper securities transactions, industrywide investigations, improper cash payments and narcotics. The IRS also watches for news articles concerning unusual business transactions, large cash windfalls, allegations of financial wrongdoing, or the theft of cash or valuables which the IRS believes to have been unreported as income, all of which may trigger an audit. Additionally, the IRS has audited taxpayers who work in a particular industry. Such industry audits have included tax-return preparers, casino dealers, self-ordained ministers, waiters and waitresses and private duty nurses.

Conclusion

Although the IRS is remarkably effective at running what is arguably the best and largest tax system in the world, the reality is that politicians in Washington have often been reluctant to support its operations or fund its budget. Thus, the recent increases in the IRS budget and the emphasis on enforcement sends an unmistakable message that both politicians and the IRS now are serious about increasing audits and tax collections. As the audit rate rises, it becomes more and more likely that you, or someone you know, will receive an audit notice in the near future. This is all the more reason to be cautious and conservative on tax day.

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Endnotes:

1. IR-2006-28 (Feb. 14, 2006).

2. Id.

3. Internal Revenue Service Budget In Brief, Fiscal Year 2009, www.irs.gov, at p.2.

4. Internal Revenue Service Fiscal Year Enforcement and Service Results, Nov. 20, 2006, 2006 WL 3391435 (IRS Misc.)

5. Internal Revenue Manual (IRM, available at www.irs.gov) 3.5.61.1.3 (1-1-2008), et seq.; 4.2.1.1 (10-1-2003).

6. In 1984, the IRS made public for the first time its "Classification Handbook," which instructs agents on what to look for when manually reviewing tax returns. IRM 4.1.5.1 (10-24-2006), et seq.

7. IRM 4.1.3.2 (10-24-2006).

8. See e.g., *Gillin v. IRS,* 980 F.2d 819 (1st Cir. 1992), and cases cited therein; *Sutton v. IRS,* 2007 WL 30547 at *3-4 (N.D. Ill. Jan. 4, 2007). See also 26 U.S.C. §6103(b)(2) ("Nothing . . . in any . . . provision of law, shall be construed to require the disclosure of standards used for the selection of returns for examination, or data used or to be used for determining such standards, if the secretary [of the Treasury] determines that such disclosure will seriously impair assessment, collection, or enforcement under the internal revenue laws.")

9. IRM 4.1.5.1.2 (10-24-2006).

10. Partnership - Audit Technique Guide - Chapter 9 - Tax Shelters - The Disclosure Regime (Revised December 2007), available at www.irs.gov.

11. IRM 4.1.5.1.11 (10-24-2006), et seq.

12. IRM 4.1.5.1.5.1 (10-24-2006).

13. 2003 IRS Data Book, Table 25 (March 2004).

14. 2004-2005 IRS Data Book.

15. IRC §7623; 26 C.F.R. §301.7623-1.

16. IRC §7623(b)(5).