(5) Tax Compliance and Procedures

Edwin Renán Maldonado ©

Catedrático – Universidad de Puerto Rico

Seg. Sem. 2017-18

Textbook: Taxation of Individuals and Business Entities, Spilker

- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Taxation of Individuals and Business Entities, 2017 Ed., Spilker which is the textbook assigned for the course CONT 4076 – “Aspectos Contributivos de Individuos” at the University of Puerto Rico, Río Piedras Campus.

Learning Objectives

1. Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.
2. Identify the statute of limitations for assessment and tax refund.
3. Describe tax professional responsibilities in providing tax advice.
4. Identify taxpayer and tax professional penalties.

Tax Audit

Tax Audit

1.1 Purpose

Tax Audit

1.1 Purpose

- In general a taxpayer's return is selected for audit because the IRS believes the tax return has a high probability of being incorrect.

Tax Audit

1.2 Audit Selection Method

Tax Audit

1.2 Audit Selection Method

- IRS uses computer programs to identify tax returns which might have an understated liability.
  1. **Discriminant Function (DIF) system (scoring system)**: The most important system which assigns a score to each tax return that represents the probability the tax liability on the return has been underreported.
  2. **Document perfection (checks for math errors, etc.)**: Checked for mathematical and tax calculation errors.
  3. **Information matching programs**: Compares tax return data with other IRS information.

Tax Audits

1.3 <u>Types of Audits</u>

Tax Audits

1.3 Types of Audits

1. Correspondence examinations

2. Office examinations

3. Field examinations

Tax Audits

1.3 Types of Audits

1. **Correspondence examinations**:
   - Most common audit.
   - Conducted by mail and are generally limited to 1 or 2 items on the return.
   - These audits are generally the narrowest in scope and the least complex.
   - When appropriate documentation is promptly supplied, these audits typically can be concluded relatively quickly.
   - However, they can also be expanded to address other issues that arise as a result of the IRS's inspection of taxpayer documents.

Tax Audits

1.3 Types of Audits

2. **Office examinations**:
   - Second most common audit.
   - Conducted in the local IRS office and tends to be broader in scope and more complex than correspondence audit.
     - Ex: *Small businesses, taxpayers operating sole proprietorship and middle to high income individual taxpayers.*
   - The taxpayer receives a notice that identifies the items subject to audit and requests substantiation of these items as necessary and notify the taxpayer the date and location of the exam. The taxpayer may attend the examination alone or with representation (tax adviser, attorney, etc.)

Tax Audits

1.3 Types of Audits

3. **Field examinations**
   - Least common audit.
   - Held at the taxpayer's place of business or location where the taxpayer's books, records, and source documents are maintained.
   - Field examinations are generally the broadest in scope and the most complex of the three audit types.
   - The audits are limited to business return and the most complex individual returns.
   - These audits can last months to years.

IRS Appeals/Litigation Process

IRS Appeals/Litigation Process

2.1 Taxpayer Agrees with Adjustment

IRS Appeals/Litigation Process

2.1 Taxpayer Agrees with Adjustment

- After the examination, the IRS agent provides a list of proposed adjustments, if any, to the taxpayer for review.
- If he or she agrees to the proposed changes, the taxpayer signs an agreement form (Form 870) and pays the additional tax owed or receives the proposed refund.

IRS Appeals/Litigation Process

2.2 <u>Taxpayer Disputes the Adjustment</u>

IRS Appeals/Litigation Process

2.2 <u>Taxpayer Disputes the Adjustment</u>

- If the taxpayer disputes the proposed changes, the taxpayer will received a **<u>30-day Letter</u>** giving him or her 30 days to either:
  a. Request a conference with an appeals officer, who is independent and resides in a separate IRS division from the examining agent, or
  b. Agree to the proposed adjustment.

IRS Appeals/Litigation Process

2.3 <u>Taxpayer Does Not Agree with the 30-day Letter</u>

IRS Appeals/Litigation Process

2.3 Taxpayer Does Not Agree with the 30-day Letter

a. If the taxpayer choose the appeals conference and reaches an agreement with the IRS there, the taxpayer can sign Form 870.

b. But, it the taxpayer and IRS still do not agree on the proposed adjustment at the appeals conference, **or** the taxpayer chooses not to request an appeals conference, the IRS will send the taxpayer a **90-day letter**.

IRS Appeals/Litigation Process

2.3 <u>Taxpayer Does Not Agree with the 30-day Letter</u>

c. The <u>**90-day Letter**</u>, also known as a <u>statutory notice of deficiency</u>, explains that the taxpayer has 90 days to either

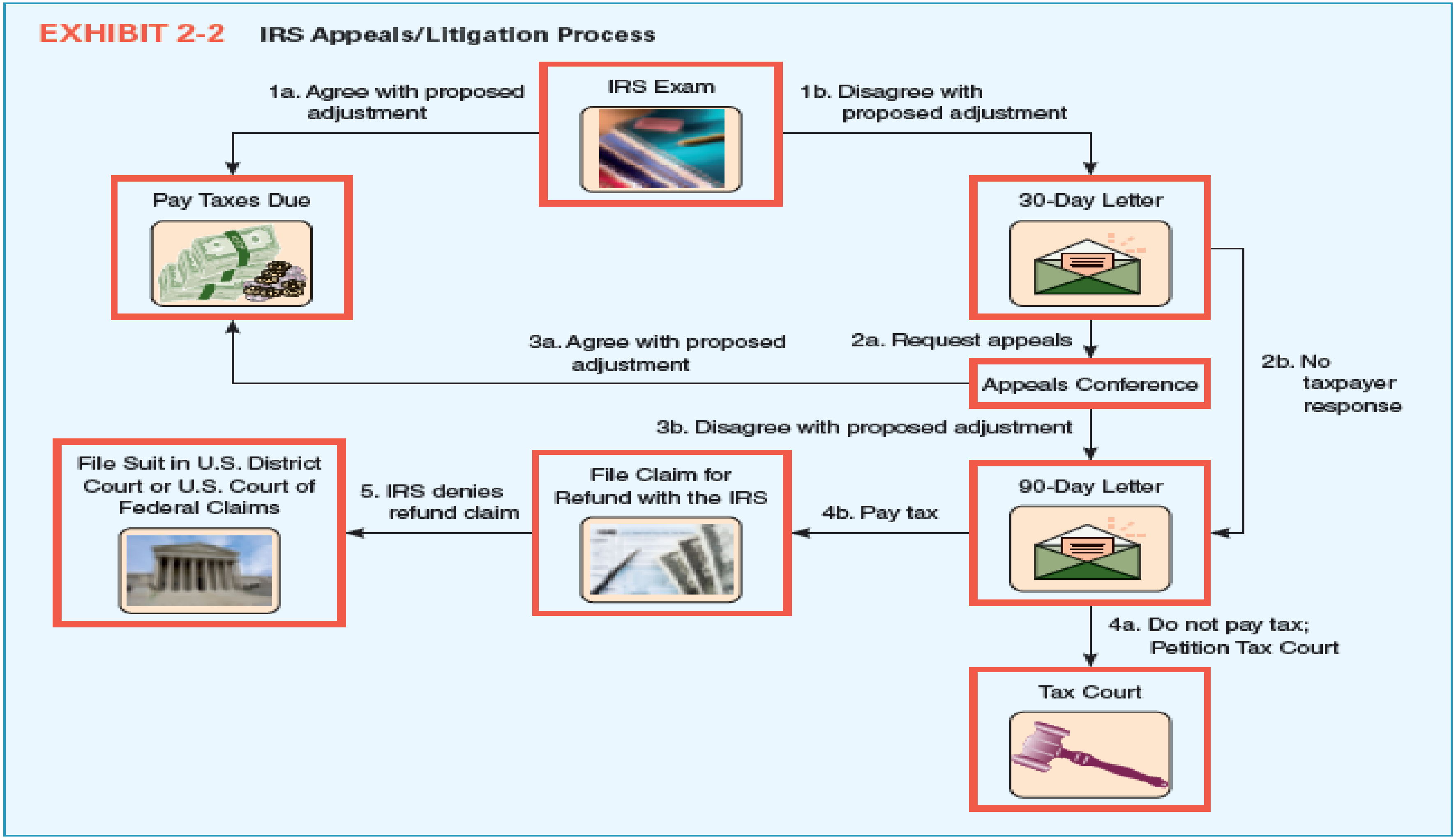
   i. Pay the proposed deficiency, or

   ii. File a petition in the

      1) <u>U.S. Tax Court</u> to hear the case.

      2) Local <u>U.S. District Court</u> or the <u>U.S. Court of Federal Claims</u>, but the taxpayer must <u>**pay** the **tax** deficiency **first**</u>, then request a refund from the IRS, and then sue the IRS for refund in the court.

IRS Appeals/Litigation Process



Statute of Limitations

Statute of Limitations

3.1 <u>Purpose</u>

Statute of Limitations

3.1 <u>Purpose</u>

- The <u>statute of limitations</u> defines the **period** in which
  - the <u>taxpayer</u> can file an <u>amended tax return to correct the error</u>, and request a refund or pay a deficiency, **or**
  - the <u>IRS</u> can assess a tax deficiency for a specific tax year (mostly after an IRS audit).

Statute of Limitations

3.2 Statute of limitations

Statute of Limitations

3.2 Statute of limitations

1. **General Rule**: The statute of limitation generally ends **3 years** from the *later* of:
   a. the date the tax return was actually filed, or
   b. the tax return's original due date.

Statute of Limitations

Example 1

Statute of Limitations

Example 1

- Bill and Mercedes files their 2012 federal tax return on March 20, 2013. In 2016, the IRS selects their 2012 tax return to audit.

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

Statute of Limitations

<u>Example 1</u>

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

- The statute of limitation ends **3 years** from the <u>*later*</u> of:
    a. the date the tax return was actually filed [**March 15, 2013**] or
    b. the tax return's original due date. [**April 15, 2013**]
- **The later date is <u>April 15, 2016</u>.**

Statute of Limitations

Example 2

Statute of Limitations

Example 2

- Bill and Mercedes files their 2012 federal tax return on September 6, 2013, after receiving an automatic extension to file their return. In 2016, the IRS selects their 2012 tax return to audit.

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

Statute of Limitations

<u>Example 2</u>

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

- The statute of limitation ends **3 years** from the *<u>later</u>* of:
  a. the date the tax return was actually filed [**September 6, 2013**] or
  b. the tax return's original due date. [**April 15, 2013**]
- **The later date is <u>September 6, 2016</u>.**

Statute of Limitations

3.2 Statute of limitations

2. **Omission of 25% of Gross Income**: A six (6) year statute of limitations applies to IRS assessments if the taxpayer omits items of gross income that exceed 25% of the gross income reported on the tax return.

Statute of Limitations

Example 3

Statute of Limitations

Example 3

- Bill and Mercedes files their 2012 federal tax return on March 20, 2013. They reported gross income of $100,000.
- In 2016, the IRS selects their 2012 tax return to audit. The IRS found that taxpayers omitted $40,000 of gross income on their 2012 tax return.

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

Statute of Limitations

Example 3

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

$$\frac{\text{Gross income omitted}}{\text{Gross income reported}} = \text{\% Gross income omitted}$$

$$\frac{\text{Gross income omitted (\$40,000)}}{\text{Gross income reported (\$100,000)}} = \text{40\% Gross income omitted}$$

- The taxpayer omitted items of gross income that exceed 25% (40% > 25%) of the gross income reported on the tax return.

Statute of Limitations

<u>Example 3</u>

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

- Therefore, the statute of limitation ends **6 years** from the <u>*later*</u> of:
  a. the date the tax return was actually filed [**March 20, 2013**] or
  b. the tax return's original due date. [**April 15, 2013**]
- **The later date is <u>April 15, 2019</u>.**

Statute of Limitations

3.2 Statute of limitations

3. **Fraud and Failure to File:** For fraudulent returns, or if the taxpayer fails to file a tax return, the statute of limitations remains open indefinitely in these cases.

Statute of Limitations

Example 4

Statute of Limitations

Example 4

- As of today, Bill and Mercedes have not filed their 2012 federal tax return.

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

Statute of Limitations

Example 4

When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

- The statute of limitations remains open indefinitely in this case.
- IRS can investigates in any time the Bill and Mercedes's items of gross for the taxable year 2012.

Tax Practitioner

Tax Practitioner

4.1 <u>Professional Conduct</u>

Tax Practitioner

4.1 Professional Conduct

- Tax practitioners are subject to a variety of statutes, rules and codes of professional conduct:
  1. AICPA Code of Conduct.
  2. AICPA Statements on Standards for Tax Services
  3. IRS's Circular 230
  4. Statutes enacted by a CPA's specific state board of accountancy.
  5. Treasury Regulations

Tax Practitioner

4.1 Professional Conduct

- Tax practitioners should absolutely have a working knowledge of these statutes, rules and guidelines because:
  1. They establish the professional standards for the practitioner, and
  2. Failure to comply with the standards could result in adverse consequences for the tax professional (*admonished, suspended, or barred form practicing before the IRS and the AICPA or suffering the suspension or revocation of the CPA license*).

Tax Practitioner

4.1.1 AICPA Code of Conduct

Tax Practitioner

4.1.1 AICPA Code of Conduct

- CPAs who are members of the AICPA are bound by the AICPA Code of Professional Conduct and Statements on Standards for Tax Services.
- The AICPA Code of Professional Conduct is not specific to tax practice and provides broader professional standards that are especially relevant for auditors, that is, for those independent CPAs charged with examining an entity's financial statements.

Tax Practitioner

4.1.2 <u>AICPA's Statement of Standards for Tax Services</u>

Tax Practitioner

4.1.2 <u>AICPA's Statement of Standards for Tax Services</u>

- The AICPA's Statement of Standard for Tax Services (SSTS) recommend appropriate standards of practice for tax professional and are intended to complement other provisions that govern tax practice (ex. IRS Circular 230).
- One objective of these standards is to encourage increased understanding by the Treasury, IRS, and the public of a CPA's professional standards.
- The seven (7) SSTS follows:

Tax Practitioner

4.1.2 <u>AICPA's Statement of Standards for Tax Services</u>

1. **SSTS No. 1: <u>Tax Return Positions</u>**
   - A tax professional should comply with the standards, if any, imposed by the applicable tax authority for <u>recommending a tax return position</u>, or preparing or signing a tax return.
     - *Example*: IRC Sec. 6694 provides this standard for federal tax purposes.

Tax Practitioner

4.1.2 <u>AICPA's Statement of Standards for Tax Services</u>

2. **SSTS No. 2: <u>Answers to Questions on Returns</u>**
   - A tax professional should make a reasonable effort to obtain from the taxpayer the information necessary to answer all questions on a tax return.

Tax Practitioner

4.1.2 AICPA's Statement of Standards for Tax Services

3. **SSTS No. 3: Certain Procedural Aspects of Preparing Returns**

- In preparing or signing a tax return, a tax professional may rely **without verification** on information that a taxpayer or a third party has provided, unless the information appears to be incorrect, incomplete, or inconsistent.

Tax Practitioner

4.1.2 <u>AICPA's Statement of Standards for Tax Services</u>

4. **SSTS No. 4: <u>Use of Estimates</u>**

- Unless prohibited by state or rule, a tax professional <u>may use taxpayer estimates in preparing a tax return</u> if it is **impractical to obtain exact data** and if the estimated <u>amounts appear reasonable based on the facts and circumstances</u> known by the professional.

Tax Practitioner

4.1.2 <u>AICPA's Statement of Standards for Tax Services</u>

5. **SSTS No. 5: <u>Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision</u>**

- A tax professional may sign a tax return that contains a departure from position previously concluded in an administrative or court proceeding if the tax professional adheres to the standards of SSTS No. 1.

Tax Practitioner*

4.1.2 <u>AICPA's Statement of Standards for Tax Services</u>

6. **SSTS No. 6: <u>Knowledge or Error: Return Preparation and Administrative Proceedings</u>**

- A tax professional must advise the taxpayer promptly of an error and its potential consequences when she learns of an error in a previously filed tax return, an administrative hearing (such an audit),or the taxpayer's failure to file a required return.
- The tax professional should include a <u>recommendation for appropriate measures</u> the taxpayer should take.

Tax Practitioner

4.1.2 <u>AICPA's Statement of Standards for Tax Services</u>

6. **SSTS No. 7: <u>Form and Content of Advice to Taxpayer</u>**
   - In providing services to taxpayers, tax professional must use judgment that reflects professional competence and serves the taxpayer's needs.
   - The professional is not obligated to communicate with a taxpayer when <u>subsequent events affect advice previously provided</u> **<u>except</u>**
     1. when <u>implementing plans</u> associated with the advice provided, or
     2. when the professional is <u>obligated</u> to do so by specific agreement.

Tax Practitioner

4.1.3 Circular 230 (IRS)

Tax Practitioner

4.1.3 <u>Circular 230 (IRS)</u>

- Circular 230, issued by the IRS, provides regulations governing tax practice and applies to all persons practicing before the IRS.

Tax Practitioner

4.1.3 Circular 230 (IRS)

- There are five parts of Circular 230

1. **Subpart A** describes who may practice before the IRS (CPAs, attorneys, enrolled agents).
2. **Subpart B** describes the duties and restrictions that apply to individuals governed by Circular 230. (Ex. Restrictions on charging contingency fees)

Tax Practitioner

4.1.3 Circular 230 (IRS)

- There are five parts of Circular 230

3. **Subpart C and D** explain sanctions and disciplinary proceedings for practitioners violating the Circular 230 provisions.
4. **Subpart E** concludes with a few miscellaneous provisions.

Tax Practitioner

4.1.4 <u>Treasury Regulations</u>

Tax Practitioner

4.1.4 Treasury Regulations

- Regulation 1.6109-2 requires that all paid tax-return preparers apply for and receive a preparer tax identification number (PTIN) and pay annual fee, as prescribed by the IRS.
- Failure to include the tax-return preparer's PTIN on tax returns is subject to a $50 penalty per violation.

Tax Practitioner

4.2 Penalties

Tax Practitioner

4.2 Penalties

- In addition to motivating good behavior via tax professional standards, the IRS can impose both criminal and civil penalties to encourage tax compliance by both tax professional and taxpayers.

Tax Practitioner

4.3 Civil Penalties

Tax Practitioner

4.3 <u>Civil Penalties</u>

- The civil penalties are much more common type of penalties.
- Generally in <u>monetary</u> penalties.
- Imposed when tax practitioners or taxpayers violate tax statutes without reasonable cause.

Tax Practitioner*

4.3 Civil Penalties

- The most common type of civil penalties to Tax Practitioner: (**Exhibit 2-12**)

Tax Violation	**Penalty**
Failure to provide a copy of the tax return to a taxpayer.	$50 per violation.
Failure to sign a tax return	$50 per violation.
Failure to include the tax practitioner's ID number on the tax return.	$50 per violation

Tax Practitioner

4.3 Civil Penalties

- The most common type of civil penalties to Tax Practitioner:

Tax Violation	Penalty
Failure to keep a listing of taxpayers or tax returns.	$50 per violation.
Failure to keep a listing of employees	$50 per violation.

Tax Practitioner

4.3 Civil Penalties

- The most common type of civil penalties to Tax Practitioner:

Tax Violation	Penalty
Understatement due to unreasonable position.	Greater of $1,000 or 50% of income derived from preparing the taxpayer's tax return.
Willful understatement of tax.	Greater of $5,000 or 50% of income derived from preparing the taxpayer's tax return.

Tax Practitioner*

4.3. <u>Civil Penalties</u>

- A **taxpayer** and **tax practitioner** <u>will not be subject to an underpayment</u> penalty if:
  1. there is ***substantial authority*** that supports the tax return position as required by SSTS No. 1 and IRS Sec. 6694 (35% to 40% range or above that taxpayer's position is sustained) **<u>or</u>**
  2. if there is a **reasonable basis** for the position (supported by tax authority) and it is **disclosed** on the taxpayer's **tax return.**

Tax Practitioner

4.4 <u>Criminal Penalties</u>

Tax Practitioner

4.4 <u>Criminal Penalties</u>

- The criminal penalties are much less common than civil penalties.
- They are commonly charged in <u>tax evasion</u> cases, which include <u>willful intent to defraud</u> the government, but are imposed only after normal <u>due process</u>, including a **<u>trial</u>**.

Tax Practitioner

4.4 Criminal Penalties

- Compared to civil cases, the standard of conviction is higher in a criminal trial. Guilt must be proven beyond a reasonable doubt, versus a "clear and convincing evidence" standard for civil tax fraud.
- The penalties are also much higher, such as fines up to $100,000 for individuals plus a prison sentence.