

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

What Every Financial Professional Needs to Know About Fighting with the IRS

Michael W. Lagos,
CFP®
President

Jane M. Roberts
*Director of Client
Services*

Justin P. Boren, PHD
*Chief Compliance
Officer*

Samuel Escobar
Financial Advisor

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Those who work with clients regarding financial matters often consider the tax implications of various strategies when giving clients professional advice. In some cases, clients come to the table with tax issues that need to be solved. In others, the advisor may recommend tax strategies that have some inherent tax uncertainty. A few clients may be unlucky enough to have an unexpected tax examination thrust upon them.

Many of our clients have an irrational fear of the IRS and will do everything possible to avoid a potential fight. Others look at the IRS as simply another creditor, and they almost welcome the opportunity to negotiate over tax liability.

If the client and Service are poised to have a tax disagreement, what should the client expect? And what is the advisor's role and responsibility in the process?

The bad news is that it is almost impossible to avoid a tax examination by the IRS. However, there's plenty of good news:

1. The odds of being audited by the IRS are less than .5 percent
2. A taxpayer can reduce the chances of having the return examined—and then fighting with the IRS—with a few sensible precautions.
3. Even if the IRS examines a taxpayer's return, the IRS itself says, "[M]any examinations result in a refund or acceptance of the tax return without change."
4. If the discussion between the IRS and the taxpayer escalates into a disagreement, the Service has established administrative procedures to allow a taxpayer to appeal the IRS's position.
5. At the end of the day, if the taxpayer and IRS still disagree on a tax issue, the courts can resolve the problem.

We originally wrote about the process of fighting with the IRS in 2010. This article has been updated to reflect the newest information.

Please feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

The Advisor's Bulletin is provided by LAGOS WEALTH ADVISORS AND LAGOS FINANCIAL & INSURANCE SERVICES, INC. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

What Every Financial Professional Needs to Know About Fighting with the IRS

Financial professionals need to understand the rules that apply to a fight with the IRS, so they can:

- Guide clients through IRS audits or disagreements that arise in the normal course of a client's tax life, and
- Coach clients in advance with regard to what to expect if the IRS challenges the client's tax position.

FIGHTING WITH THE IRS

The IRS generally gets involved with a taxpayer if:

1. The taxpayer's return gets selected for review, or
2. The taxpayer has failed to file a required return.

Examination of Returns

A return may be examined for a variety of reasons.

A return may be selected for examination on the basis of computer scoring. The IRS uses a computer program called the Discriminant Inventory Function System (DIF), which assigns a score to each individual and some corporate tax returns after they have been processed. If the program generates a high score under the DIF system, the return is likely to be selected for examination.

What kind of information on a return will generate a high DIF score? The IRS won't say specifically. However, the philosophy behind the DIF is to identify those returns that, statistically speaking, are inconsistent with returns for taxpayers in similar circumstances. Tax returns with the highest DIF scores represent returns with the highest probability of inaccuracy and should provide the best chance for IRS personnel to collect additional taxes.

A return may also be selected for examination on the basis of information received from third-party documentation, such as Forms 1099 and W-2, that does not match the information reported on the return. Or a return may be selected both to address the questionable treatment of an item and to study the behavior of similar taxpayers in handling a tax issue.

In addition, a return may be selected as a result of information received from other sources on potential noncompliance with the tax laws or inaccurate filing. This information can come from a number of sources, including newspapers, public records, and individuals.

In fact, the IRS has an entire department devoted to gathering information provided by tax informants. The Whistleblower Office (you can't make this stuff up) will even pay rewards to snitches.

To claim a reward, the informant must submit IRS Form 211. If approved, the amount of award will be at least 15 percent, but no more than 30 percent, of the collected proceeds in cases in which the IRS determines the information submitted by the informant substantially contributed to the collection of tax.

After an examination of a taxpayer's return, no matter how the review was initiated, if any changes to the tax liability are proposed, the taxpayer can either agree with those changes and pay any additional tax owed or disagree with the changes and appeal the decision.

Failure to File Return

The IRS may also be alerted to tax issues if a taxpayer fails to file a required tax return.

In addition to the potential for IRS scrutiny, taxpayers who don't file required tax returns are subject to the following consequences:

- Penalties and interest will be assessed and will increase the amount of tax due.
- The IRS may file a substitute return based on information the IRS has from other sources. If the IRS prepares this substitute return, it will probably not include any additional exemptions or expenses to which the taxpayer may be entitled.
- The taxpayer may be subject to civil and criminal penalties, including fines and possible jail time.

The IRS does not usually recommend criminal prosecution of individuals for failure to file tax returns so long as they make arrangements to file before being notified they are under criminal investigation. However, the Service aggressively pursues flagrant cases involving criminal violations of tax laws. See, for example, the case of Real Housewives of New Jersey star Joe Giudice, where he served time in prison, in part for failing to file a federal tax return

FAILURE TO FILE MONETARY PENALTY

The failure-to-file monetary penalty is calculated based on the time from the deadline of the tax return to the date the return is actually filed. The penalty is 5 percent for each month the tax return is late, up to a total maximum penalty of 25 percent. The percentage is of the tax due as shown on the tax return.

FAILURE TO PAY PENALTY

The failure-to-pay penalty—in addition to the failure-to-file penalty—is calculated based on the amount of tax owed. The penalty is 0.5 percent for each month the tax is not paid in full. The maximum limit to the failure-to-pay penalty is 25 percent of the amount owed. The penalty is calculated from the original payment deadline (the original April 15 filing deadline for individual taxpayers) until the balance due is paid in full.

INTEREST

Interest is calculated based on how much tax is owed. Interest rates can change every three months. Currently, the IRS interest rate for underpayment of tax is 8 percent per year. The interest is calculated for each day the balance due is not paid in full.

How to Fight

The IRS has summarized its rules about internal examination of returns and how a taxpayer may argue with the IRS in Publication 556. Examinations may be done entirely by mail, or they may be done in person—sometimes including the examiner, the taxpayer, and the taxpayer's authorized representative.

FIRST STEPS

If the IRS thinks a taxpayer owes tax, the examiner will propose the changes to the taxpayer or the taxpayer's authorized representative. If the taxpayer agrees with the proposed changes, any additional tax is due within a short time of the assessment.

If the taxpayer does not agree with the changes, the taxpayer may opt to do one or both of the following:

1. Immediately appeal to the examiner's supervisor.
2. Ask for fast-track mediation (FTM).

Under FTM, the taxpayer and his advisor meet with an IRS Appeals Officer who has been specially trained in mediation. The officer acts as an impartial mediator between the taxpayer and the branch of the IRS seeking to collect the tax. The mediator discusses with each side the strengths and weaknesses of its case and seeks to get them to reach a voluntary agreement.

FTM is voluntary, and the taxpayer does not give up any rights by using it to try to resolve the dispute.

There are different types of fast-track mediation programs, depending on the type of taxpayer and the nature of the tax dispute. For more information about FTM and how to request it, see IRS Publication 3605.

ADVOCACY

Taxpayers may call on help when they are in a dispute with the IRS. The Service allows attorneys and CPAs to be advocates on behalf of a taxpayer during examinations and other internal IRS procedures. Other professionals may be eligible to participate as enrolled agents, enrolled actuaries, or enrolled retirement plan agents. The process to become an enrolled professional requires the submission and approval of the professional's credentials by the IRS itself.

Even if a tax professional is not in one of these categories, the IRS may permit him or her to take part in an examination if the professional prepared the return. Further, the IRS may authorize some others to take part in the administrative process:

- Members of the taxpayer's family
- Employees of the taxpaying business
- Partners of the taxpaying partnership
- Officers of the taxpaying corporation

APPEALS OF A MORE FORMAL NATURE

After the IRS decides tax is owed and the taxpayer does not agree, the Service may begin the process to initiate collection. But before doing so, the IRS is required to send the taxpayer a package that includes:

- A 30-day letter notifying the taxpayer of the proposed changes,
- A copy of the report explaining the proposed changes,
- A form allowing the taxpayer to agree with the changes, and
- A copy of Publication 5, which explains the taxpayer's appeal rights.

Appeals within the IRS

The taxpayer has 30 days from the date of the 30-day letter to ask for a conference with the IRS Office of Appeals. The Office of Appeals is local for the taxpayer and is separate from the IRS office that is assessing the tax.

According to the IRS, most of the differences the Service has with taxpayers are settled at the appeals conference.

In most cases a written protest must accompany the request for an appeals conference. The written protest must include, among other things, the specific items over which the taxpayer disagrees with the IRS, as well as a description of facts and law upon which the taxpayer is relying.

In addition to the appeal process, the IRS also provides access to the Taxpayer Advocate Service (TAS). The TAS is an independent organization within the IRS designed to help taxpayers deal with situations that are unfair.

TAS is not a normal part of the appeal process, and its ability to intervene in a situation is usually limited to special circumstances. The kinds of cases TAS gets involved with are listed on its request for assistance form (Form 911). A taxpayer might choose to contact TAS where one of the following facts applies:

1. The IRS has failed to properly follow its own rules in determining the taxpayer's liability, or
2. The rules are being administered in a way that treats the taxpayer unfairly.

Not every appeal will yield a favorable result for the taxpayer. Where the taxpayer is still unhappy, he or she may resort to the courts.

When All Else Fails—the Courts

If a taxpayer still disagrees with the IRS after an appeals conference—or if the taxpayer chooses to bypass the IRS appeals system—the taxpayer may choose to appeal the result to one of three courts:

- United States Tax Court
- United States Court of Federal Claims
- United States District Court

The IRS sends the taxpayer a 90-day letter

- if the 30-day letter expired without response, or
- if the taxpayer went through the IRS appeal process and the Service still claims a disputed tax liability.

The taxpayer has 90 days from the date of the notice to file a petition in the Tax Court.

Tax Court

The Tax Court primarily hears cases related to income, estate, and gift tax. Taxpayers usually choose the Tax Court path when they want the court to decide whether the tax is owed before the taxpayer makes payment.

Although the Tax Court is physically located in Washington, D.C., its judges travel to conduct trials in various cities. Trials are conducted before one judge, without a jury, and taxpayers are permitted to represent themselves if they desire. After trial, the judge renders a written decision to the parties.

Tax Court judges are generally those who are familiar with the tax code and have experience in tax litigation.

If the taxpayer or the IRS is not satisfied with the decision of the Tax Court, the relevant party may appeal the decision to United States Court of Appeals within 90 days of the Tax Court's decision. After that step, either party may decide to appeal further to the United States Supreme Court.

Court of Claims and District Court

If the taxpayer pays the disputed tax, two other forums are available. After paying the disputed tax, the taxpayer must also file a claim for a refund, which the IRS must deny before litigation can be pursued. Under those circumstances, the taxpayer may choose to file a claim with the U.S. Court of Federal Claims or the U.S. District Court. The deadline for filing such a claim is usually two years after the IRS rejects the claim for refund.

The U.S. Court of Federal Claims gets the larger number of tax disputes. Cases are heard by a judge, who renders a written decision to the parties. If either party is not satisfied with the result, the decision may be appealed to the U.S. Court of Appeals for the Federal Circuit and then finally to the U.S. Supreme Court.

The taxpayer may choose to ask for a refund decision from the U.S. District Court, where a jury trial may be requested. Adverse decisions from that court may be appealed to the U.S. Court of Appeals and then ultimately to the U.S. Supreme Court.

SPECIAL REMEDIES

The IRS imposes criminal and civil penalties for a taxpayer's failure to file a required tax return. The IRS also can collect interest and penalties for tax liabilities that were unpaid at the time they were due.

What if the IRS decides to argue with a taxpayer over a tax liability and the Service loses? If a dispute is resolved in the taxpayer's favor at the administrative level, there are generally no extra remedies available to the taxpayer—other than the fact that the costs associated with litigation are avoided.

If the IRS loses a case in the courts, the taxpayer has the potential to recover the costs associated with the fight, including some attorneys' fees. Unfortunately, this kind of award happens infrequently. The court may award a taxpayer a judgment to recover both litigation costs and administrative costs when the IRS's tax position is rejected by the court and the court determines the Service's position was not substantially justified.

For a court to conclude the IRS's position was not substantially justified requires meeting one of the following two tests:

1. The Service did not follow the relevant published guidance in the proceeding.
2. The IRS had previously lost in courts of appeals on similar issues.

If a court decides the IRS is potentially liable for the costs, it also looks to the taxpayer's net worth to determine whether any award will be made. For example, individual taxpayers who have a net worth more than \$2 million will generally not be able to recover the costs of a fight. See 28 U.S.C. § 2412(d).

Although there have been cases where the courts have awarded the costs of pursuing administrative remedies and litigation to the taxpayer, those cases are relatively rare. If our clients are inclined to argue with the Service, they should not count on recovering the costs of the fight.

CONCLUSION

While most try to avoid conflict with the Service, sometimes disagreements are inevitable. For example, wrangling over a tax issue that has no clear precedent can lead to a fight. So can something as simple as submitting a return that doesn't match a W-2 or a 1099 form.

The IRS and courts provide ample forums and methods to resolve disputes. While none is guaranteed to lead to a positive result for the taxpayer, they do keep the deck from being stacked in the IRS's favor.

Accountants and attorneys are the most likely to be the client's advocates at the end. Other financial professionals may be precluded from being part of the conversation when it gets that far.

What's the best advice for insurance and financial professionals? We recommend that they fully discuss strategies with clients before they are implemented, especially those strategies that involve tax risk or increase the odds of IRS scrutiny. If such strategies are recommended, the best practice is to get those who will be involved in any ultimate fight with the IRS to be part of the decision-making process.

By having all of the professional team involved, the advisors are more likely to reach consensus on a tax position. In those circumstances where the tax result is uncertain, they will also be more prepared for a prospective fight. More importantly, the client will also be aware of the potential consequences of tax decisions and be in a position to be an active participant. The client will also be less likely to feel unpleasantly surprised by the process or the ultimate outcome.



LAGOS
WEALTH ADVISORS

BUILDING. PROTECTING AND PERPETUATING FAMILY WEALTH

**1320 VALLEY VISTA, SUITE 202
DIAMOND BAR, CA 91765**

Phone: 866-444-4964, Fax: 714-940-0889

IN THIS ISSUE OF ADVISOR'S BULLETIN

What Every Financial Professional Needs to Know About Fighting with the IRS

Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.

IMPORTANT NOTICE: PLEASE READ

The Advisor's Bulletin is not intended to be a source of advice. This is only an update of current laws regarding Estate and Insurance Planning. Please seek professional consultation for more further information. Securities offered only by duly registered individuals through Madison Avenue Securities, LLC ("MAS"), member FINRA/SIPC. Advisory and insurance services offered through Lagos Financial & Insurance Services, Inc. (DBA Lagos Wealth Advisors), a registered investment advisor in the State of California. CA Insurance License #8B60836. Lagos Wealth Advisors and MAS are not affiliated entities. This information is for Advisor's Use Only—Not for client distribution.
