

# *Sy Accountancy Corporation*

Member, American Institute of CPAs

704 Mira Monte Place, Pasadena, California 91101

Tel (626) 744-0200 • Fax (626) 744-0300 • vsy@victorsycpa.com • www.victorsycpa.com

## LIFE CYCLE OF AN AUDIT

By Victor Sy, CPA, MBA

While audit penetration has substantially decreased over the last few years, courtesy of budget constraints and personnel reductions, the quality of audits has improved due to specialization training. The intrusion into the lifestyle of taxpayers has become disturbing. If you have had the honors to be selected for audits, read on and let us analyze the life cycle of an audit and the collection function of the IRS:

1. Returns are filed on April 15 of each year with the extensions through October 15 for individual returns. Upon arrival at the Service Center, the tax returns are **sorted and assigned a document locator number (DLN)**, a control number that serves as the identification for the particular item. Although different DLNs may be assigned to the same taxpayer, the taxpayer's Social Security number ties all together.
2. After each return is sorted, returns are **reviewed for completeness**. Selected items are entered into computers and returns are checked for mathematical accuracy. Paper returns are filed and computerized versions are forwarded to the National Record Center in West Virginia.
3. After returns are received at the National Records Center, information is then entered into a **master file**, an on-line file of all known taxpayers. Returns are classified into individual master files (IMF) and business master files (BMF). The IMF is a magnetic tape record of all individual income tax filers arranged by Social Security numbers. All of tax data and related information pertaining to an individual are posted to this IMF and is continuously updated. The BMF is arranged by employer identification numbers (EIN) and is maintained for corporations, partnerships, payrolls, fiduciaries and gift taxes.
4. At the National Records Center, the returns are scored with a **discriminant function system (DIF)** to determine which of you will be reviewed for audits. The DIF function is a statistical scoring of each return based on information developed by the taxpayer compliance measurement program (TCMP). The scoring is based on total positive income and total gross receipts. Once scored, the returns are sent back to the Service Center (in your case, the Fresno Service Center) for audit consideration. The returns are selected for audit based on the DIF score and other criteria such as failure to report all W2s and 1099s. **NEW: The TCMP is old and outdated. It was replaced by National Research Program (NRP). A new scoring system has been generated as a result of the recent audit of 50,000 tax returns.**
5. The selected returns are then **scheduled for audit** - internal audit, correspondence audit, office audit, or field audit. Returns with specific questions or easily verifiable information such as missing W2s and 1099s undergo correspondence audits. Office audits require you to visit an IRS office where you will be examined by an office auditor. The more complex returns are assigned to Revenue agents in field audits.
6. The first notice that you receive, one that will stick in your mind for a while, is a **contact letter** advising you that your return has been selected for examination. It spells out the preliminary areas for audit. You are required to contact the IRS office within 10 days. An appointment is made and you or your rep proceeds to the nearest IRS office. In field audit, the Revenue agent visits your place of business.
7. At the conclusion of the audit, the auditor issues an RAR (Revenue Agent **Report**) detailing the proposed adjustments. At this time, you have two choices: pay up or file an appeal.
8. If you disagree with the findings, file an **appeal**. The mission of the Appeals Office is to resolve tax controversies on a fair and impartial basis. It is designed to enhance voluntary compliance and improve

public confidence in the integrity and efficiency of the IRS. The purpose of the Appeals process is to provide an administrative procedure for taxpayers to resolve their disagreements with the IRS without resorting to legal action. You may file a formal written protest, a brief written statement, or an oral request, depending on the amount of taxes. Most cases referred to Appeals are settled. In my personal experience and those of my colleagues, the Appeals is a wonderful arena for taxpayers. The Appeals officer is neutral as opposed to being at the examination level where the office auditor or Revenue agent is, of course, pro-government. (Caveat: Be careful in signing Form 870, waiver of the statute of limitations). If your case is not settled in Appeals, the tax will be assessed and a statutory notice (90-day letter) is issued.

9. You then have 90 days to file a [Tax Court petition](#). If you fail to file that petition, you lose the case. It is equivalent to losing by default in a civil lawsuit. At that juncture, you have no alternative but to pay. You may then file a suit for refund in a Court of Federal Claims or Federal District Court. (The IRS is prohibited from collecting the tax and harassing you until the Tax Court has rendered a final decision).
10. The [collection](#) phase starts as soon as it is determined that you owe additional taxes. At this time, you then find out that what was supposed to be a kinder, gentler IRS has become a leaner and meaner IRS. The Service assesses the tax and your account is forwarded to the Collection Division for further action. The Service Center issues the first series of collection notices (CP501 through CP504). These notices grow increasingly demanding and forceful in tone and eventually result, if unanswered, in levies and seizures of property.
11. If the Fresno Service Center fails to collect the taxes at that time, the case is referred to the [Automated Collection System \(ACS\)](#). ACS is a nameless, faceless computerized collection system that utilizes the telephone. IRS personnel at various “call sites” have little authority to help you by way of compromise or installment but have great authority to harm you. If I may suggest, do not be rude to them of as they could easily levy your bank accounts by simply pushing buttons in their computer terminals.
12. If ACS fails, your case is then assigned for collection to a [Revenue officer](#) who contacts and visits you at your residence or place of business. It is at this time that you really have to be represented by a CPA, enrolled agent, or tax lawyer. This is serious, folks. I do not relish Revenue officers visiting my clients at their homes where they can spot a Lexus or Mercedes in your driveway or in your place of business where there is much more activity than what you may have reported in your income tax returns. The Revenue officer interviews and asks you to complete a detailed collection information statement that gives him/her a road map to what you own. The Revenue officer then proceeds to collect by using several avenues: file a lien on your properties, levy your bank accounts, garnish your wages, sell your assets, or allow you to enter into an offer in compromise or installment arrangement.
13. When delinquent taxes are paid or an [offer in compromise or installment agreement](#) is in place, the collection matter is closed. If collection efforts fail, your liabilities are entered into your very own individual master file where it will remain for the next 10 years. Future refunds will be seized to offset your outstanding liabilities.
14. You may go to the [Appellate Division](#) of the IRS just after your return is examined (pre- assessment case) or after you are referred to the Collection Division (post-assessment case). About 10% of examined returns are brought to Appeals with only [less than 2% unresolved requiring litigation](#). Invocation of Appeals Division jurisdiction to hear contested issues before a petition is filed in Tax Court is a non-docketed case. On the other hand, it becomes a docketed case after a petition is filed in Tax Court.

As you can see, the collection function is a complex process. It could be a nerve-wrecking experience or an exciting lesson depending on circumstances that include your records, the auditor, and your representative. One final thought: Do not stubbornly represent yourself when issues get tough. Do not save on representation fees as it could get much more expensive in the end especially with respect to penalties and interests.