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A Practical Guide to an IRS Audit

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- The Audit Process
- The Targets for an IRS Audit
- The IRS Focus
- How Can We Help You

Introduction

Introduction

What does it actually mean?

An IRS audit is a review/examination of an organization's or individual's accounts and financial information to ensure information is being reported correctly, according to the tax laws, to verify the amount of tax reported is accurate.

- IRS Manual

Introduction

With IRS budget decreasing substantially along the years, the IRS adopted an approach of “Do more with less”:

- Increased mid-market audit coverage.
- Increased audits of flow-through entities.
- International enforcement receives favorable funding.
- Stricter enforcement of IDR timelines.
- Delinquency notices are on the rise.

Introduction

The IRS also adopted a more aggressive enforcement approach:

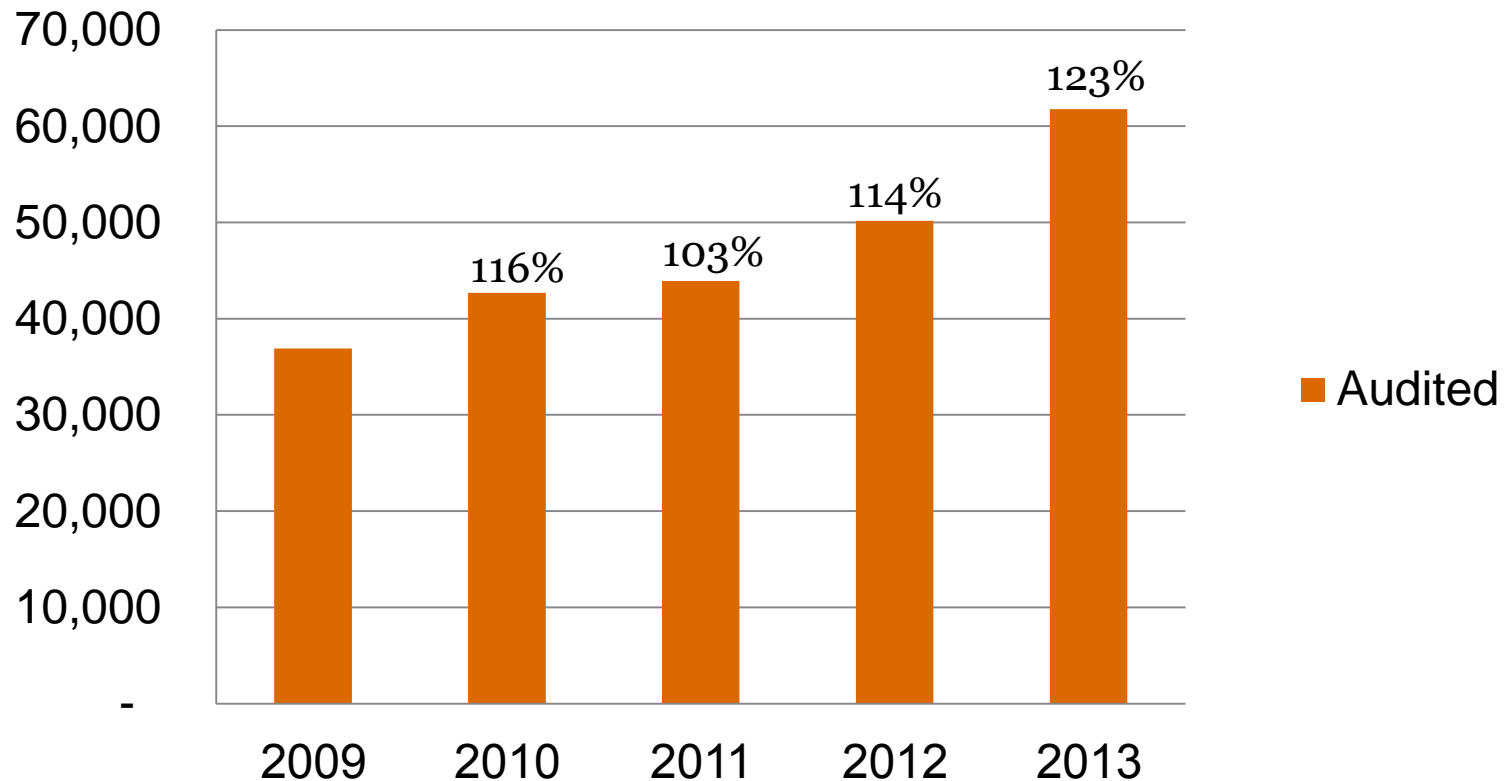
- Economic substance.
- No consideration of real-world time constraints and limitations placed on taxpayers.

In other words – “We don’t care”

- Discretion is removed from the enforcement process, and deadlines are firm.
- Agents displaying tendency to send issues on to Appeals rather than resolving.
- Exercise significant influence at Exam and Appeals.

Introduction

Growth in audited returns per year



Data Source: Internal Revenue Services Data Book, 2013

The Audit Process

The Audit Process

How it is determined that a return should be audited?

1. **Random selection**- the statistical factor.
2. **High computer algorithmic score (DIF System)**- the algorithm rates potential unreported income- the higher the score the higher the risk.
3. **Third party documentation matching**- Forms 1099 and W-2 received that do not match information declared.
4. **Related audits**- transactions with investors/business partners who are being audited.
5. **Specific market segments**- each year a different sector/segment is being closely examined.
6. **Whistleblowers**- former employees or competitors tip the IRS of possible tax evasion.

The Audit Process

How long after filing a tax return can the IRS perform an audit?

- In most cases, the IRS has **three years** after filing to audit your tax return.
- In cases where 25% of income was omitted, or substantial errors are noted, the time is doubled to **six years**.
- In cases such as where foreign assets were failed to be reported or where there are signs of fraud or over-deduction, there is **no time limit**.
- In practice, in many cases the IRS approaches the taxpayer requesting an extension of time to audit the returns.

The Audit Process



The Audit Process

<i>Information Request (IDR)</i>	<i>Deliberations</i>	<i>Determining your taxable income</i>	<i>Agree or Disagree</i>
<ul style="list-style-type: none">• The IRS sends a letter with request for documentation.• Documents should be sent back to the IRS by the due date.• Some documents, such as salaries, should be kept up to 7 years.	<ul style="list-style-type: none">• The IRS chooses a certain tax position and proposes it.• You have the opportunity to persuade the agent otherwise.	<ul style="list-style-type: none">• The IRS agent takes a position and accordingly sets your tax liability.	<ul style="list-style-type: none">• If you decide to agree with the IRS agent position- you are to pay or refund the difference.• If you decide to disagree- appealing to the local Appeals Office.• Still disagree- appeal to court.

The Targets for an IRS Audit

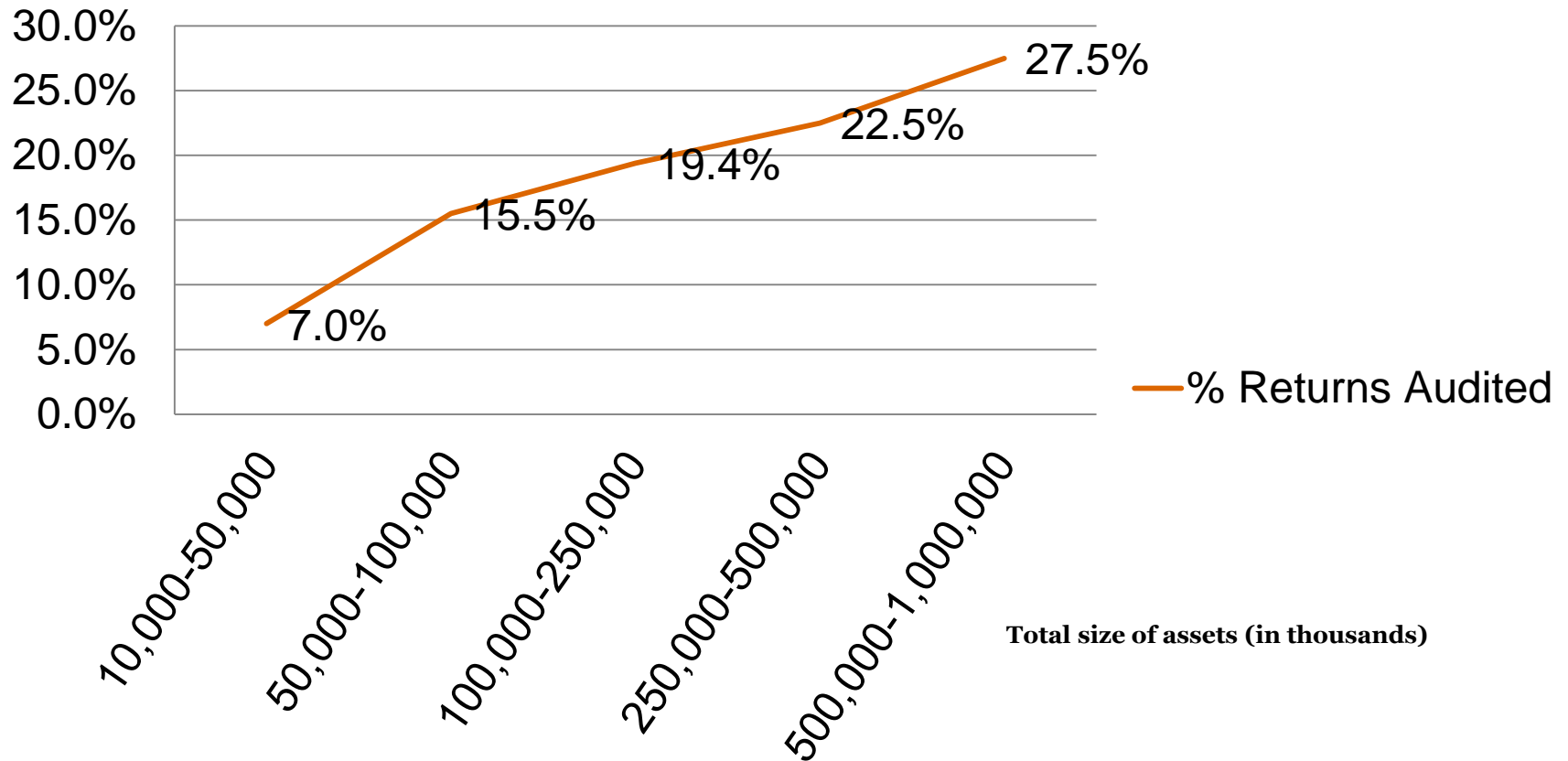
The Targets for an IRS Audit

Who is considered as a “Quality Target” for an IRS audit:

- International corporations and partnerships (small to large)
- Mid-Market & Large corporations (Over \$50M in assets).
- Flow/Pass-through entities
- Private equity, venture capital and hedge funds
- Corporations with Reportable Transactions.
- Offshore credit card users
- FBAR filers
- Tax withholding agents and employers submitting W-4/2
- High-income and high-risk individuals
- High amounts of itemized deductions
- Abusive schemes and promoter investigations
- Unreported income
- Non-filers

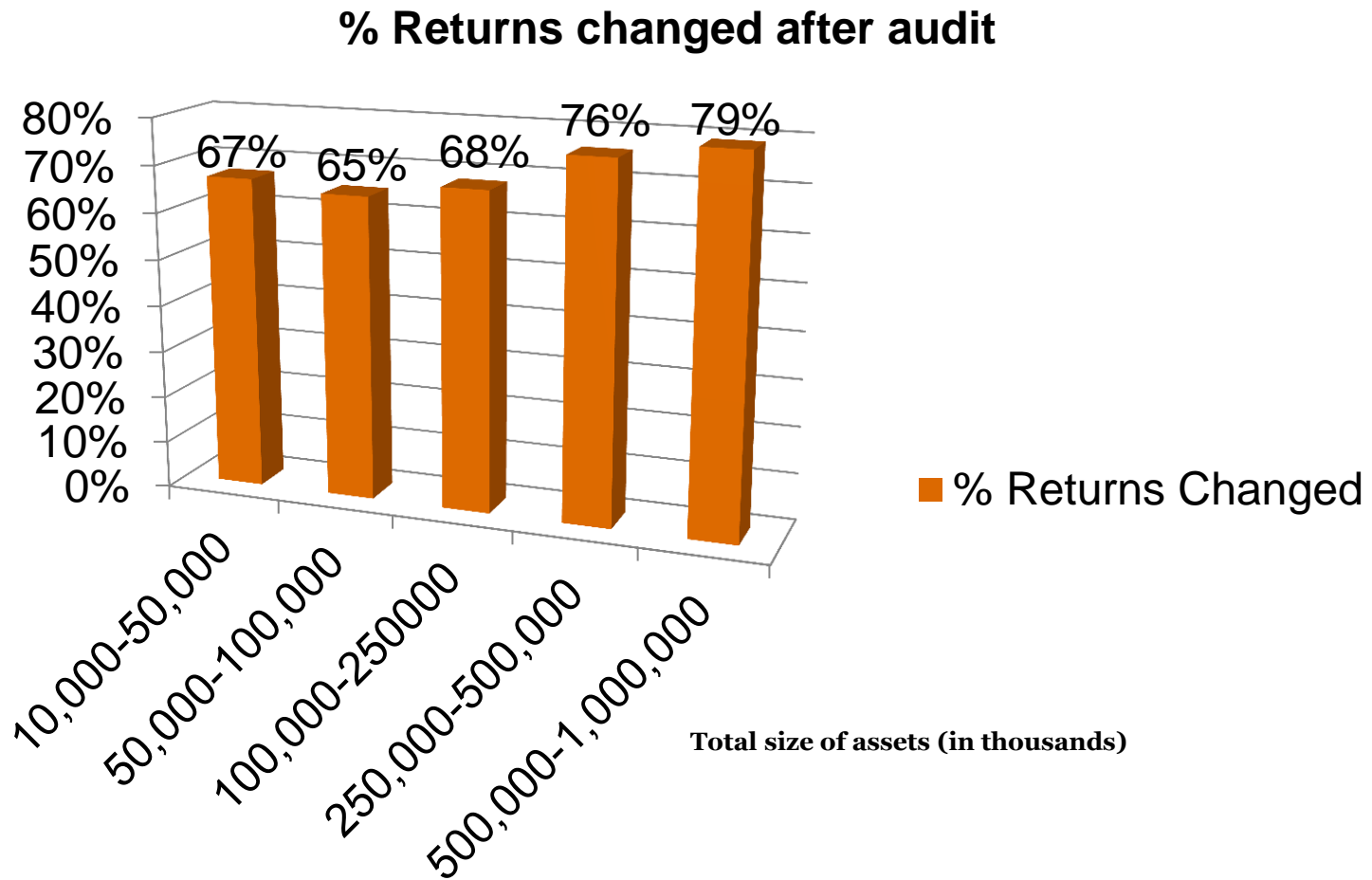
The Targets for an IRS Audit

Percentage of returns audited (by size of assets)



Data Source: Internal Revenue Services Data Book, 2013

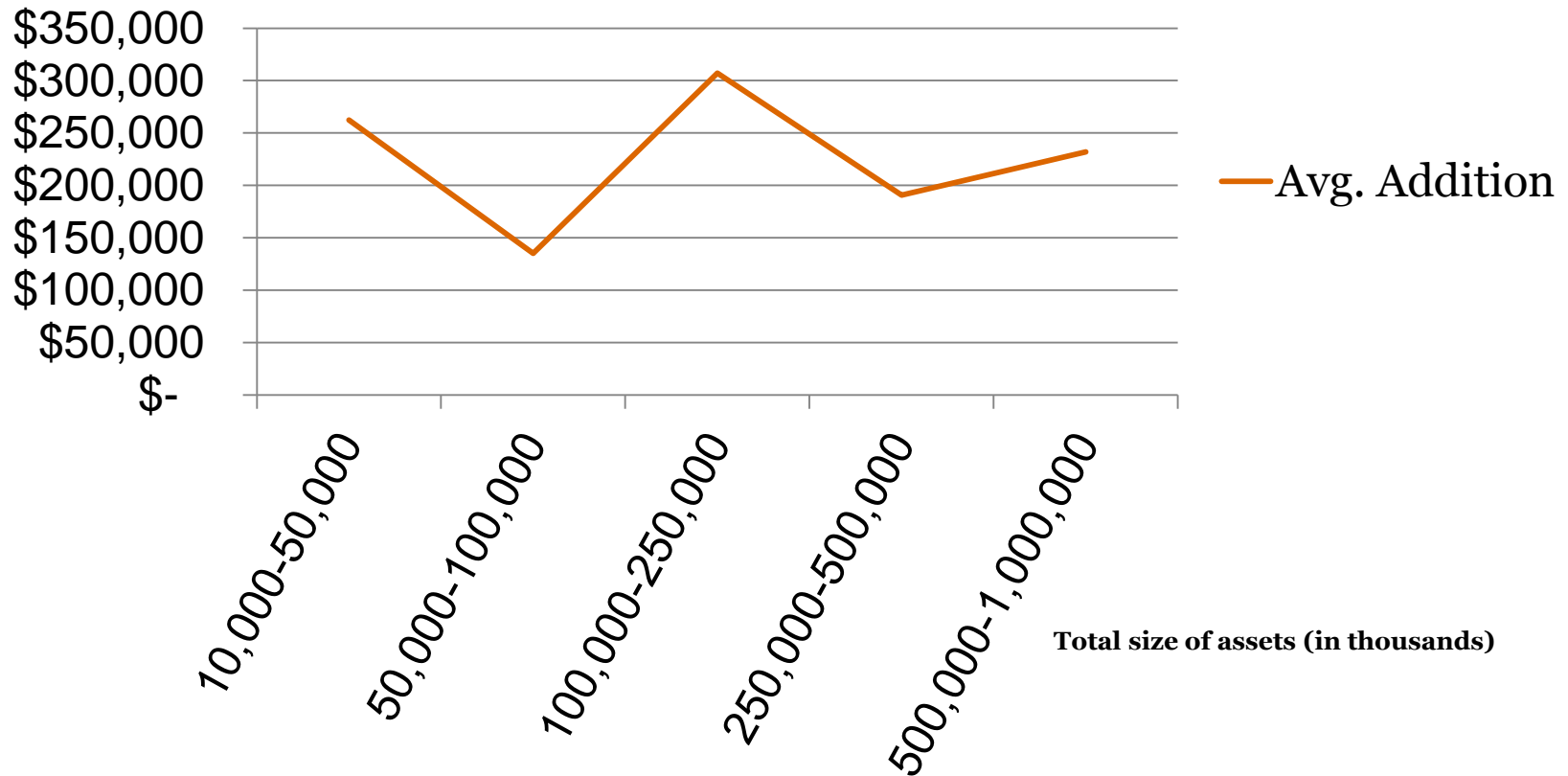
The Targets for an IRS Audit



Data Source: Internal Revenue Services Data Book, 2013

The Targets for an IRS Audit

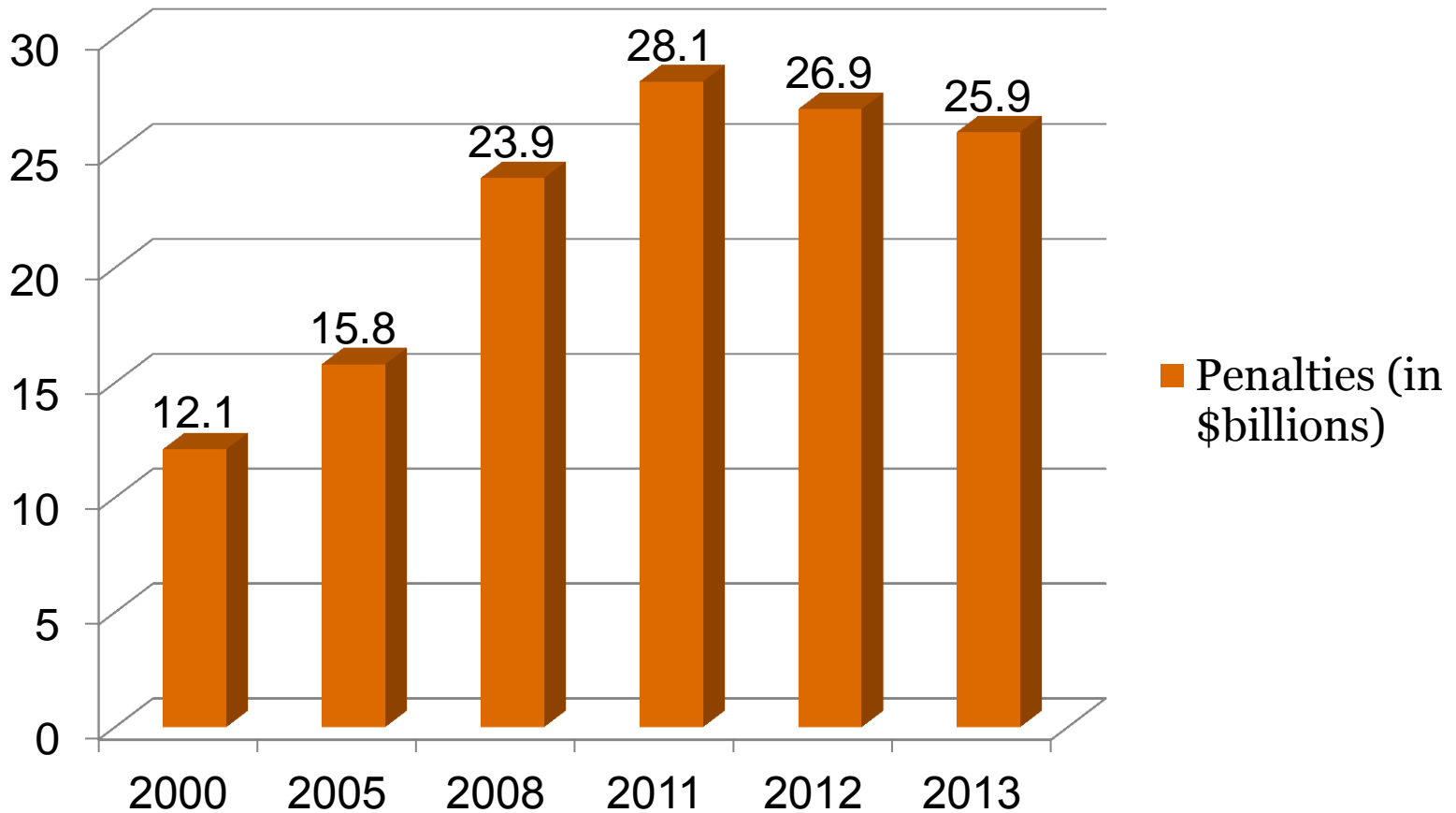
2013 Tax additions after audit



Data Source: Internal Revenue Services Data Book, 2013

The Targets for an IRS Audit

Penalty amounts assessed (in \$ billions)



Data Source: Internal Revenue Services Data Book, 2013

The IRS Focus

The IRS Focus

Issues determined important for 2014 by the US Treasury Dept.:

- Foreign tax credits.
- Foreign bank accounts.
- Transfer Pricing.
- Employment tax for all businesses.
- M&A transactions.
- High-income individuals.
- Entities with reportable uncertain tax positions.

The IRS Focus

Identified issues and areas of focus on fund audit:

- Payroll Issues - Forms 940, 942s and W-2s; Form 1099s and Withholding Form 1042
- U.S. Reporting Requirements with respect to foreign investments - Form 926, 5471, 5472, 8865, 8858
- PFIC reporting
- Listed Transactions
- Foreign Investors List
- Transfer Pricing
- Allocation of Expenses
- Deferred Compensation
- Qualified Dividends Income/Dividends Received Deduction
- Investment in U.S. Property
- Change of Accounting
- Organizational costs

How Can We Help You

How Can We Help You

Taking steps in order to prevent tax disputes

- Mock Audits to evaluate risks and exposures.
- Maintaining appropriate documentation to support all major tax positions of the reporting entity.

How Can We Help You

Proactively manage disputes as they arise

- Analyzing, planning and responding to IDRs in a timely manner.
- Designing a methodology and strategy in order to creatively resolve issues raised by the IRS in a favorable manner without the need of costly and unpredictable litigation.
- Writing memos, professional opinions, and reviews for the deliberations and appeals.
- Fast track settlements, post appeals mediation and arbitration.

How Can We Help You

Support by Ex-IRS officials employed by PwC-US

- Providing real time advice and assistance from a team of former high level officials at the U.S. Treasury, IRS and Justice Department during each phase of an IRS audit life cycle.

How Can We Help You

And for those times when audit is inevitable, we give you this free T-shirt:

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Thank you!

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