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# Tax Pitfalls for Small Businesses & Their Employees

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# Tax Pitfalls for Small Businesses & Their Employees

- Employee Classification
- Trust Fund Recovery Penalty
- W-2 & 1099 Issues
- IRS Exams
- Identity Theft

# Tax Pitfalls for Small Businesses & Their Employees

## Assignment

- Consider whether your business is vulnerable.
- Consider the steps can be taken to reduce risk.
- Consider the cost to your business if you don't take those steps.

# Tax Pitfalls for Small Businesses & Their Employees

## Summary of Employment Taxes

Paid by Employee; Withheld by Employer:

- Employee Share of FICA
  - OASDI – Old Age, Survivors, and Disability Insurance – 6.2%
  - Hospital Insurance / Medicare – 1.45%
  - Medicare surcharge – 0.9% (if applicable)
- Income Tax – percentage varies

# Tax Pitfalls for Small Businesses & Their Employees

## Summary of Employment Taxes

Paid by Employer:

- Employer Share of FICA
  - OASDI – Old Age, Survivors, and Disability Insurance – 6.2%
  - Hospital Insurance / Medicare – 1.45%
  - No Medicare surcharge

# Tax Pitfalls for Small Businesses & Their Employees

## Summary of Employment Taxes

Example: Quarterly payroll of \$150K; income tax withholding at 15%.

	<u>Employer Share</u>	<u>Employee Share</u>	<u>Total</u>
<b>OASDI</b>	\$9,300	\$9,300	\$18,600
<b>Medicare</b>	\$2,175	\$2,175	\$4,350
<b>FUTA</b>	\$2,100	--	\$2,100
<b>Income Tax</b>	--	\$22,500	\$22,500
<b>Totals</b>	<b>\$13,575</b>	<b>\$33,975</b>	<b>\$47,550</b>



# Employee Classification

## Employee or Independent Contractor: Why does the IRS care?

Because classification dictates:

- Whether employer must withhold employee share of employment taxes.
- Whether employer must withhold income taxes.
- Whether employer or employee will pay the employer share of employment taxes.
- Whether unemployment tax is paid.
- Whether a W-2 (99% reporting rate) or 1099 (77% reporting rate) will be issued.

# Employee Classification

## Employee vs. Independent Contractor

	<u>Employer Share</u>	<u>Employee Share</u>	<u>Indep. Cont.</u>
<b>OASDI</b>	\$9,300	\$9,300	\$17,177
<b>Medicare</b>	\$2,175	\$2,175	\$4,017
<b>FUTA</b>	\$2,100	--	--
<b>Income Tax</b>	--	<u>\$22,500</u>	<u>\$22,500</u>
<b>Totals</b>	<b>\$13,575</b>	<b>\$33,975</b>	<b>\$43,694</b>

Employee: ER withholds \$33,975 and pays ER share of \$13,575 for a total of \$47,550.

Independent Contractor: ER withholds and pays \$0 and IC pays \$43,694.

# Employee Classification

## What is the test?

- IRS test focuses on three evidentiary categories:
  - Behavioral control
  - Financial control
  - Relationship of the parties
- IRS test differs from the economic realities test applied under the Fair Labor Standards Act.
- Tax Court and other federal courts may apply variations or combinations of these tests.

# Employee Classification

## Behavioral Control

- Does the business provide instructions regarding:
  - When and where the work is performed;
  - What tools and equipment to use and where to purchase supplies or services;
  - Who shall perform the work, in what order, and whether particular methods are required
- Does the business conduct a performance evaluation of the worker?
- Does the business provide training as to procedures and methods of performance?

# Employee Classification

## Financial Control

- Extent of worker's investment in tools, facilities, and equipment required to perform the service.
- Extent of worker's unreimbursed expenses (e.g., training, advertising, insurance, licensing, etc.).
- Extent to which worker makes services available to the open market.
- Manner in which worker is paid (e.g., hourly or weekly vs. flat fee or time and materials).
- Extent to which worker can realize profit or loss.

# Employee Classification

## Relationship of the Parties

- Is there a written contract?
- Does worker receive a W-2 or 1099?
- Does worker receive employee benefits?
- How is the worker classified for state law purposes?
- Does business have authority to terminate the work relationship?
- Has there been a long-standing working relationship?

# Employee Classification

## How does the IRS detect worker misclassification?

- IRS Exam
- Employee files Form SS-8
- Employee files Form 1040 and Form 8919
  - Form 8919, Uncollected Social Security and Medicare Tax
- Employee files Form 1040 and Form 8275
  - Form 8275, Disclosure Statement

# Employee Classification

## What is the exam risk?

- Between 2010 and 2012, as part of an IRS compliance research program, 6,000 businesses were examined to determine whether they were properly withholding employment taxes.
- The IRS will use information gathered from this program to determine return scoring protocols for future years.
- Since 2007, the IRS and state departments of labor share data and exam results.



# Employee Classification

## IRS Form SS-8

- Used to determine worker status for purposes of withholding employment taxes and income tax.
- Interview form requesting information relating to behavioral control, financial control, and relationship between the parties.
- IRS will assign the case to a technician who will gather information from the business and third parties and will make a determination regarding worker status.
- In most cases, IRS will issue formal determination of worker status that is binding on the parties and the IRS.

# Employee Classification

## IRS Form 8919

- Used to calculate employee share of uncollected employment taxes (and to exclude employer share).
- Filed after Form SS-8 has been submitted.

## IRS Form 8275

- Used to disclose position taken on tax return for which there is not substantial authority.
- Reduces the likelihood that an accuracy-related penalty would be asserted by the IRS.

# Employee Classification

## What are the tax consequences of misclassifying workers?

- The employer will generally be liable for the following:
  - Employer share of Social Security and Medicare taxes;
  - A **reduced** percentage of the employer share of Social Security and Medicare taxes; and
  - A **reduced** percentage of income tax withholding.
- N.b. Reduced rates not available in case of intentional disregard for withholding requirements.

# Employee Classification

	<u>Employer Share</u>	<u>Employee Share</u>	<u>Indep. Cont.</u>
OASDI	\$9,300	\$9,300	\$17,177
Medicare	\$2,175	\$2,175	\$4,017
FUTA	\$2,100	--	--
Income Tax	--	<u>\$22,500</u>	<u>\$22,500</u>
Totals	<b>\$13,575</b>	<b>\$33,975</b>	<b>\$43,694</b>

If this employer's workers were re-characterized by the IRS as employees, the employer's ***minimum*** tax liability for the tax year would be \$72,480 (\$18,120 per quarter).

# Employee Classification

## Section 530 Safe Harbor

- Enacted to enable businesses to contest reclassification for federal tax purposes only (see Revenue Act of 1978).
- Safe harbor requirements for the business:
  - **Reasonable Basis** – business had a reasonable basis for not treating workers as employees;
  - **Substantive Consistency** – business treated all workers in similar positions the same; and
  - **Reporting Consistency** – business filled all previously required tax returns (e.g., 1099-MISC).

# Employee Classification

## Reasonable Basis

- Facts and circumstances test applies.
- Prima facie evidence includes the following:
  - **Judicial precedent** or IRS rulings or advice that relate to the business
  - **Prior IRS exam** where there was no assessment relating to misclassification
  - **Long-standing practice** of significant industry segment (10 years and >25% of industry)

# Employee Classification

## Substantive Consistency

- Business must offer proof that all workers in similar positions were treated the same.
- E.g., contracting business should not be staffed with some painters who are employees and others who are independent contractors.

## Reporting Consistency

- Business must offer proof that federal tax reporting for workers in similar positions was the same.
- E.g., business should not issue W-2s for some painters and Forms 1099-MISC for other painters

# Employee Classification

## Voluntary Classification Settlement Program

- Permits qualifying business to reclassify workers as employees for employment tax purposes and receive partial relief from past employment taxes.
- Eligibility Requirements:
  - Consistent treatment of workers as non-employees in the past;
  - All required Forms 1099 have been filed for all workers for the previous three years; and
  - Not subject to current or prior worker classification audit by the IRS, DoL, or a state agency.



# Employee Classification

## How does the VCSP work?

- Business applies using Form 8952.
- Business enters into a closing agreement with the IRS.
- Business pays 10 percent of the employment tax liability that would have been due on compensation paid to workers for the most recent tax year.
- No interest or penalties will be assessed.

# Employee Classification

	<u>Employer Share</u>	<u>Employee Share</u>	<u>Indep. Cont.</u>
<b>OASDI</b>	\$9,300	\$9,300	\$17,177
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- Re-characterization following exam would result in employer's minimum tax liability of \$72,480.
- In contrast, settlement payment under VCSP, would be \$7248.

# Employee Classification

## Summary

- What's an employee? You know one when you see one.
- Test has strong emphasis on control over the worker.
- Intentionally misclassifying an employee could be an expensive mistake.
- Section 530 could provide a defense.
- Consider VCSP if risk and potential cost of IRS re-classification are high.

# Trust Fund Recovery Penalty

## What are Trust Fund Taxes?

- Employee Share of FICA
  - OASDI – Old Age, Survivors, and Disability Insurance – 6.2%
  - Hospital Insurance / Medicare – 1.45%
  - Medicare surcharge – 0.9% (if applicable)
- Income Tax – percentage varies
- ***Withheld by employer***

# Trust Fund Recovery Penalty

## What Taxes are not Trust Fund Taxes?

- Employer Share of FICA
  - OASDI – Old Age, Survivors, and Disability Insurance – 6.2%
  - Hospital Insurance / Medicare – 1.45%
  - No Medicare surcharge

# Trust Fund Recovery Penalty

## What is the trust fund recovery penalty (TFRP)?

IRC § 6672(a): Any person who is required to collect, account for, and pay over any tax imposed by this title, but fails to do so or willfully attempts to evade or defeat such tax shall be liable for a penalty equal to the amount of tax due.

# Trust Fund Recovery Penalty

Example: Assume quarterly payroll of \$150,000 and income tax withholding at 15%.

	<u>Employer Share</u>	<u>Employee Share</u>	<u>Totals</u>
OASDI	\$9,300	\$9,300	\$18,600
Medicare	\$2,175	\$2,175	\$4,350
Income Tax	---	<u>\$22,500</u>	<u>\$22,500</u>
941 Totals	\$11,475	\$33,975	\$45,450
TFRP =		<b>\$33,975</b>	

# Trust Fund Recovery Penalty

## What is the scale of this problem?

According to the U.S. GAO:

- In 1998, 2 million businesses owed \$49 billion in unpaid employment tax and 185,000 responsible individuals owed \$15 billion in TFRP.
- In 2007, 1.6 million businesses owed \$58 billion in unpaid employment tax and >10,000 businesses owed employment tax for >20 quarters.
- In 2015, the tax gap is estimated to be \$380 billion, of which an estimated \$70 billion is unpaid employment taxes.



# Trust Fund Recovery Penalty

## Procedurally, how does the TFRP investigation work?

Collection efforts to begin with businesses:

- IRS identifies employers with late or deficient deposits.
- IRS issues a Federal Tax Deposit Alert and sends to local Revenue Officer (“RO”).
- Local RO decides whether to conduct full compliance check.
- RO may require employer to set up a “Special Trust Account” for deposit of employment tax.
- RO may permit employer to enter a business installment agreement.
- In more egregious situations, RO determines whether criminal referral is appropriate.

# Trust Fund Recovery Penalty

**If the business can't pay, the investigation continues:**

- The RO will examine tax returns, bank records, canceled checks, bylaws, minutes, etc.
- Individuals with knowledge of the business are interviewed using Form 4180.
- Participating in the interview and completing Form 4180 without advice of counsel or a CPA familiar with TFRP is often a crucial error.
- The goal is to identify “responsible persons.”

# Trust Fund Recovery Penalty

## What is a responsible person?

- The term is not defined in the Internal Revenue Code.
- IRC § 6671(b) defines “person” as an officer, employee, or member of a business entity who is “under a duty to perform the act in respect of which the violation occurs.”
- The IRM defines “responsible person” as follows:
  - Officer, director, shareholder, or employee of a corporation;
  - Partner or employee of a partnership;
  - Member, manager, or employee of an LLC.

# Trust Fund Recovery Penalty

**Whether a person is responsible is a question of fact.**

The IRS considers an individual's **status**, **duty**, and **authority**, including, for example:

- Check signing authority or control over payroll;
- Control of the financial affairs of the business;
- Ability to hire and fire; role as officer or director;
- Authority to sign and file federal tax returns;
- Authority to make federal tax deposits;
- Control of whether and in what order creditors are paid.

# Trust Fund Recovery Penalty

## Letter 1153

- When the RO identifies a responsible person, Letter 1153 is issued via certified mail.
- Letter 1153 serves several purposes:
  - Notifies taxpayer of the ***proposed*** assessment;
  - Describes appeal rights; and
  - Provides 60 days for taxpayer to appeal the proposed assessment.

# Trust Fund Recovery Penalty

## What are the options after TFRP is proposed?

- Pre-assessment appeal (within 60 days of Letter 1153)  
-or-
- Post-assessment refund claim (after expiration of 60-day period)
- “Assessment” means tax balance due has been recorded by the IRS as a liability on the taxpayer’s account.

# Trust Fund Recovery Penalty

## What are the options after TFRP is proposed?

- Pre-assessment appeal (within 60 days of Letter 1153)
  - Case will be referred to IRS Appeals.
  - Small Case Request – proposed assessment for each period is <\$25,000.
  - Formal Protest – Proposed assessment for each period is >\$25,000.
  - Interest does not begin to accrue.

# Trust Fund Recovery Penalty

## What are the options after TFRP is proposed? (cont.)

- Post-assessment refund claim (after expiration of 60 day period)
  - Taxpayer pays employee share for one employee for each quarter at issue.
  - Taxpayer files Form 843 to abate tax and claim refund of tax paid.
  - If refund claim is disallowed, taxpayer can file protest with Appeals.



# Trust Fund Recovery Penalty

## Appeals Conference

- To collect under IRC § 6672, IRS must determine that:
  1. The individual was a “responsible person;” and
  2. The individual *willfully* failed to collect, account for, and pay over trust fund taxes.
- The absence of either element vitiates liability.
- The burden of proof is on the taxpayer.
- As a general rule, only the taxpayer’s representative should attend the Appeals conference.

# Trust Fund Recovery Penalty

## Who is a responsible person?

- An individual who controls the process by which the employer allocates funds to other creditors in preference to satisfying employment tax obligations.

## Who is not a responsible person?

- An employee who performs ministerial acts without exercising independent judgement.

# Trust Fund Recovery Penalty

## Willfulness

- Making a voluntary and intentional decision to prefer other creditors over the IRS, knowing that employment tax is due; or
- Actions that are grossly negligent or in reckless disregard of the fact that taxes are due and will not be paid.
- Mere negligence  $\neq$  willfulness.
- In some circuit courts, establishing reasonable cause has been found to avoid a finding of willfulness.
- Lack of financial control or lack of knowledge of unpaid tax may also avoid a finding of willfulness.

# Trust Fund Recovery Penalty

## What are the options if you lose in Appeals?

- Pay the tax in a lump sum or by entering into an installment agreement.
- File an offer in compromise.
- File refund claim in Federal District Court or Federal Court of Claims.

# Trust Fund Recovery Penalty

## Strategies to Avoid Payment

- Shift blame to other responsible persons.
- Employ delay tactics to allow the business or other responsible persons time to pay the tax.
- Demonstrate minimum collection potential.
- Bring suit for contribution against other responsible persons.
- Have the business apply payments to trust fund taxes first, rather than employer share.
- Attempt to settle case among other responsible persons.
- Make a capital contribution or loan to the business to pay tax.

# Trust Fund Recovery Penalty

## Summary

- IRC § 6672 allows IRS to pierce the entity's veil of limited liability and determine individual liability.
- Other than a criminal tax matter, this is the worst IRS liability to have (because the employee gets credit for SS and Medicare but Treasury never gets the money).
- IRS efforts to enforce payment of employment taxes and impose the TFRP are increasing.
- TFRP cannot be discharged in bankruptcy.
- Liability can even extend to paid non-profit board members.

# W-2 and 1099 Reporting

## W-2 Filing Requirements

- An employer required to withhold employment tax or income tax on behalf of an employee must file Form W-2 in respect of such employee.
- Due date for providing W-2 to SSA and employee is January 31.
- Deadline to file with SSA can be extended but not deadline for providing W-2 to employee.
- See Rev. Proc. 2004-53 for filing requirements when a business is acquired by a successor.
- When a business terminates, W-2 must be filed with SSA by last day of the month following the due date of the final Form 941.

# W-2 and 1099 Reporting

## W-2 Penalties

- IRC §§ 6721 & 6722 – impose penalty for incomplete filing and late filing of information returns with SSA/IRS & employee.
- Penalty is \$50 per return is  $\leq$  30 days late (\$500K maximum); \$100 per return if filed by August 1 (\$1.5M maximum); and \$250 per return if filed after August 1 (\$3M maximum).
- Penalty can be waived if failure is due to reasonable cause and not willful neglect.
- De minimis failures are excepted (but TIN, surname, and dollar amounts are never de minimis).
- Penalty for intentional disregard of filing requirement is not less than \$500 per return (no maximum).
- *Penalties are inflation-adjusted (2017 penalties are slightly higher).*



# W-2 and 1099 Reporting

## W-2 Penalties (cont.)

- IRC § 6674 – furnishing fraudulent W-2 or willful failure to provide W-2 to employee
  - Penalty is \$50 per return.
- IRC § 7204 – furnishing fraudulent W-2 or willful failure to provide W-2 to employee
  - For each offense, upon conviction, the penalty is:
    - A fine of up to \$1000, imprisonment of up to one year, or both.
    - ***This is a criminal offense!***

# W-2 and 1099 Reporting

## 1099 Varieties

- 1099-A – abandonment of secured property
- 1099-B – proceeds from broker exchange
- 1099-C – cancellation of debt
- 1099-DIV – dividends and distributions
- 1099-G – government payments
- 1099-H – health coverage tax credit advance payments
- 1099-INT – interest income
- 1099-K – payment card or 3<sup>rd</sup> party network transactions

# W-2 and 1099 Reporting

## 1099 Varieties (cont.)

- 1099-MISC – miscellaneous income
- 1099-OID – original issue discount
- 1099-PATR – taxable distributions received from cooperatives
- 1099-Q – payments from qualified education programs
- 1099-QA – distributions from ABLE accounts
- 1099-R – distributions from pensions, annuities, IRAs, etc.
- 1099-S – proceeds from the sale of real estate transactions
- 1099-SA – distributions from an HAS, Archer MSA, etc.

# W-2 and 1099 Reporting

## 1099-MISC Filing Requirements

- Payer must file Form 1099-MISC for each person to whom the payer has paid during the year:
  - \$10 or more in royalties or broker payments
  - \$600 or more in rents, services, prizes, awards, health care payments, crop insurance proceeds, cash payments for fish, etc.
  - Any fishing boat proceeds
  - Gross proceeds to an attorney
  - Certain direct sales of consumer products of \$5000 or more for resale

# W-2 and 1099 Reporting

## 1099-MISC Filing Requirements (cont.)

- *Required only when payments are made in the course of payer's trade or business.*
- Requirement also applies to nonprofit organizations.
- Filing deadline is January 31 (with limited exceptions).

# W-2 and 1099 Reporting

## Examples

- You hire a contractor to repair the roof of your home – no 1099 necessary.
- You are in the business of renting houses and you hire a contractor to repair the roof of a rental property – Form 1099 must be filed.
- You hire a contractor to repair the roof of your home and your home contains your home office – is a 1099 required?

# W-2 and 1099 Reporting

## When is a 1099-MISC not required?

- Payments to a corporation (subject to certain exceptions)
- Payments for merchandise, freight, storage, similar items
- Rent paid to real estate agents
- Business travel allowances
- Cost of current life insurance protection
- Payments to tax-exempt organizations, including IRAs and governmental organizations
- Payments to H-2A foreign agricultural workers (must be reported using Form W-2)

# W-2 and 1099 Reporting

## Exceptions for Corporations

- 1099-MISC is required for payments to a corporation for the following:
  - Medical and health care payments
  - Purchases of fish for cash
  - Attorney fees and gross proceeds paid to an attorney (e.g., settlement)
  - Substitute payments made in lieu of dividends or tax-exempt interest
  - Payments by a federal executive agency for services



# W-2 and 1099 Reporting

## Examples of Non-Employee Compensation

- Payments for services performed by independent contractors (and to Section 530 workers)
- Professional service fees (e.g., fees for attorneys, CPAs etc.)
- Referral fees between professionals
- Payments by attorneys to expert witnesses
- Exchange of services in the course of trade or business
- Taxable fringe benefits
- Fees paid to a corporate or non-profit director
- Golden parachute payments to non-employees

# W-2 and 1099 Reporting

## 1099 Penalties

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- Penalty can be waived if failure is due to reasonable cause and not willful neglect.
- De minimis failures are excepted (but TIN, surname, and dollar amounts are never de minimis).
- Penalty for failure due to intentional disregard is not less than \$500 per return (no maximum).
- *Penalties are inflation-adjusted (2017 penalties are slightly higher).*

# W-2 and 1099 Reporting

## IRS 1099 Scrutiny

- “Did you make any payments that would require you to file Form 1099?”
- “If ‘yes,’ did you or will you file the required forms?”
- See Schedules C, E, and F of Form 1040, as well as Forms 990, 1065, 1120, and 1120-S.
- If you indicate that all 1099s have been filed when they have not, you’ve committed perjury.
- If you indicate that not all 1099s have been filed, this is a red flag for an audit.
- If audited, IRS will ask for copies of Forms 1099-MISC.

# W-2 and 1099 Reporting

## Summary

- The rules for W-2 and 1099 reporting are not always intuitive.
- Penalties are small but can add up quickly.
- The IRS pays special attention to 1099 reporting.
- Don't wait until the last minute to figure out your filing obligations.

# IRS Exams

## How are returns selected for exam?

- Potential participants in abusive tax avoidance transactions.
- Large corporations may be examined annually.
- Information matching (e.g., 1099, K-1).
- Related exams.
- Compliance projects (e.g., employee classification).
- ***DIF Score***

# IRS Exams

## Return Selection Using DIF Score

- IRS has a national examination plan based on ever-changing priorities.
- The national examination plan is secret.
- Returns are scored based on the likelihood that an exam would result in a change and based on the likelihood that there is unreported income.
- IRS personnel screen the returns with the highest scores and select certain returns for exam.

# IRS Exams

## Types of IRS Exams

- Correspondence exams: usually limited to a few issues that can be substantiated by written documentation; about 75% of all exams are conducted by mail
- Office exams: multiple issues, often requiring verbal explanation and voluminous records
- Field exams: more complicated issues; usually limited to businesses (including sole proprietors)

# IRS Exams

## Limits on Assessment

- General rule: 3-year limit on assessment from date return was filed
- Substantial understatement: 6-year limit on assessment
- Fraud: no limit on assessment
- Willful attempt to evade tax: no limit on assessment
- Non-filer: no limit on assessment



# IRS Exams

## Initial Contact

- Notice of Exam (e.g., Letter 566(CG), Letter 2205-A)
- Request for Documents (e.g., Form 886-A, Form 4564)
- Publication 1 – Your Rights as a Taxpayer

# IRS Exams

## Goals in Handling Exams

- *Limit the scope and duration of the exam.*
- Control the flow of information.
- Keep track of every document turned over to the IRS during the exam.
- *Do not give the examiner reason to doubt your veracity.*
- If you are unrepresented, be prepared and know your limits.

# IRS Exams

## Preparing for the Exam

- Summarize complicated or voluminous documents.
  - IRS agents work multiple cases and have to provide progress reports to their managers.
  - With a credible summary, agent may merely spot check records.
- Research the legal issues.
- Anticipate the IRS's position and objectively evaluate your own position.
- Consider whether to agree to extend period of limitations on assessment.
- Request an estimated completion date.
- Consider whether the taxpayer makes a good witness.

# IRS Exams

## Providing Requested Documents

- The IRS does not know how you maintain your books and records, so documents requests are usually overly broad.
- If the request is unclear or if certain item do not exist, contact the IRS agent and refine the document request.
- Provide only those documents specifically requested.
- Provide all of the documents by the deadline, preferably in one package.
- If requested documents are not provided, the IRS may issue a summons.

# IRS Exams

## Third-Party Involvement

- The IRS may request information from any third-party it deems proper.
  - IRS must notify taxpayer that third-party contacts will be made.
  - Taxpayer may request list of all third-party requests that the IRS has made.
- The IRS may also issue a third-party summons to acquire documents or testimony.
  - Copy of the summons must be provided to the taxpayer.
  - Taxpayer has right to bring court proceeding to quash the summons.

# IRS Exams

## Protected Information

- Attorney-client privilege
- Work product doctrine
- Tax practitioner privilege
- Consider whether it is better to maintain or waive the privilege.

# IRS Exams

**IRS Players** (in approximate order of fear):

- Tax Compliance Officer
- Revenue Officer
- Revenue Agent
- Fraud Technical Advisor
- Special Enforcement Program Agent
- Criminal Investigation Special Agent (the “police”)

# IRS Exams

## Criminal Investigation

- Fraud changes everything.
- If the case is referred to CI, the Revenue Agent will usually just go silent.
- Once CI is involved, there is an 80% conviction rate and 80% of those go to jail.
- Therefore, it is critical to restrict focus of the exam to civil matters.



# IRS Exams

## Exam Proceedings

- A reasonable request for additional time to prepare before the exam is usually permitted.
- If a site visit is required, request that it be scheduled to avoid disruption to business.
- Maintain open lines of communication.
- When submitting documents, send copies and describe them in a transmittal letter.
- *Look for opportunities to dispose of issues.*
- *Request that the IRS to refrain from imposing penalties.*

# IRS Exams

## What can go wrong?

- Lack of evidence
  - Cohan rule – reasonable and credible basis for approximation may be permitted
  - Obtain affidavits from third parties
- Bad facts
  - Attempt to distinguish or minimize
- Problem examiner
  - Request meeting with manager
  - Contact Taxpayer Advocate Service

# IRS Exams

## Concluding the Exam

- No-change letter: best result; return accepted as filed
- Fully agreed cases: next best result; taxpayer agrees to assessment
- Partially agreed cases:
  - 30-Day Letter – provides opportunity to request administrative appeal
  - Notice of Deficiency (90-Day Letter) – provides opportunity to petition Tax Court

# IRS Exams

## Finality of Settlement

- Cases closed by agreement are unlikely to be reopened except in cases of:
  - Subsequent evidence of fraud;
  - Substantial error based on established IRS position; or
  - Serious administrative omission.
- Taxpayer can request a formal closing agreement if it wants to bind the IRS.

# IRS Exams

## DO NOT!!!

- Ignore the initial IRS exam notice.
- File an amended tax return for the years under exam.
- Wait to file your current year tax return until the exam has been completed.
- Destroy evidence that is contrary to your reporting position.
- Manufacture or alter evidence to support your reporting position.

# IRS Exams

## Basic Rules for Deducting Business Expenses

- An expense is deductible as a business expense only if you have a ***trade or a business***.
- To have a trade or business, you must have a ***genuine profit motive*** (not a hobby!).
- Deductions are further limited to expenses that are ***ordinary and necessary***.
- Failure to maintain ***adequate books and records*** may trigger 20% accuracy-related penalty.
- Dealing in cash is a mistake unless you have a system to track every dollar.

# Identity Theft

## What is the scope of the problem?

- According to the IRS, phishing e-mails increased by 400% from last year.
- In 2014, there were **17.6 million victims of ID theft** in the U.S. (Bureau of Justice Statistics).
- According to the FTC, there is a new victim of ID theft every 3 seconds.
- An FBI study found that an average of 210 days go by before victim of ID theft realizes it.
- In 2015, there were 781 data breaches and **169 million records exposed** (ID Theft Resource Center).
- The Business E-Mail Compromise scam has caused losses of \$3.1 billion in 30 months.
- The “internet of things” is developing faster than measures to ensure its security, creating vulnerabilities not just for private information but for every device on the user’s network.

# Identity Theft

## IRS Efforts to Prevent Tax-Related ID Theft

- Use of ID theft tracking indicators on tax returns.
- Assignment of six-digit identity protection PIN to victims.
- Creation of centralized privacy program for standardized ID theft procedures.
- Creation of specialized IRS unit to assist victims of ID theft.
- Use of shared data elements to verify returns.
- Expansion of **W-2 Verification Code initiative** (Box 9) from 2 million in 2016 to 50 million in 2017.
- Education campaign for taxpayers and tax professionals.
- Other secret steps.



# Identity Theft

## Results of IRS Efforts, 2015 – 2016

- Reduction in number of ID theft affidavits filed from 512,278 to 237,750
- Number of fraudulent returns reaching processing stage decreased from 1.2 million (equating to \$7.2 billion) to 787,000 (equating to \$4 billion)
- Decrease in fraudulent refunds from 243,361 (equating to \$829 million) to 108,539 (equating to \$239 million)
- New shared data elements specifically responsible for detecting 74,000 suspicious returns.

# Identity Theft

## ***Warning to Advisors*** (financial, legal, accounting):

- Your office is a goldmine to perpetrators of ID theft.
- Very few other locations where a client's critical financial information is consolidated.
- Dark web contains a market for buying and selling access to practitioner's networks.
- Extremely organized – some sites run “specials of the day.”
- Example: **2200 taxpayer records were for sale for \$4,000.**
- Professional tax preparers are required by law to have written information security plan.

# Identity Theft

## Best Practices for Businesses

- Mandate security control measures (e.g., strong passwords, authentication, encryption).
- Educate your staff and clients.
- Conduct a periodic deep scan of your computer network.
- Prepare an evergreen written security plan and follow it.
- Purchase cyber security insurance.
- Don't collect personal information you don't need and purge unneeded information regularly.
- See IRS Publication 4557 and FTC Publication, "Start With Security."

# Identity Theft

## Best Practices for Individuals

- Use security software, including firewall, virus/malware protection, and file encryption.
- Never access a WIFI network that is not password protected.
- Only provide personal information over secure, encrypted websites (“https”).
- Do not reply to phishing e-mails and forward to [phishing@irs.gov](mailto:phishing@irs.gov).
- Do not open unverified e-mail links or attachments.
- Download apps and software only from known, trusted companies.
- Never provide tax payment information over the phone to someone who claims to be from the IRS; instead, hang up and report call to TIGTA at [https://www.treasury.gov/tigta/contact\\_report\\_scam.shtml](https://www.treasury.gov/tigta/contact_report_scam.shtml).

# Identity Theft

## Steps to Take if a Business is Compromised

- Contact local IRS stakeholder liaison.
  - In PA: [cassandra.l.hellmann@irs.gov](mailto:cassandra.l.hellmann@irs.gov), 412-404-9151
- Contact IRS Identity Protection Specialized Unit: 800-908-4490
- Contact local office of the FBI: 215-418-4000
- Contact local police to file report on data breach.
- Contact PA Dept. of Revenue Fraud Investigation Unit at 717-772-9297 or [ra-rvpitfraud@pa.gov](mailto:ra-rvpitfraud@pa.gov).
- Report the incident to the PA AG Bureau of Consumer Protection by calling 800-441-2555.

# Identity Theft

## Steps to Take if a Business is Compromised (cont.)

- File report with FTC at <https://identitytheft.gov> or by calling 877-438-4338.
- Contact a cyber security expert to determine cause and scope of the breach.
- Contact insurance company to determine breach mitigation coverage.
- Contact one of three main credit bureaus to place a fraud alert on your credit record.
  - Equifax – 800-525-6285
  - Experian – 888-397-3742
  - TransUnion – 800-680-7289

# Identity Theft

## Steps for Individual Victims of ID Theft

- Take all of the steps described above for businesses.
- File IRS Form 14039 to report issue to IRS.
- Contact companies where you know fraud occurred.
- Change passwords and PINs for all services, accounts, and WIFI networks.
- Close accounts and replace credit and debit cards.
- Review your credit report, Social Security Administration earnings report, and IRS wage & income transcript.



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# QUESTIONS & ANSWERS

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