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IRS Targeting Smaller Businesses – Here's How To Fight Back

The IRS recently released its enforcement results for 2011. Based on a number of conversations with senior IRS officials, reviewing the statistics and what we are seeing first hand in our tax controversy practice at alliantgroup – one trend is clear (and will be continuing) — that the IRS is focusing greater resources on small and medium businesses. However, it is important for these businesses to recognize what the large corporations already know – it often pays to fight the tax man.

The IRS is reducing audits on households below 200k and shifting the focus to taxpayers with income over 200k and especially those with over income over $1 million. For example, audits of the over one million crowd went from 14,187 in 2006 to 36,422 in 2011 – resulting in a coverage rate of 12.48% of all filers. Similarly, for taxpayers over 200k in income the number of exams has gone from 87,558 in 2006 to 174,854 for 2011 for a coverage rate of just under 4%.

The story is somewhat different for corporations – with IRS audit focus shifting from larger corporations and concentrating more on small and medium corporations ($10 million to $250 million in assets). In fairness to the IRS, some of this shift is due to the IRS reaching pre-filing agreements with large business taxpayers. Looking at the last four years (2008-2011 — and this reflects where the IRS is trending) – there you see:

Corporations with asset size $10 – $50 million – audit coverage has gone from 11.7% to 13.3%;
Corporations with asset size $50 – $100 million – audit coverage has gone from 11.7% to 18.9%;
Corporations with asset size $100 – $250 million – audit coverage has gone from 12.8% to 16.6%;
Corporations with assets over $250 million – audit coverage has gone from 27.4% to 27.6%.

At the same time, audits of S Corps and Partnerships have gone up in raw numbers but given the significant increase in S Corps and Partnership filings – the coverage rate has stayed roughly the same – about 0.40%.

It should be noted that a significant amount of the individual audits are what are termed "correspondence" audits (gotta letter in the mail). However, the number of in-person audits — "field" audits (who's that knocking on my door?) has jumped in recent years.

Why the IRS emphasis on small and medium businesses? A number of reasons – but two that stand out: first, Washington has rung the bell on the "tax gap" – that there are billions of dollars in uncollected taxes out there (no, not just in Greece). The IRS' latest analysis says that ground zero for the tax gap is unreported or underreported business income (and more specifically small and medium businesses being the problem in this view).

Second, the IRS is going through a line change with a number of new examiners and auditors being brought on while at the same time a good number of older hands are retiring. The IRS is understandably not een on having these new employees cut their teeth on the biggest companies. Bottom line: if your business isn't in the Fortune 500, has a lot of cash transactions and not much third party reporting – be prepared for a close relationship with the tax man.

As a sidenote: I wouldn't have thought this needed mentioning, but apparently it does — if you are going to engage in tax fraud and don't want to have the IRS contact you – do not create a rap video and post it on youtube highlighting your tax cheating ways. Who knew?

You Can Stand Up To The Tax Man – and Win!

During my time as a Senior Policy Advisor to the National Commission on Restructuring the IRS (the Commission's worked served as the basis for the 1998 IRS Restructuring Act) in the late 1990s, after a good deal of effort ("Many Bothans died to bring us this information") we managed to pry out of the IRS statistics on how well taxpayers did when they contested the IRS's audit claims. It turns out – taxpayers do pretty well when they stand up to the tax man. The information from 1992-1996 can be found in the Final Report — in Tables I-1, 2 and 3 (starting on P. 57).

Just a sample of the 1996 results: for taxpayers who went to appeals, overall they were able to reduce their tax bill by over 68% in the last year provided. Similarly, in tax court with big dollars at issue (over $10 million) the taxpayer was able to reduce the tax bill by over 80%. The numbers make clear that taxpayers with good counsel can have a better day when it comes to tax disputes with the IRS. Not surprising, the IRS is not trumpeting these numbers – your writer could not find any updated numbers (I welcome readers providing more recent information).

I've written previously about steps taxpayers should do if audited. At alliantgroup we find working with hundreds of business clients that a strong offense continues to be key to a good defense – for example, looking hard at open year returns for additional tax savings that weren't claimed on the original claim. This has resulted at times in our clients not having to pay additional tax but actually getting additional dollars back from the Treasury (you can't beat that with a stick). In addition, it is working in cooperation with the IRS early on to establish the framework and ground rules for the examination (we find in practice that the IRS is happy to do this).

Finally, preparing during examination and audit for the possibility that you may have to go forward to IRS appeals or even tax court is key. Quite frankly, focusing on having the needed facts and legal analysis before you and presenting them to IRS during exam will actually lessen the chances you will have to go to appeals or tax court. You don't want to call your lawyer for the first time when you are heading to appeals or tax court.

The IRS calling is never a bowl of strawberries but there are important steps you can take to lower the costs and burdens for your business.