

**SPECIAL REPORT:****HANDLING THE INCREASINGLY COMMON  
AUTOMATED IRS EXAMINATION**

The tax gap, which is the amount of taxes that should have been reported and paid on time but were not, has three components—underreporting, underpayment, and nonfiling. According to the IRS, a large part of the tax gap is caused by individuals underreporting their income tax by, for example, omitting taxable income or claiming erroneous or inflated deductions or credits. Two important compliance programs for reducing underreporting are the correspondence examination, also known as the “corr exam,” and the automated underreporter or AUR program.

As stated in the August 2013 Treasury Inspector General for Tax Administration report (number: 2013-30-077), in fiscal years (FYs) 2008 through 2012, the IRS conducted 5.7 million corr exams, resulting in \$40.4 billion in additional taxes. Each year, the additional taxes collected from corr exams exceeded the total for the previous year. In its most recent Data Book, the IRS reported that it had conducted more than 1.4 million audits of individual income tax returns in FY 2013. Over 1 million of those audits (1,060,779 to be exact) were conducted by correspondence.

Simply said, corr exams enable the IRS to reach more taxpayers. In a recent blog, National Taxpayer Advocate Nina Olson stated that the IRS has achieved a higher audit coverage rate primarily through the expansion of its automated exam programs. For example, in addition to conducting audits of more than 1.4 million individuals in FY 2010, the IRS worked 3.9 million underreporter cases, 4.7 million math error cases, and 564,000 automated substitute-for-return (nonfiler) cases. This boosted the audit coverage rate for individuals with incomes below \$100,000 from about 1% to 6.9%, and from 0.6% to 7.3% for individuals reporting incomes between \$100,000 and \$200,000.



The IRS's 2013 Nationwide Tax Forum included a presentation on corr exams and AUR contacts by an IRS official who has managed both programs. According to her presentation, both programs are highly automated, highly effective, and are conducted at the IRS Campuses, which are comparable to what were IRS Service Centers in past years. Corr exams are worked out of 10 Campuses located across the country, while AUR inquiries are conducted at seven Campuses. Although the cases initiated in each Campus are site-specific, both programs allow universal access. This allows the corr exams to be worked at any of the 10 Campuses and the AUR cases to be viewed and worked at any AUR Campus.

While there are some fundamental differences between the two Campus programs, both start with a computer-generated notice asking about one or more entries or schedules on a tax return. If the taxpayer does not respond, a Statutory Notice of Deficiency (90-day letter) will be sent to the taxpayer by certified or registered mail. If no response is received to the statutory notice, the IRS will assess the tax liability and applicable penalties and initiate collection action (e.g., serve levies on banks or employers and/or file a notice of federal tax lien) if there is a balance due.

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### **Correspondence Examinations**

Correspondence examinations (corr exams) focus on issues where a face-to-face meeting with the taxpayer or representative is not necessary. The criteria defining what type of case can be worked via correspondence are pretty straightforward. In a nutshell, the case must have a defined scope. The focus is on a specific schedule or line item on the tax return rather than the entire return, although if something unusual is identified the scope can be expanded or the case referred to a field or office audit group.

The audit issues are less complex than those handled by a Revenue Agent or Office Auditor, and frequently involve requests for records to substantiate specific tax return entries, such as receipts to support car and truck expenses on Schedule C, cancelled checks to support a charitable contribution deduction, and birth certificates or school records to support a dependency exemption. If the requested documents or records are not provided, the item will be disallowed, although there are times when the IRS will allow a partial deduction where the substantiation supports that determination.

A common issue is the Earned Income Tax Credit. The IRS asks for documentation, such as a birth certificate, to support the claim for the credit, and generally releases the portion of the refund that is not under examination. In fact, corr exams are an integral part of the IRS's strategy for ensuring compliance with the requirements for claiming a refundable credit. The Adoption Credit and the First-time Homebuyers' Credit are other credits that have been extensively worked in corr exams over the past few years. Schedule A deductions are another significant part of the corr exam inventory. Two major Schedule A issues are employee business expenses and charitable contribution deductions.

Different notices are used to contact the taxpayer. They identify the issue(s) under audit and request information from the taxpayer to verify and support the identified credit or deduction. For example, Letter 566 (Initial Contact–Notification of Examination and Request for Documentation) informs the taxpayer of the area(s) the IRS has selected and requests documentation to substantiate the information shown on the return. Some initial contact letters also include issue-specific questionnaires, which are to be filled out and returned with the response. All initial contact letters should include a copy of Publication 3498-A, which explains the process for examinations conducted by mail and addresses taxpayer appeal and advocacy rights.



Once informed of the corr exam, the practitioner should consider filing Form 2848 (Power of Attorney and Declaration of Representative). Although it is not always necessary to have a Form 2848 on file to handle a corr exam, it can expedite the process. Furthermore, under IRC Sec. 7521(c), a taxpayer has the right to be represented by an attorney, CPA, enrolled agent, or other person authorized to practice before the IRS under Treasury Department Circular 230. Once a Form 2848 has been submitted, the taxpayer should refer any subsequent questions or contacts from the IRS to the practitioner.

Notices will continue to be sent throughout the process, depending on when and whether responses are received. If the taxpayer does not reply or the IRS decides that the response does not fully support the credit or deduction, the IRS will send Letter 525 (general 30-day letter) with an examination report showing the proposed tax liability. A response must be received by the IRS within 30 calendar days from the date of the letter; otherwise, the proposed tax liability will be assessed. The response should include the taxpayer's signature if agreeing with the proposed tax liability, or a statement disagreeing with the proposed liability and requesting Appeals Office consideration. But before going to Appeals, taxpayers should provide the examiner with all information they have to support their position. Appeals will refer the case back for additional information if it feels that the documentation is incomplete.

Representatives with account issues and a valid Form 2848 from the taxpayer can use the Practitioner Priority Services, or PPS, line. This enables the representative to bypass the recorded messages and move up in the queue. The phone number is (866) 860-4259, option 7 for corr exams.



### Automated Underreporter Cases

The Automated Underreporter (AUR) program initiates inquiries about discrepancies between information reported on tax returns and information reported to the IRS by employers, banks, and other third parties. The issues vary, but can include wages reported on a Form W-2, or interest or dividend income reported on a Form 1099. AUR cases come from the Individual Master File (IMF), which contains information from filed individual tax returns, and

the Information Returns Master File (IRMF), which contains information submitted by third parties. After all current-year returns are processed, they are computer-matched to the corresponding IRMF file.

As formidable as the AUR program is, it is not a real-time program. When mismatches are identified, returns are inventoried for further analysis, beginning about seven months from the filing due date. Tax Examiners verify whether the mismatched item is located elsewhere on the return before creating a case. Generally, the earliest that taxpayers are contacted will be 12 months from the date they filed the return. Given the IRS's current processing systems and the fact that information returns can be received throughout the year, contact cannot be made any sooner in order to ensure that all information returns have been received and the matching process has been completed.

If income reported by payers cannot be identified on the tax return, AUR will notify the taxpayer. When certain conditions are present, a multipage Notice CP2501 will be issued. This notice is a preliminary inquiry letter that does not propose a change to tax liability but rather quantifies and explains the apparent mismatch and requests an explanation for the mismatch. The CP2501 may also indicate that an accuracy-related penalty will be proposed if there is an understatement of tax [and in the case of a Section 6662(d) substantial understatement penalty, if the dollar prerequisites are met].

A response is requested within 30 calendar days of the date of the notice. If the taxpayer agrees, an amended return need not be filed—the IRS will make the adjustment. But the CP2501 does instruct the taxpayer to file an amended return for any other tax year(s) where the same discrepancy occurred [assuming of course that the statute of limitations for the other tax year(s) is still open]. If the taxpayer does not agree with the third party information, the response portion of the notice should be completed, and available supporting documentation should be attached to the response. If the taxpayer wants a practitioner to discuss and provide information to the IRS about the notice, the "Authorization" should be completed and signed.



A multipage Notice CP2000 will be issued if the IRS does not issue a preliminary CP2501, the taxpayer does not timely respond to the CP2501, or the IRS rejects the taxpayer's explanation. The CP2000 is the most widely issued AUR notice. It is not a bill but does propose additional tax (and so functions as a 30-day letter). It provides the (1) payer's name, address, and tax identification number; (2) kind of document issued, such as a Form W-2 or 1099; (3) pertinent account information, including Social Security Number; (4) amount per return and per the third party; and (5) resulting difference. Unlike the CP2501, the CP2000 computes the tax understatement, including any automatic adjustments because of changes to the taxpayer's AGI, such as Schedule A miscellaneous deductions.

Generally speaking, an amended return should not be filed in response to a CP2000. Instead, the response section of the notice should be prepared. A response must be received by the IRS within 30 calendar days from the date of the letter. While extensions of time are possible, it is better not to risk an extension denial, particularly one received after the 30-day period has expired.

Taxpayers who agree should sign the response, which signifies agreement that they owe the additional tax plus interest and possibly penalties as well. The method of payment must also be indicated, with payment in full (the IRS's preferred method) appearing on the top line. A benefit of full payment for the taxpayer is avoiding the further accrual of interest. Otherwise, the "I don't agree with some or all of the proposed changes" portion of the notice should be completed and any supporting documentation should be attached to the response. If the taxpayer wants a practitioner to discuss and provide information to the IRS about the notice, the "Authorization" should be completed and signed.

Representatives with account issues and a valid Form 2848 from the taxpayer can use the Practitioner Priority Services, or PPS, line. This enables the representative to bypass the recorded messages and move up in the queue. The phone number is (866) 860-4259, option 6 for AUR cases.

### **Problems with Automated Examinations**

In her 2011 annual report to Congress, National Taxpayer Advocate Nina Olson included a section titled "An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights." While acknowledging that "the IRS needs automation to administer tax laws and tax-based social programs efficiently," she expressed concerns about the IRS "continuing to expand its automated examination, and examination-like procedures."

**A response must be received by the IRS within 30 calendar days from the date of the letter. While extensions of time are possible, it is better not to risk an extension denial, particularly one received after the 30-day period has expired.**

While automated exams have given the IRS a low-cost way to expand its audit coverage, they do not provide a detailed analysis of income and expenses to determine whether taxable income was properly reported. For example, a corr exam may determine whether a credit claimed on the return was properly claimed, or an AUR case may require the taxpayer to report 1099 income reported to the government by a third party payer. But income that was never reported to the government on a 1099 is not addressed. In that sense, the correspondence or AUR exam "may actually reduce voluntary compliance if taxpayers conclude and tell others that the IRS did not uncover cheating."



Ms. Olson has specific concerns about both types of exams. First off, corr exam work, which is “now the backbone of the IRS examination strategy, is completed by Tax Examiners, an entry-level position that requires a high school diploma or General educational development (GED) certificate.” Furthermore, it is difficult to reach a Tax Examiner on the toll-free line because the system is overloaded. She cites research that for corr exam units, 62% of the callers are repeat callers, while 13% phone more than eight times to resolve their issues. Calls that get through are routed to the next available Tax Examiner. For this reason the IRS does not provide a specific examiner’s name and extension. As a result, no single employee is responsible or accountable for the processing and closure of the case.

She adds that the lack of contact information may be more than frustrating—it may contravene the IRS Restructuring and Review Act of 1998. This is because the 1998 Act requires the IRS to include in all manually-generated correspondence the name, telephone number, and identifying number of a person the taxpayer can contact regarding the correspondence. She cites an Internal Revenue Manual provision (that is not publicly available on [www.irs.gov](http://www.irs.gov)) defining “manually-generated correspondence” as “correspondence issued as a result of an IRS employee exercising his/her judgment in working/ resolving a specific taxpayer case or correspondence, or where the employee . . . is asking the taxpayer to provide additional case-related information.”

For example, assume that a Tax Examiner concludes that the IRS needs documentation to resolve an issue. Because the examiner issues a Letter 565 (Acknowledgement and Request for Additional Information) through an automated system, the IRS considers this a computer-generated letter and does not include identifying information for the employee making the determination. According to Ms. Olson, the fact that an automated correspondence system is used to generate the letter does not negate the fact that the letter was issued as a result of the examiner exercising judgment and making a decision on a specific case. With the extensive use of computer-generated correspondence, the end result is that fewer taxpayers will be provided with the protection envisioned by Congress in 1998.

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Regarding AUR audits, the IRS has taken the position that an attempt to resolve a discrepancy between the taxpayer’s return and third party information is not an examination because it is not examining books and records but is merely asking the taxpayer to explain the discrepancy. Ms. Olson refers to AUR cases and other automated assessments as “unreal” exams because they do not give taxpayers the same rights as “real” correspondence, office, or field exams. While the IRS generally cannot audit a return twice, it can examine a return that was previously subject to an “unreal” exam. In that circumstance, it reserves the right to examine the books and records later without violating IRC Sec. 7605(b).

While the IRS may not consider an AUR contact to be a real examination, it is easy to understand why a taxpayer would. The IRS website has a sample copy of the CP2000, which is the most commonly issued underreporter notice (see <http://www.irs.gov/Individuals/Understanding-Your-CP2000-Notice>). The CP2000 states that for additional information, the taxpayer can review the enclosed Publication 3498-A, “The Examination Process.” As if the name were not enough, the first item listed under “Audits by Mail” states that: “The IRS will send a letter informing you that you have been selected for an audit, and listing what information you need to send to the IRS.”



### Responding to an Automated Exam Letter or Notice

It is important to understand what item or items are being questioned by the corr exam or AUR notice. (For help in doing this, the practitioner can access the Checkpoint IRS Response Library, which provides explanations of and guidance for handling hundreds of IRS letters, notices, and forms.) It is also very important to understand what the IRS proposes to do if the taxpayer does not respond or the response is deemed to be unsatisfactory. Is the IRS merely requesting information? Or will it assess the proposed tax and penalties (if applicable) if the taxpayer does not respond in a timely manner?

Even if the practitioner prepared the tax return, a wage and income transcript for that year should be obtained from the IRS by calling the Practitioner Priority Service or accessing the online e-Services Transcript Delivery System. Proper authorization from the taxpayer is required—either Form 2848 (Power of Attorney and Declaration of Representative) or 8821 (Tax Information Authorization). To advocate on the taxpayer’s behalf, a Form 2848 must be on file. If the dispute involves a joint income tax return, both spouses must execute their own form.

### Taxpayers who used representatives were nearly twice as likely to be found eligible for the credit compared to those who were not represented.

As discussed more fully in PPC’s Guide to Dealing with the IRS, when responding to a letter or notice:

1. Attach copies of all notices and other correspondence received by the taxpayer (or at least the last notice received) or provide a detailed description of the problem. Attach an original or photocopy of the Form 2848 authorizing the practitioner to represent the taxpayer(s).
2. Provide copies of all taxpayer and/or practitioner responses to the IRS notices or other correspondence. Specifically reference each response in a letter outlining the problem.
3. Provide copies of all documents supporting the client’s position. Do not send original documents. If copies of tax returns or schedules are requested or needed to clear up the matter, stamp or write “Copy only, do not process” on each one.
4. Request specific action by the IRS, such as: do not assess the proposed tax increase, abate the assessed penalty, or the taxpayer requests Appeals Office consideration.
5. Provide a telephone number, name, and time of day the IRS can call to discuss the matter if there are any questions or other problems.
6. Place the expected response date on a tickler file to monitor the matter.

Representing taxpayers in these matters is not a fruitless exercise. In her 2013 Objectives Report to Congress, National Taxpayer Advocate Olson noted that 46% of all correspondence exams in fiscal year 2011 covered the Earned Income Tax Credit, and taxpayers who used representatives were nearly twice as likely to be found eligible for the credit compared to those who were not represented.

Remember that the Taxpayer Advocate can be contacted if the taxpayer is suffering or will suffer a “significant hardship,” which is defined as a “serious privation caused or about to be caused to the taxpayer as the result of the particular manner in which the revenue laws are being administered by the Internal Revenue Service” [Reg. 301.7811-1(a)(4)(ii)]. The Taxpayer Advocate is an independent organization within the IRS that assists taxpayers experiencing significant economic harm or long long delays, or who have not received a response to a tax issue through normal channels. There is at least one Taxpayer Advocate in every state, the District of Columbia, Puerto Rico, and each Service Center (Campus). There is also a nationwide toll-free number: (877) 777-4778 or TTY/TTD (800) 829-4059.



You'll find all the comprehensive tools and learning opportunities you need to successfully deal with today's IRS.

## IRS PRACTICE AND PROCEDURE GUIDANCE

### [Checkpoint IRS Response Library](#)

The *Checkpoint IRS Response Library* provides subscribers the comfort and confidence to efficiently and effectively respond to IRS taxpayer notices and represent clients in many types of engagements. Subscribers can quickly search by notice number and respond to the IRS and clients using a variety of tools, including scripts and response documents.

The IRS Issues section includes a topical listing of commonly encountered IRS issues/engagements, broken down into Individuals and Businesses/Payroll. Chapters are grouped together by common topic, with an Introduction, Issue Overview, Practice Overview, Workplan, and list of Documents and Resources. The step-by-step Workplan displays detailed instructions, practice tips, and examples of necessary documents and forms.

### [PPC's Guide to Dealing with the IRS](#)

*PPC's Guide to Dealing with the IRS* shows you how to apply the rules for your clients' benefit with more than 150 tools and practice aids that enable you and your staff to work efficiently and effectively with the IRS. You'll get step-by-step guidance for more than 50 matters, work programs for major engagements, checklists for preparing forms, and summaries of the law. There's also a chapter on managing client matters, and another profiling typical client situations — including strategies, filled-in forms, and other practice aids for completing the engagement.

For more information, visit [tax.thomsonreuters.com](http://tax.thomsonreuters.com) or call 800.431.9025



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