Financial Accounting & Executive Alert

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TAXES: Prepare Yourself - The IRS is Looking Harder At Smaller Companies

An IRS insider gives you the inside dope on how to dodge the audit bullet.

For years, the **Internal Revenue Service's** resources have been flat, and it has devoted most of its energy to large, publicly held companies. But as the agency is outsourcing much of its compliance-enforcement and collections functions, it has more and more time to dissect your returns as well, warns **Lawrence Gibbs**, a partner with Washington, DC-based **Miller and Chevalier Chartered**, who also served as IRS commissioner from 1986 to 1989.

To help explain the best ways for you to keep the IRS wolf at bay, Gibbs graciously sat down with **Eli** for a detailed interview. The following Q&A is excerpted from this conversation.

Eli: What kinds of actions should our readers take to keep clear of the IRS and maintain compliance?

Gibbs: I'll tell you a story to help bring this home. Within the last two weeks, we had an IRS agent that is a specialist called an employment-tax agent, and he is coming in to look at the returns at the company level. And the company does not pay any income taxes because they've had large start-up expenses, so they've got net operating loss carryovers. They've had net operating losses in the past, they haven't been able to use all of them, and they've carried them over for another four or five years, where they'll pay no income tax. But they do pay employment taxes, withholding and otherwise.

Well, the employment-tax agent came in and said, "Look, I'm going to audit 2003, 2004, 2005. I don't have much time, and I'd really like to have your assistance. Why don't you tell me, in 2003, 2004, 2005, where are the soft spots in the company's returns? Where are the areas that you've handled something at the corporate level that could affect your corporate return? Now if you'll do that, it'll make it a lot easier for me, and I'll go to bat for you -- if there are any major adjustments, I'll do what I can to try to help you minimize or avoid any penalties. Now if you don't want to do this, I can just go ahead and audit you; it'll take me a lot more time, but in that event, here are seven civil penalties and eight criminal penalties that could potentially apply to you if you don't want to do it the easy way. Oh, and by the way, I intend to start with the programs that will affect your senior executives. So think it over and let me know."

We're telling our CFOs and controllers, "Look, guys, the absolute key here is to get ready before this guy walks in. Because if we have the chance to go through 2003, 2004, 2005 in advance, we know ahead of time what the soft spots are, and we can figure out how -- ahead of time -- we're going to deal with it. Maybe we'll file an amended return to get rid of a major problem. But we'll figure out ahead of time what the strategy is and it will become much easier when we go through the audit process." But the controller and the CFO will also have a much better idea about what to do with their tax reserves, and they'll have a better idea of what's going to come at them in the audit.

Then, when we get to the audit, usually we wind up assisting the company personnel, but on a much-reduced basis, because we've already got a game plan -- we just help them handle what comes up as we go through the audit. And we have found that from the standpoint of our major clients, this is a good way to deal with what would otherwise be a very sensitive, difficult area for the company, for the board and for the officers, in a way that either minimizes or avoids the time and the cost that would otherwise occur in these kinds of audits.

Eli: Are these actions the kinds of things that private companies should look at?

Gibbs: Let me make one point here: your chances of being audited have gone up because of the current program. By forcing the IRS auditors to shorten their audit times, they've got more time available to do more audits of more companies. So what's happening is, the focus used to be on the large publicly held corporation; basically most of their resources were going toward large companies.

Now what they're doing is shifting that down into your midsize and smaller businesses, particularly when they see non-compliance. When you get down into the smaller-sized companies, that can be a much bigger problem in terms of executive compensation, because those folks have not been audited for years. I don't think I'm a criminal, but if I'm driving and I don't see a patrolman for 100 miles, my foot gets heavy on the pedal. We're getting calls on a daily basis from your midsize and smaller businesses because this is something that, when you get to the audit of the senior executives, it's often the owner of the business. So this is serious stuff.

So my advice is, hey, whether you call us or someone else, take a look in advance and see what your soft spots are in your corporate returns, and where the soft spots are in your individuals' returns. The trend at the IRS today is that if they find someone, company or individual, that they feel their foot's gotten heavy on the accelerator, they spend more time and more resources, for two reasons: One, to persuade them to become compliant; and two, to persuade them to tell their friends what they had to go through.

Eli: What soft spots is the IRS most likely to find or to scrutinize?

Gibbs: Well, companies now have to maintain tax reserves. And there's a new accounting regulation (FIN 48) the FASB has put out, and that's causing more problems than you can imagine. We've got companies large and small, if they're having audited financials, they're having to deal with it. But that's where your soft spots are in your tax reserve. It's worth sitting down on a privileged, attorney-client basis and saying, "What's in your tax reserve?" And then you should be talking about the executive compensation items as well, if they're not in the reserve.

Any reader that's having problems with FIN 48, everything I've said today goes right to that. And the thing they need to know is that it's much more likely that they're going to be audited by the IRS, because the IRS is beginning to free up audit resources so they can audit your midsize and smaller companies seems to be out of line with the rest of the industry?

And with electronic filing, which the business world is increasingly moving toward, the IRS can touch even more returns. They can even do it on a more granular basis.

What that means is that, even if there's nothing wrong with your return, if you have something peculiar and you become an outlier, you may be subject to a knock on the door from the IRS.

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