The IRS Audit Process: Practical Tips for Success

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Life Cycle of an IRS Audit

• Audit Selection
• Audit vs. Inspection
• How Far Back Can IRS Audit?
• Types of IRS Audits
• Preparing For An Audit
• Audit Logistics
  • Information Document Requests (IDRs)
  • Agreed and Un-agreed Issues
• Appeals and Litigation
• The Cost of Being Wrong
Audit Selection

• How companies selected for audits?

• What role do the following play?
  • Matching (W-2, 1099, K-1)
  • DIF Score
  • Collateral Parties (Partners, Officers, Beneficiaries)
  • Referrals (Prior audit, Informant)
  • Large Case
Audit Selection

• Matching (W-2, 1099, K-1?)
• DIF score
• Collateral
  • Partners / Members / S-Corp Shareholder
  • Officers / Directors
  • Party to same transaction
  • Trust / Beneficiary
• Referrals
  • Prior audit
  • Informant
• Large Case
Audit Selection

• Are there any IRS audit initiatives underway?
• Is the IRS specifically targeting “831(b) captives?”
Audit Selection

• How far back can the IRS audit?
Audit Selection

How far back can the IRS audit?

• 3 Years – Normal
• 6 Years – Omit 25% of Gross Income on Return
• Forever – No Return Filed (or False/Fraudulent Return Filed)
• Extending the Statute of Limitations
• Extending All Issues vs. Selected Issues
Audit Selection

• How am I notified of an IRS audit?
Types of Audits

- What types of IRS audits are there?
- How do the costs vary?
Types of Audits

• Types of IRS audits
• Mail-In Audit
• Office Audit (IRS Office)
  • Informal
  • Needed items specified in letter
  • One sitting
  • Can reschedule if request made
• Field Audit
  • Taxpayer or representative’s office
  • Off premises? One coordinator?
  • Multiple meetings
  • Large taxpayers – every day for two years
Audit Preparation

• What are the keys to preparing for a successful audit?
Audit Preparation

Best Approach Is To Have A Good Foundation

- Excellent Captive Manager
- Well Conceived Feasibility Study
- Good Purpose
- Proper Structure and Insurance Program
- Regulatory Compliance
- Capitalization
- Good Records
- Corporate Formalities
Audit Logistics

• Where will the audit be located?

• What kind of representation should I have?
  • Attorney?
  • Accountant?
Audit Logistics

• What are the IRS’ “hot topics” they are looking at these days?

• Other than qualifying as insurance, are there other hot button issues?

• What are the best ways to handle an Information Document Request (IDR)?

• What is the intent of IDR?
Audit Logistics

• Explain the basic concepts of:
  • Non-tax Business Purpose
  • Insurance Risk vs. Business Risk
  • Common Notions of Insurance
  • Risk Transfer/Shifting
  • Risk Distribution
Audit Logistics

• Is the way we price the premium really important?

• Is capitalization important?
Audit Logistics

• What are Agreed Issues?

• How are Agreed Issues documented?
Audit Logistics

• What is a Notice of Proposed Adjustment (NOPA)?

• How do you respond to a NOPA?
Audit Logistics

• How does an audit end?
  • Via Settlement?
  • Via Negotiation?
  • Via Litigation?

• How does the appeals process work?
Audit Litigation

• How does an audit proceed to litigation?

• What kind of representation should I have?
  • Attorney?
  • Accountant?
Audit Litigation

• What information is confidential?

• How much can litigation cost? How long can it take?

• Does venue matter?
## Audit Litigation

<table>
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<tr>
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<th>TAX COURT</th>
<th>DISTRICT COURT</th>
<th>COURT OF FED. CLAIMS</th>
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<tr>
<td>JUDGE/JURY</td>
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<tr>
<td></td>
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<td>*Judge or Jury</td>
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<td>PLACE OF TRIAL</td>
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<td>**Judge Travels from DC</td>
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<td>% OF TAX CASES</td>
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<td>GOVT. LAWYER</td>
<td>IRS</td>
<td>DOJ</td>
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Audit Litigation

• What are the penalties if premium is determined to not be “insurance” for tax purposes?
## Audit Litigation

<table>
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<tr>
<th>Interest Second Quarter 2014</th>
<th>Overpayment</th>
<th>Underpayment</th>
<th>Deduct</th>
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<tr>
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<td>3%</td>
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<tr>
<td>Large Corporate</td>
<td>.5%*</td>
<td>5%**</td>
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</table>

* Overpayment above $10,000

** Underpayment of $100,000 beginning 30 days after 30-day or 90-day letter
Audit Litigation

• Penalties
  • 20% - Negligence/Substantial Understatement
  • 40% - No Economic Substance
    – Undisclosed Foreign Financial Asset
  • 75% - Fraud
  • “Reasonable Cause” “Act in Good Faith” Relief
    – Not available for “Economic Substance” Penalties
Conclusion

IRS Audits can be daunting experiences for captive owners. However, with solid insurance practices including feasibility studies, premium development, risk transfer and distribution, and documentation, IRS audits costs and the risk of potential fines and penalties can be minimized.
QUESTIONS