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SERVING ALL POINTS OF NEBRASKA AND THE MIDWEST

Face to Face with the IRS

For most taxpayers, the Internal Revenue Service is simply a faceless agency that spits out forms and instructions and regularly accepts tax returns and tax money. For those singled out for an income tax audit, however, the whole process gets a little more personal and quite a bit more unsettling. Though an audit must be dealt with seriously, it need not be a scary or a mysterious experience. The key is to respond appropriately and in a timely manner. Here is a brief summary of the audit process and some tips for success in dealing with the IRS.

Audit Notice:

A taxpayer normally becomes aware that an income tax audit is beginning when a notice is received indicating the tax years involved and the records sought. Individual taxpayers normally bring their records to the local IRS office where, if everything is properly documented, the audit may last only an hour or two. What triggers the selection of one taxpayer over another? Tax audits may result from many sources, including anonymous tips or transactions reported in a newspaper. The vast majority, however, are selected by computer on the basis of certain aspects of a tax return determined to be outside the norm for a taxpayer in that income range. In other words, most often the selection is impersonal, with the IRS computer identifying items to be verified.

Audit Preparation:

The most important aspect of a tax audit is preparation. The taxpayer is told what records will be examined. If the records are complete and accurate, the audit should be quick and simple. If the records are incomplete and inaccurate, the auditor may determine that a more thorough examination of the tax return is necessary. The failure to produce records also may result in a more serious reaction such as auditing additional years or referring the case for criminal investigation. If major problems are identified or if there are obvious record-keeping problems, legal counsel should be retained as quickly as possible.

The Audit Meeting:

At a prearranged time, the auditor or revenue agent will meet personally with the taxpayer who may be represented by legal counsel or an accountant. If the records are complete and no major issues have been identified by the taxpayer, it is entirely feasible for the taxpayer to handle the audit without professional assistance. It is important to note,

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however, that an auditor can only propose or not propose a tax deficiency. The auditor is not authorized to negotiate with the taxpayer. It is a mistake for a taxpayer to attempt to negotiate with an auditor as concessions offered will be used against the taxpayer and the auditor cannot offer concessions.

Audit Results:

For most taxpayers, the audit results are easily understood and appropriate. For example, the taxpayer may lack documentation for certain deductible expenses or innocently fail to report income from a particular transaction or financial institution. If there are adjustments which involve questions of how the Internal Revenue Code or regulations should apply to a particular situation, or if the adjustments relating to missing or incomplete documentation are substantial, it is advisable to seek professional assistance.

The taxpayer usually receives a preliminary audit report. This allows the taxpayer an opportunity to clarify any misunderstandings and correct any errors by the auditor. If it appears that there are proposed adjustments to which the taxpayer will not agree, the auditor frequently is tempted to include everything possible so that the IRS can eventually compromise and still obtain agreement on the basic adjustments being asserted.

Remember –
The Auditor's Job Is to Audit:

It is a natural part of the auditor's job to be suspicious. Written documentation of expenses, for example, is excellent proof, whereas an oral explanation may only raise more questions. IRS auditors have heard it all and are aware of the many "tricks" attempted by more devious taxpayers. Don't be offended if they don't accept an oral explanation without some sort of documentary proof. It is up to the taxpayer TO PROVE the correctness of the tax return and the auditor is simply requiring the proof mandated by Congress.

Criminal Investigations:

Criminal investigations result from a variety of sources including normal audits which are referred for this purpose when potential misconduct is uncovered. The "old" rule was that an agent should consider a referral if unreported income exceeds $10,000. Our experience has been that referrals occur only at much higher levels of unreported income. Though the threat of prosecution is real for those engaged in schemes to avoid paying tax, the typical taxpayer who wants to do the right thing need not be particularly concerned about a criminal investigation. It is not uncommon for audits which result in substantial tax adjustments to be concluded without referral for a criminal investigation.

Appeals:

What happens if a taxpayer and the auditor do not reach agreement? In that case the taxpayer receives a letter which allows the taxpayer thirty (30) days to appeal the proposed adjustments. The time period may be extended for good reason. The appeal will be heard by an appeals officer, an individual in a different branch of the IRS who is typically very experienced and capable. The appeals officer has broad authority to negotiate a settlement and may take into account the risk the IRS might not prevail at a trial on the issues. Most unresolved cases are settled at this point. Assuming the amount in issue (taxes, interest and penalties) is significant, the taxpayer should consider retaining legal counsel, if not already retained, since the appeals process is primarily advocacy with an emphasis on the weight or value to be attributed to the various factors.

Litigation:

If the taxpayer fails to settle the case at Appeals, the taxpayer may elect to litigate the case. After a failed attempt at settlement, the IRS will issue a Statutory Notice of Deficiency which allows the taxpayer ninety (90) days to file a petition in U.S. Tax Court. The ninety (90)-day period is mandatory for the Tax Court and may not be extended. If suit is filed in Tax Court, the income taxes need not be paid first, although a taxpayer may elect to make a deposit in order to stop the accumulation of interest and penalties.

If a petition is not timely filed in Tax Court, the taxpayer must pay the tax. If, after paying the tax the taxpayer still wishes to contest the correctness of the assessment, the taxpayer may file a claim for refund with the IRS and, if the claim is not allowed, file suit in U.S. District Court or Federal Claims Court. Either the taxpayer or the government may request a jury trial in District Court. Most jury panels are not particularly sympathetic to taxpayers attempting to avoid paying taxes, although a jury's attitude depends on the nature of the case and the circumstances of the taxpayer. Most tax cases are tried in Tax Court for two reasons: (1) it avoids the need to obtain funds with which to pay the tax, and (2) the Tax Court is the court most experienced in tax matters.

Summary:

In sum, an income tax audit is not something to be feared. The auditor's job is to verify the correctness of your return. If you are prepared and your records are complete and well-organized, there should be no problem. Don't worry about minor errors–most audits result in some sort of an adjustment. Also, remember that the auditor is the first word, not the last word; there are more chances to successfully resolve difficult issues. Finally, if the process is too nerve wracking or involves substantial errors, do not hesitate to consult a qualified tax professional. We deal with the IRS and the audit process on a regular basis. We would be happy to help.

–David A. Ludtke, Esq.
and Timothy L. Moll, Esq.

Netting Some Help

www.irs.gov The Internal Revenue Service recently renovated their web site to make it easier to navigate and search. Forms or publications are easy to pull up and print (no more hunting for forms on those racks in the library!) and the site contains a wealth of information on a wide variety of topics, including e-filing, deductions, and regulations.

www.firstgov. com This site is sponsored by the federal government, and it's here to help you. Really. You can search for anything dealing with the government on here to find information and links to other government sources. If you have questions on such diverse topics as passports, social security numbers, consumer publications, travel information, or OSHA regulations, give this site a try. And, of course, they have links to IRS information.

How do we look?

The Rembolt Ludtke & Berger LLP web site at www.remlud.com has recently undergone a redesign. Check it out and let us know what you think. Web sites are never a finished product, and we still have plans for ours, and we would be interested in your comments on functionality and content.

Tried and true tax-saving transactions

The Internal Revenue Service is the unseen third party in most transactions involving the sale of assets. When an asset is sold, the transaction is reported and any gain on the sale must be recognized as income. In some instances, the potential income tax consequences that would be paid upon the sale of an asset are so severe that it does not make economic sense to sell. This is particularly true in the case of long-held assets which have appreciated greatly in value.

As a general rule, if someone tells you can sell an asset without paying any tax, they are probably wrong and you should be careful. Fortunately, however, there are some tried and true methods to transfer an asset without immediate income tax consequences. A few of the most common are described briefly below.

Sale of Residence: A taxpayer can exclude up to the first $250,000 of gain ($500,000 of gain for joint filers) on the sale of a residence. The exclusion is available if the residence was used by the taxpayer as a principal residence for at least two of the five years prior to the sale. The exclusion is not a one-time exclusion, but may be used again in the future provided the two out of five years rule is met. Please note, however, that the portion of the residence used for business purposes (as a home office, for instance) does not qualify for the exclusion.

Like Kind Exchange: A taxpayer can exchange business or investment property for "like kind" business or investment property without paying tax. This treatment is not available for stocks, bonds, and other securities, but is a very useful tax planning tool for other assets, particularly real estate. Real estate is generally considered to be of "like kind" with any other type of real estate. Thus, a taxpayer using this provision could exchange rental real estate for farm land or a commercial building for development property without having to pay tax. The rules for complying with the like-kind exchange provisions are strict and technical, but the benefits can be significant.

Charitable Trust. For taxpayers who are charitably inclined, the charitable trust provides a tax-friendly means to avoid the tax on the sale of an appreciated asset. The taxpayer transfers the appreciated asset to the charitable trust managed by an independent trustee. The trustee then generally liquidates the asset. The trust then directs the trustee to pay a percentage of the value of the trust (5%, for instance) to the taxpayer each year. The amount paid is often larger than the amount of income that would have been generated had the taxpayer sold the asset, paid the tax on the gain, and invested the remaining proceeds. Upon the taxpayer's death, the balance in the trust is paid to the charitable organization designated by the taxpayer. The overall tax benefits can be significant: a) No tax is paid on the transfer to the trust and the taxpayer can claim a charitable deduction for a portion of the value of the transferred asset; b) No tax is paid on the sale of the asset by the trust because a charitable trust is exempt from tax; c) The taxpayer still receives the benefit of the asset through a regular income stream; and d) A charity of the taxpayer's choice is benefitted upon the taxpayer's death.

Corporate Reorganizations: For taxpayers who own stock in a closely held or family corporation, the Internal Revenue Code offers some opportunities to "sell" the family business without immediately recognizing gain. In certain situations, a closely-held corporation can be acquired by another corporation as part of a merger or consolidation in which the "selling" taxpayers receive stock in the acquiring corporation in a tax-free transaction. Likewise, it is sometimes possible to split an existing corporation with distinct business operations into two separate corporations on a tax-free basis. There are, however, restrictions on the sale of stock received in a tax-free merger or a tax-free split up.

Think you could benefit from one of the above? If so, please contact us for more information. We would be happy to help you sort through how any one of the above opportunities might apply to your particular situation.

–David A. Ludtke, Esq.
and Timothy L. Moll, Esq.

Tax Practice Group of Rembolt Ludtke & Berger LLP

David A. Ludtke

David's accomplishments over his distinguished career have established him as one of this region's foremost authorities on tax law. He earned his B.A. from Harvard, and his J.D. magna cum laude from the University of Michigan. David taught at the University of Nebraska College of Law, has published numerous articles and books, and is a frequent seminar speaker. He has been with the firm since 1973.

Kevin C. Siebert

Kevin joined Rembolt Ludtke & Berger LLP in 1983, after receiving his B.S. and J.D. degrees, with high distinction, from the University of Nebraska, where he was the Executive Director of the Nebraska Law Review. He was an adjunct Professor at the University of Nebraska College of Law, and has lectured at seminars and continuing education programs around the state, and contributed articles to several publications.

Timothy L. Moll

Tim received his B.A. from Concordia College and his J.D., with highest distinction, from the University of Nebraska College of Law. He was the Managing Editor of the Nebraska Law Review and, after graduation, served as Chambers Attorney for The Honorable C. Arlen Beam of the Eighth Circuit Court of Appeals. Tim joined Rembolt Ludtke & Berger LLP in 1995, having clerked with the firm during law school. He has co-authored several published articles, and been an adjunct professor at the University of Nebraska College of Law.

How do I tax thee? Let me count the ways!

Ever wondered how many different kinds of taxes there are? The short answer is a lot more than any one person can keep track of. Here is just a partial listing of the categories of taxes that can apply to individuals and businesses in Nebraska.

Federal Taxes

Income Tax (Individual & Corporate)
Estate Tax
Gift Tax
Generation Skipping Transfer Tax
Retail Excise Taxes
Manufacturers Excise Taxes
Facilities and Services Taxes (Communications Taxes)
Wagering Taxes
Environmental Taxes
Distilled Spirits, Wines & Beer Taxes
Tobacco Products Taxes
Firearms Taxes

State Taxes

Income Tax (Individual & Corporate)
Real Property Tax
Personal Property Tax
Sales Tax
Use Tax
Estate Tax
Generation Skipping Transfer Tax
Inheritance Tax
Insurance Tax
Cigarette Tax/Tobacco Products Tax
Documentary Stamp Tax
Mechanical Amusement Device Tax
Financial Institution Tax
Marijuana and Controlled Substances Tax
Motor Fuels Tax
Aircraft Fuels Tax
Diesel Fuel Tax
Lodging Tax
Litter Fee
Tire Fee
Charitable Gaming Taxes

Too Good to Be True

scams

Each year as tax return season draws near, we are likely to hear of a new (or revived) tax scam promising to free taxpayers from the obligation to file or pay federal income taxes, or even to generate a refund above and beyond the amount of taxes owed.

The scam du jour is a credit purportedly available solely to African-Americans, generally promoted as the “Black Investment Tax Credit,” “Reparations for African-Americans,” or the “Black Inheritance Refund.” In a typical case, an African-American is contacted by phone, mail or the Internet, told that there is a little known tax credit in the Federal Income Tax Code available only to descendants of slaves, and that if the taxpayer will send a fee (generally $100-$200) to the person making the contact, he or she will receive a form with instructions for filing a refund claim, generally represented to be in the range of $40,000 to $80,000 per taxpayer. By the time the taxpayer has filed the return and heard back from the Internal Revenue Service, the promoter is long gone, together with the “fee” received from the taxpayer.

The Internal Revenue Service, in an effort to stem the tide of the current scam and other scams, has released two publications which summarize typical schemes. “The Truth About Frivolous Tax Arguments,” published last year, lists the most common legal arguments advanced by scam promoters to save taxpayers from filing or paying taxes, and also describes in some detail the legal reasons why each of the frivolous arguments are groundless.

“The Truth about Frivolous Tax Arguments” also summarizes penalties that may be sought against a taxpayer who files a return which takes a frivolous position or claims a frivolous refund. In addition to civil penalties of up to $25,000 per return in certain circumstances, together with possible additional underpayment and civil negligence and fraud penalties, a taxpayer knowingly filing a frivolous return can be subject to criminal tax fraud charges.

This year, the Service published the “Dirty Dozen,” which is a list of the 12 most common tax scams advanced by various promoters in recent years. The “Black Investment Tax Credit” is included on the list, together with various scams such as “selling” dependants for earned income tax credit purposes and how to set up a bogus home-based business and thereby deduct personal living expenses. Both of these documents are on the IRS web site at www.irs.gov, and make for some interesting reading. The “Dirty Dozen” is in the Newsroom section of the site. “The Truth About Frivolous Tax Arguments” is found under the “Tax Scams and Fraud Alerts” link on the Service’s home page.

So when you hear from your neighbor about their cousin who doesn’t file tax returns or pay income taxes because of a little known case or constitutional provision, don’t believe for a minute that there is a valid legal excuse for not filing or paying taxes. While new scams appear periodically, they are generally based on the same old theories, and the IRS has seen and heard them all. The ultimate cost of taking a frivolous position far exceeds, invariably, the promised savings.

–Kevin C. Siebert, Esq.

Update on Federal Estate Taxes

Though death and taxes are a sure thing, how the tax laws apply at death is a lot less certain. Due to legislation enacted by Congress which became effective January 1, 2002, the federal estate tax rules have changed and will keep changing for several years. The federal estate tax is a tax (at rates which generally range from 37%-50%) on the fair market value of everything you own at the time of your death, including the death benefit on life insurance policies.

In addition to various deductions which are available, a portion of each estate is exempt from federal estate tax. The exemption for persons dying in 2002 or 2003 is $1,000,000 and will change in future years as follows:

$1,500,000 for 2004 and 2005;
$2,000,000 for 2006, 2007, and 2008; and
$3,000,000 for 2009.

Planning for these taxes is an important part of a complete estate plan. If you have not reviewed your plan in light of these coming changes, the time to do so is now.

What is "Use Tax" Anyway?

Most people are familiar with the sales tax that applies when you purchase products in Nebraska. That tax is collected by the retailer and forwarded to the Department of Revenue. The use tax is the lesser known companion tax to the sales tax. Use tax applies when products (to which sales tax would normally apply) are purchased without paying sales tax and then are used or consumed within Nebraska.

The use tax rate is the same as the sales tax rate. For example, if a business purchases a computer out-of-sate or by mail order without paying Nebraska sales tax, Nebraska use tax will likely apply when the computer is used in Nebraska. Likewise, if a retailer takes items out of inventory and uses them (for example, a paint store uses paint in inventory to paint the store), use tax is generally due on the paint because sales tax would have been due had the paint been sold to a customer.

Overall, it pays to pay attention to whether you are paying sales tax on items you purchase and whether use tax might be due if you do not. If the Department of Revenue identifies such items in an audit, use tax will be imposed along with interest and possibly penalties.

You Could Have Mail

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