Ways to Steer Clear of IRS Tax Disputes

By Robert W. Wood

No one sets out to engage in a tax controversy. Perhaps an exception would be an ardent tax protestor itching for a fight. Yet even most tax protestors probably don't actually *want* to do battle. If you are anything like most people, you want to file your return, pay your tax, and remain undisturbed.

Of course, when it comes to just how *much* tax you have to pay, you may want to be mindful of Learned Hand's famous iteration of the taxpayer's role in the system. Judge Hand admonished that

> [t]here is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.[1]

During the recent presidential race, then-candidate Joseph Biden suggested that paying higher taxes is actually patriotic, but there has been little suggestion that Biden's patriotic spin on taxes has eclipsed Judge Hand's mantra. Still, just how much tax planning and maneuvering is too much is debatable. Different taxpayers have different comfort levels with various degrees of risk on a tax return.

Few people want a tax controversy. On the contrary, most of us would do just about anything within reason to steer clear of an audit or dispute. As such, it may surprise you to know there are simple steps you can take to make it less likely you'll have to endure a tax controversy. What's more, these basic principles apply whether you're talking about a personal tax return or one for your business.

Here, then, are 10 tips to help you avoid tax controversies.

1. Keep Good Records

You might think that keeping good records is something that can help you only if you actually *end up* in a tax controversy. Yet, believe it or not, there is something about keeping good records that can keep you out of trouble in the first place. Maybe it's karma.

Whatever you call it, there is a cosmic notion that when you follow the Boy Scout's motto and are prepared, you probably won't need to be. Or perhaps it is some larger principle at work. The fact is that good records reduce the likelihood you will face a tax dispute, at least in my experience. Besides, if you keep good records, your numbers will likely be more reliable. That is a tangible effect of being well-organized.

2. Use a Return Preparer or Return Preparation Software

Depending on what type of taxpayer you are, you may swear by doing your own tax return, or you may swear by your accountant. This is a matter of individual preference, but you should consider this carefully. There's nothing wrong with doing your own return, if you are comfortable doing it.

Moreover, although some old wives' tales suggest that a return prepared by a professional is less likely to be audited, there's little reliable data to suggest this is true. Nevertheless, having a professional prepare the return or at least be involved and advise on anything quirky is a good idea. In many cases, a professional will help steer you clear of pitfalls.

If you do insist on doing your own return, using one of the commercially available software packages will make the job easier and probably more reliable.

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3. Stick to the Forms

Tax returns are all about the forms. This may sound silly, but you'd be surprised how many people, professional and amateurs alike, try to submit information on non–tax forms. You can, however, submit footnotes to the forms on separate sheets of white paper. Especially if your tax return is complex, you may find you need to add explanations or disclosures in footnotes. Such disclosures can be made on regular paper or on special IRS forms.

> You may find you have a range of available choices, depending on your risk profile and the advice from the tax professional.

The two basic IRS disclosure forms are Form 8275, called a "Disclosure Statement," and Form 8275-R, called a "Regulation Disclosure Statement." The 8275 is used any time you need to disclose something that isn't adequately disclosed on the forms. The 8275-R is a more serious form, used for disclosing positions on your tax return that are contrary to IRS Regulations or other authority. You probably shouldn't be filing a Form 8275-R – or taking a tax return position that would require you to file this form – without professional help.

4. Be Reasonable and Conservative

Of all the rules, this is the toughest to impart and the hardest to summarize. Preparing tax returns often involves judgment and choice. True, many tax issues are mechanical, such as the notion that wages represent income, or that interest is treated as interest.

But if you receive a lawsuit settlement, you may have a range of choices for reporting the recovery. It may be debatable whether your recovery is all ordinary income, all capital gain, or some of each. It may be debatable whether it is fully excludable as a personal physical injury recovery under Internal Revenue Code § 104.

You should rely on professional advice in such a case. Even then, you may find you have a range of available choices, depending on your risk profile and the advice from the tax professional. If that's the case, my advice is to be reasonable. Don't take an extreme position.

If you find yourself rereading Judge Learned Hand's quote for the 10th time, don't assume that means you should cheat the system. You shouldn't. You shouldn't take a position you won't be comfortable defending.

This may be karma again, but if you take tax positions that are reasonable, you'll likely find you won't end up having to defend them. Another way to look at it is this: Always take tax positions that are reasonable, and don't take the last dollar off the table. If you follow this rule and you DO face a controversy, it is likely to be far easier to resolve. In fact, it can be an effective strategy to point out to the IRS that a range of tax choices was available to you, and you nevertheless took a moderate position.

One final point about being reasonable: Many taxpayers think that if the "right" position on a return is, say, 50% tax-free and 50% taxable on an item, the smart play is to claim a 100% exclusion. After all, the reasoning continues, you can always give up on the other 50% when you're audited! In contrast, such taxpayers reason, if you file with the 50/50 position from the get-go, you've got nothing to give up.

Every situation is different, and the facts and the tax law should be examined carefully. In general, though, this kind of "I can always be reasonable later" reasoning is flawed. It has far more integrity – and is generally far more effective – to take a reasonable filing position, and then be prepared to defend it. I've found that strategy is generally the best one.

5. Make Sure Your Math Is Correct

Here's another rule that sounds silly: Make sure you add and subtract accurately. You'd be surprised at how many times a tax return is audited because 200 and 200 just don't equal 500. Check your numbers throughout, at each step of your return, and do some simple math checks when you finish, just to be sure.

6. Disclose and Explain, But Don't Go Overboard

We've already talked a bit about disclosure. You should fill out tax forms completely, and disclose your positions adequately. Usually that means filling out the forms, and when you need to footnote something to explain it more fully, doing it on 8½ x 11 white paper and including it with the return. That's why you'll hear some tax return preparers and others in the tax field talking about "white paper disclosures," to distinguish them from disclosures made on IRS Forms 8275 and 8275-R, the two forms noted under point 3 above.

When it comes to disclosure and explanations, be concise, truthful and accurate, but don't go crazy. For example, don't provide copies of sales agreements, settlement agreements, bank statements, and so on. Don't provide such items unless you're asked to. Where you have an unusual item on your tax return, such as a lawsuit recovery, even though some tax professionals may advise attaching a copy of your settlement agreement to your tax return, don't do it.

7. Account for Every Form 1099

IRS Forms 1099 come in many varieties. You may receive a Form 1099-INT, which reports interest, 1099-DIV to report dividends, 1099-G that report tax refunds, 1099-R for pensions, and 1099-MISC for miscellaneous income. Chances are you'll receive a number of these forms every year. Be careful, and be watchful. Most 1099s come in January for the preceding year.

In fact, payors are required to issue them to you by January 31. While the payor is required to mail the form to you by January 31, the deadline for submitting all Forms 1099 to the IRS is the end of February. That built-in one-month delay means that if you receive a Form 1099 that you know is wrong, you may be able to get it corrected *before* the payor sends the incorrect form to the IRS.

But beware of two things. One, many payors send the forms simultaneously to the taxpayer and the IRS, notwithstanding the permitted one-month delay. Two, you may need professional help to deal with incorrect Forms 1099. There are so many Forms 1099 these days that many payors aren't terribly cooperative when it comes to untangling a mistake.

Regardless of how many Forms 1099 you receive, make sure you reflect them all on your tax return. The IRS matching program has been immensely successful, and one way to almost guarantee yourself a tax dispute is to fail to account for something. If a Form 1099 is wrong, you can usually explain it on the return, but you do need to report it on the return.

For example, if you receive a Form 1099-MISC reporting that you received $30,000 for the pain and suffering settlement from an auto accident, you still need to list this amount on your tax return. Since the $30,000 settlement should probably be tax free (and you probably shouldn't have received a Form 1099 for it in the first place), you can report the $30,000, then offset it with a $30,000 adjustment, explaining (in a footnote) that it was a personal physical injury settlement for an auto accident that was erroneously the subject of a Form 1099. But if you fail to deal with every Form 1099 you receive, you're asking for trouble.

8. Make Sure You Assemble Your Return Correctly

This advice probably sounds ridiculous, but professionals and amateurs alike make this mistake. Comply with the IRS instructions for how to assemble the return. Usually that means the return itself first, followed by schedules in alphabetical order, ancillary forms in numerical order, and plain paper statements and footnotes at the end.

But follow the IRS instructions carefully. That goes for where to attach Forms W-2 also. And don't attach forms that are not required, such as Forms 1099. If you don't follow the rules, you make your return stick out (which isn't good), and you risk something being overlooked because it is not in its proper place.

9. If You Receive a Small Bill, Pay It

Here's a rule that many find difficult to swallow. If you follow my advice and take reasonable tax positions, check your math, keep good records, and so on, why should you pay a bill if the IRS sends you one? The answer is more practical than principled.

It's fine to want always to be correct and to stick to your guns. However, tax matters are complicated, and despite the best efforts of you and/or your tax return preparer, you may have made a mistake. Alternatively, even if you are quite correct and the IRS sends you a small bill that you know is wrong, my advice is to pay it. The reason is that it usually doesn't pay to fight about something that is small, whether with the IRS or anyone else.

Whether you use a tax professional to write a letter or start a tax controversy or do it yourself, the potential costs can outweigh the benefits. If the tax bill is small, don't get into the system and risk bigger problems for a few dollars. Just pay the bill and move on.

Of course, what is a small bill to one person is a major bill to someone else. There's no absolute standard here. But at least consider the possibility of just paying the tax bill (plus the inevitable interest that comes with it) unless you really and truly think you're better off contesting it.

10. If You Do Have a Tax Controversy, Hire a Professional

This may sound like a tautology, since the subject of this article is how to *avoid* tax controversies, not how to *handle* them. It isn't a tautology, though. After all, it can be hard sometimes to know exactly when a tax controversy starts.

You might reasonably believe that if you receive a letter from the IRS asking about some aspect of your return, or a letter from a state taxing authority asking why you didn't file a tax return in their state for a particular year, you can safely answer it yourself. That's hardly starting a tax controversy, you might reason.

Actually, while you should clearly find a way to respond to any such query (either yourself or through a representative), you should think carefully about *how* you do it. It's hard to generalize here, and I'm not suggesting that you need a lawyer any time a single piece of paper comes from the IRS. Still, be cautious and reflective, and get some advice about whether or not you need a representative. You should be able to do that for free, such as by contacting accountants or tax lawyers to see if they think you need their services, how much they would charge to represent you, and so on.

The notion that you should hire a professional is painful for some people to accept, but you generally can't represent yourself very effectively. That is true in tax matters and in many other disciplines too. Find someone who does this for a living and who isn't emotionally involved in the case, and you'll usually be better off. There are cases in which representing yourself can make sense up to a point, but they are pretty rare, and the point at which you need to change horses is usually pretty early.

In fact, I've seen cases where taxpayers end up spending huge amounts of money on a tax case precisely because they tried to handle the early stages of the case themselves. Sometimes you dig a hole that is bigger and wider and deeper than it would have been had you handed it off to a professional from the start.

Conclusion

There's no way to guarantee that you'll never have a tax controversy, no matter how careful you are. While you should be reasonable and you should not be too aggressive in any tax filing, these are often questions of degree. Moreover, no matter how careful and how conservative you are, sometimes your number just comes up. While audit rates for most types of tax returns are now at historic lows, IRS enforcement efforts are on the uptick. That will probably continue.

So do what you can to minimize your exposure. Then, like the refrain from an old Bobby McFerrin song, "don't worry, be happy." ■

1. *See Helvering v. Gregory*, 69 F.2d 809, 810–11 (2d Cir. 1934).