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ALERT: IRS EXAMS RISE SIGNIFICANTLY;
IRS REQUIRES HIGHER STANDARDS OF PROOF FOR CERTAIN TAX POSITIONS ON 2007 RETURNS

ISSUE: IRS Exams Continue to Increase

Following the trend of the past few years, the IRS has demonstrated it will continue to both increase examinations of targeted groups and more aggressively pursue enforcement. IRS exam data for fiscal year 2007 (which ended Sept. 30) shows exam rates rose – in some cases dramatically – over fiscal year 2006.

The IRS is particularly focusing on high-net-worth individuals (individuals with income of more than $100,000) and larger companies (companies with assets of more than $10 million). From 2006 to 2007, IRS exams of individuals with income of more than $1 million increased by a startling 84%. One out of 11 individuals with incomes of $1 million or more faced an audit in 2007. Exams of individuals with income of more than $200,000 increased by 29%; exams of individuals with incomes of more than $100,000 increased by 14%.

Audits of S corporations increased 26% from 2006 to 2007 and audits of partnerships increased nearly 25%. The larger companies, in the form of C Corporations, S Corporations and Partnerships, can expect to be audited approximately every five to six years.

In other words, **it is more likely than ever that you or your organization will receive an IRS examination and that if additional tax liabilities are identified, penalties and fines may be assessed.**

ACTION: Timely and thorough tax planning is more critical than ever. Attention should be focused on the accounting methods, the major expenses and the various tax positions taken in the past on tax returns.

ISSUE: IRS Standards for Tax Positions Raised

After a May 2007 amendment to the Internal Revenue Code, both taxpayers and tax preparers are now being held to higher standards for including and documenting tax positions on 2007 returns and beyond.

Taxpayers must have substantial authority (usually interpreted as approximately a 40% likelihood of success) for return positions taken, or at least have a reasonable basis (approximately a 20% likelihood of success) and adequately disclose the return position taken.

Under the old preparer standard, a tax preparer needed only to believe there was a

33% chance of success for a tax position to be able to sign a return without additional disclosure. The new standard requires a preparer to believe there is a greater than 50% chance that a reported position is proper. If the preparer cannot document that belief, then an additional disclosure must be attached to the return. The new standard now also applies to all paid preparers, not just CPAs.
These higher standards may affect taxpayers in several ways:

- Some tax preparers may become more conservative in adopting some strategies to reduce tax liabilities, which could potentially result in higher tax liabilities.

- The new standards will require tax preparers to either document a higher level of assurance for certain tax return positions or to prepare disclosure forms to be incorporated into the returns. This could increase the complexity and time required to complete your returns.

ACTION: Again, work toward identifying tax positions that may be affected by the new standard, and evaluate your alternatives in addressing these positions. Some factors you may want to consider:

- Performing additional research and analysis for “uncertain” tax positions to reach the new greater-than-50% standard to avoid the need to disclose the position on a tax return. Please be aware that many areas of tax law are extremely complex and some factual situations raise issues that have not been adequately addressed by existing authority. As a result, additional research may not guarantee that disclosure will not be required.

- Accounting methods that would require disclosure under the new standard can often be addressed by a change in accounting method, which requires a separate filing with the IRS.

- Evaluating the risks of disclosure of a particular position and the costs of remedial action. In some cases, the most appropriate course of action may be to simply attach the additional disclosure required by the new standard.

Your AGH tax professional would be glad to review the new standards and their application to you.

NOTE: Pursuant to federal regulations imposed on practitioners who render tax advice ("Circular 230"), we are required to advise you that any tax advice contained herein is not intended or written to be used for the purposes of: (i) avoiding tax penalties that may be imposed by the IRS, or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.