1

Why Every Taxpayer Must Read This Book

Each year hundreds of reputable books are written about taxes, audits, and the IRS. Unfortunately, the information taxpayers really need rarely, if ever, surfaces. No matter how much taxpayers read, hear, or research on the subject, they still remain easy targets for the IRS. We live in a megatechnology environment and hear promises about a more consumer-oriented IRS. This book tells you just how to approach the "new" IRS to maximize your tax return success.

It also includes the very latest information on the Jobs and Growth Tax Relief Reconciliation Act of 2003, the Job Creation and Worker Assistance Act of 2002 (JCWA) and the Economic Growth and Tax Relief Reconciliation Act of 2001. Throughout this book, the 2003 tax law will be referred to as the Tax Act of 2003, and the 2001 tax law will be referred to as the Tax Act of 2001; you'll learn what's in them for you and what you must know. To help you stay on top of your current financial situation, a detailed explanation of the most far-reaching provisions of this legislation is in Chapter 12, The Latest Tax Legislation.

So, welcome to the most important book you may read in 2003!

First, let's face some facts. Traditionally, the IRS has had a reputation for being all-knowing, all-powerful, and ruthless (many would say vicious). It is seen to have extensive manpower and technological resources, and the law seems to be on its side. Without actually knowing what the IRS is and how the organization really works—or, perhaps more important, how it doesn't work—the public remains in the grip of the IRS's reputation as the Big Bad Wolf.

Millions of taxpayers live with the fear that an IRS agent will single out an item from their tax return, initiate an audit, and come after them. In fact, the IRS is often referred to as an agency out of control—and with good reason. Once it selects its culprits, it chooses the punishment and proceeds to administer it with very little containment from any other governmental or nongovernmental agencies. It's not surprising that most taxpayers envision the IRS as harassing and abusive, using its power in an uncaring, even brutal way to potentially destroy their careers and families. Taxpayers are so fearful of dealing with the IRS that they rank an audit as an event as traumatic as divorce or losing their home, illustrating how enormously successful the IRS has been in creating its all-powerful-and-untouchable image.

Now let's look at those who know exactly what is going on and find out why they aren't talking. Any good Certified Public Accountant (CPA) or tax professional knows how to beat the IRS at its own game. But an unwritten law among tax professionals has traditionally prevented this vital information from being revealed publicly. What is this tacit agreement based on? It's based on their healthy fear that the IRS will turn against them, the tax professionals.

When filling out clients' returns, tax professionals use information they have gained as experts. But these very same professionals do not traditionally disclose information in three crucial areas. They don't tell the public

1. What the IRS really is and how it thinks, responds, and operates—or, more precisely, doesn't operate.
2. About endless loopholes in the tax laws that can be used in the preparation of an individual tax return.
3. How both of these can be used consistently to benefit taxpayers.

Tax professionals have made it a practice *not* to reveal such information—and with good reason: They've seen firsthand how people can be destroyed by both warranted and unwarranted IRS attacks. Why would CPAs, or any professionals in the tax field, put their lives, families, careers, and futures on the line? The answer traditionally prevents tax professionals from publicly explaining why the right kind of information never gets to the taxpaying public. It also keeps them from revealing that information on a broad scale.

To prevent an all-out personal conflagration and probably endless repercussions, tax professionals continue to offer whitewashed material that tells taxpayers how they can disappear from the IRS's view. In fact, much of this information is correct. It does work. But too much inside information that is critically important is left out, and no one knows this better than we do.

In 35 years as a CPA, I have repeatedly watched how the IRS can financially ruin all kinds of people: rich, middle-class, the average working family—people exactly like you.

A few years ago a fascinating case involving IRS wrongdoing hit the newspapers. It had begun simply enough.

Mrs. Carole Ward accompanied her son to an audit of their family business, three children's clothing stores in Colorado Springs. Because the audit was going poorly, Mrs. Ward spoke up to the female IRS revenue agent, saying, "Honey, from what I can see of your accounting skills, the country would be better served if you were dishing up chicken-fried steak on the interstate in West Texas, with all that clunky jewelry and big hair."

Four weeks later, IRS revenue agents raided the family's stores, padlocked all three of them, and posted notices in the windows that implied that Mrs. Ward, who was 49, was a drug smuggler. The IRS then imposed a tax bill in the amount of $324,000.

Mrs. Ward hired two attorneys and sought press coverage to publicize her plight. The IRS countered with a publicity campaign that included sending a letter to the editor of the local newspaper, giving details of Ward's case and providing a fact sheet about it to the TV show *Inside Edition*.

Three months after the raid, the government settled the tax dispute for $3,485, but a week later the IRS district director appeared on a radio show, detailing the IRS's position against Ward. He failed to mention that the bill had already been settled for little more than 1 percent of the original amount.

At this point, Ward sued the IRS for disclosing confidential information from her tax return. Until the case was brought to trial, Ward's daughter had to quit high school because the IRS statements led students to believe the family was engaged in drug smuggling. The family went from having no debts at the time of the raid to owing $75,000. The lease on one of the stores was lost. And only two-thirds of the goods and equipment seized in the raid was returned, much of that badly damaged.

During the nine-day trial the IRS and the Justice Department, which defended the lawsuit, denied any wrongdoing. In a harshly worded 17-page opinion, Judge William Downes of the federal district court in Denver found that one of the IRS agents had been "grossly negligent," had acted with "reckless disregard" for the law, and had made three false statements in a sworn declaration. The judge awarded Mrs. Ward $4,000 in damages for improper disclosures, $75,000 in damages for the emotional distress the IRS caused her to suffer, and $250,000 in punitive damages, giving "notice to the IRS that reprehensible abuse of authority by one of its employees cannot and will not be tolerated." The judge also criticized the IRS district director who had made the radio appearance.

"I never should have spoken condescendingly," Ward later said, "but what they did to me for mouthing off was criminal."

Never forget—the amount awarded by the judge, and the fact that such a case was settled in the taxpayer's favor, is the result of almost 20 years of private citizens fighting for retribution in thousands of similar cases but receiving nothing except bureaucratic doors slammed in their faces.

Here's another case that demonstrates the blatant and unmitigated arrogance of the IRS.

A high-level executive in a nationally known insurance company was the subject of an extensive IRS investigation. Allegedly he owed $3,500. The taxpayer agreed to admit to tax evasion, and the IRS promised, in a written agreement, to keep the matter out of the public eye. When the executive informed his employer of his tax problem, he was told that the one thing he must avoid was a public scandal. Since the agreement with the IRS seemed to preclude this, the matter should have ended there. But it didn't. About three months into the investigation, the IRS issued to more than 21 sources news releases that included the taxpayer's name, his address, and the name of his employer. The taxpayer promptly lost his job, had to move out of town, and never again regained his prominent position.

Why was the IRS so interested in pursuing a case in which the tax liability was only $3,500? The answer was revealed about two years later at a trial resulting from a suit the executive brought against the IRS. Here's what really happened:

Initially, when the taxpayer found out that the IRS was investigating him, he asked the agent assigned to the case what he had done wrong. He was told that his wife had made some bookkeeping errors in managing his records, resulting in the amount owed. But a transcript from the trial showed the real reason for the extensive investigation. "The only publicity that is good for the IRS is when it brings a big one down" were the agent's words. Since the taxpayer was a prominent figure in his area, he satisfied that need, although the agent admitted that he didn't think there was any real proof that the taxpayer even owed the IRS money. After a 20-year battle, the case was settled to the tune of $3 million for the much maligned insurance executive.

More recently, an IRS revenue agent informed a TV station that a search warrant was being served on a local company, and it was subsequently shown on the evening news. The reputation of the business was permanently damaged, even though the IRS never filed any formal tax charges. The company sued and was awarded $2 million from the IRS.[1]

I know many cases like these, but I have also come to understand which words, style, techniques, and knowledge can effectively make the IRS come to an abrupt standstill in a lot less time.

What is more heartening is tax legislation—the Taxpayer Relief Act of 1997 (TRA '97) and the Restructuring and Reform Act of 1998 (RRA '98)—that contains laws designed to limit the unbridled power of the IRS and restore certain rights to taxpayers.

In December 1994, an IRS collection agent entered the tax preparation office of Mr. Richard Gardner in Tulsa, Oklahoma, and demanded that he turn over $20,000 for nonpayment of income and Social Security taxes withheld from the paychecks of his seven employees. Mr. Gardner said that he would pay the amount in a few weeks, after receiving payment from his clients. The collection agent then threatened a "jeopardy assessment," in which cash, bank accounts, and property can be seized. To stall the IRS collection action, Mr. Gardner, who is the sixth-largest income tax preparer in Oklahoma, placed his two businesses, the second being a store selling used books and comics, in bankruptcy. Days later, he paid the overdue taxes and canceled the bankruptcy actions. Three months after that, armed agents raided Mr. Gardner's tax preparation office, seizing all the computers and files. That very night, Mr. Gardner purchased new computers, and the next morning he was back in business when an IRS agent from the Criminal Investigation Division telephoned. Hearing Mr. Gardner's voice, he said, "I'm surprised you're open. We thought we'd put you out of business."

In January 1998, the Justice Department withdrew the charges made against Mr. Gardner and, without admitting wrongdoing, paid $75,000 to Mr. Gardner's lawyer for the cost of the case. The two men had sought $102,000. This made Mr. Gardner the first person to have his legal defense fees paid by the Justice Department under a 1997 law intended to curb prosecutions that are "vexatious, frivolous, or in bad faith."

Mr. Gardner's lawyer has stated that the IRS took what were lawful, routine business actions on the part of his client as a personal affront and set out to destroy his client's business. Mr. Gardner believed that the charges made against him were essentially "unlawful actions" designed to punish him because he had the temerity to exercise his constitutional rights as a way of delaying payment of back taxes. What has made this case particularly extraordinary is that once an indictment is handed up in a tax matter, the Justice Department routinely insists on either going to trial or obtaining a guilty plea to at least one charge. It is inordinately rare for such a case to be withdrawn.[2]

Although examples such as this one, where a taxpayer wins out over the IRS, may occur more frequently these days, over the years, as I continued to witness the seemingly uncontrollable behavior of the IRS, I realized that I could no longer keep silent.

I have been collecting the information contained in this book for over 20 years. Am I afraid of repercussions from the IRS? Yes. But this information is too important not to be told. The value of the assistance it can bring to every U.S. taxpayer will, I hope, offset my risk.

In *What the IRS Doesn't Want You to Know* I will

- Tell taxpayers why they have been kept in the dark for so many years.
- Present a point of view that can make taxpayers more powerful than they ever thought possible.
- Give the taxpaying public new information, legal and legitimate, that is traditionally presented only by CPAs to clients in low voices and behind closed doors.
- Let taxpayers know in advance what they need to watch out for and how to protect themselves from new IRS onslaughts.

This information will allow taxpayers to

- View the IRS from an entirely new and realistic perspective.
- Learn how to use glitches, crevices, and loopholes in our tax laws to their benefit.
- Recognize the shortfalls of the IRS so that the scales of justice are tipped in the taxpayers' favor.

I have decided to make this information available so that you, the average taxpayer, can be armed with the same tools of the trade that I use every day. You will learn how to use these tools to

- Avoid an audit.
- Minimize your tax assessment.
- Dramatically improve your business and tax situation, especially if you are self-employed, a service provider, or an independent contractor.
- Increase your tax-deductible expenses without drawing attention to your return.
- Dramatically reduce your personal tax liabilities by learning little-known techniques used in the tax trade.
- Make the IRS consistently work for you, once and for all reversing a long-standing trend.
- Learn what to watch out for as the IRS undergoes its enormous reorganization.

These commonsense tools, rarely divulged to the average taxpayer, represent specific legal steps you can take to shield yourself from the far-reaching clutches of the IRS.

Furthermore, the idea that only wealthy individuals, those who hire expensive tax attorneys, or those in the know can avail themselves of aggressive tax information is false. Anyone has the right to receive the same kind of information and advice on how to best handle the demands of the IRS, particularly the average taxpayer. No one is too small to *deal successfully* with the long, powerful, and often ruthless and arbitrary arm of the IRS.

I intend to set taxpayers free by offering them a brand-new foundation from which they can deal with the IRS, one based on expert knowledge never before revealed publicly. For example, did you know that

- Despite spending billions of dollars, most of the technological advances the IRS predicted for the year 2000 and beyond have not happened?
- Each year the IRS loses files on which audits have commenced; the audit is then abruptly terminated?

- Travel and entertainment are still the first areas that are examined by an IRS auditor, because a partial disallowance of deductions is virtually certain?
- You should never represent yourself at an IRS audit? Such an ego trip usually ends up costing taxpayers dearly.
- In the past, the IRS has claimed responsibility for almost 50 percent more prosecutions than recorded by the Justice Department and more than twice the number of individuals sentenced to prison?
- You probably have a greater chance of being audited if you live in a certain part of the country?

With this information, and a great deal more like it, taxpayers will not only have a fighting chance in dealing with the IRS but can actually come out winners.

CPAs GRADE CLIENTS

Now, let's enter a CPA's inner sanctum, a place most taxpayers are not privy to.

Over time it has become customary for tax professionals to "grade" their clients. Clients who make the highest grade from the tax professional's view pay less in taxes, are rarely audited, and have more money in their pockets. I would venture to say that in our profession we deal with three types of clients. Let's call them Type A, Type B, and Type C. Here's how this works.

Type A are the "good" clients. A good client is a person who heeds the professional's advice most of the time, but especially when the professional presents the advice in the form of a strong recommendation. The ideas presented in this book are strong recommendations, and nothing irks a tax professional more than when a client doesn't follow strong recommendations and ends up paying higher taxes or, worse, is audited.

Let's skip Type B clients for a moment and discuss Type C. Type C clients, because of their difficult behavior and negative attitudes, are at the bottom of the totem pole. The fee that they are charged is never commensurate with the time that is spent with them, both at face-to-face meetings and on the telephone. They are usually terrible listeners who refuse to hear much-needed information, which must therefore be continually repeated. Type Cs often argue against the recommended course of action because they usually have a know-it-all mentality. Type Cs also receive the greatest number of notices from the IRS, simply because they do not follow the tax professional's instructions. In short, a Type C client causes the professional the greatest amount of aggravation, the professional earns the lowest hourly rate, and Type Cs are usually the first to complain that the bill is too high.

Type B represents all the clients who don't fit into Type A or C categories. As you might suspect, the majority of people are Type Bs. Although Type Bs aggravate you once in a while, they may overcome this by paying bills promptly. They may complain a lot, but they may also be a source of client referrals.

The dilemma faced by tax professionals concerning their client base should be becoming clear to you: Wouldn't it be great if we could drop Type Cs from our client roll, and have Type Bs gradually mend their ways and work themselves up to Type As? But, alas, this is a tax professional's fantasy. In reality, clients drop down from Type A or B to become a Type C, but a Type B or C rarely moves up to become a Type A.

Now that you are aware of this aspect of the tax business, I'd like you to benefit from it as fully as possible by incorporating these discoveries into your own thinking and behavior from this moment on, while you are reading this book. Here's how.

Most of the advice, recommendations, and tips contained in *What the IRS Doesn't Want You to Know* has not been made available to the average taxpayer before. Therefore, to receive the full value of what I am revealing, you need to respond like a Type A client. In fact, I'd like each of you to become a Type A client by the time you have completed this book. The closer you come to being a Type A client, the easier it will be for you to understand how your own thinking and behavior can positively or negatively affect how your return will ultimately be handled by the IRS. Behaving like a Type A or B instead of a Type C client can actually make the difference between an unnoticed return and an audit. Here's what I mean:

A Type C client, Mr. Richards, came to me with a problem. He had received a fee of $35,000, for which the payer issued a 1099-Misc form (Miscellaneous Income) listing him as the recipient. Mr. Richards claimed that the fee was actually earned by his son. I suggested that he contact the payer of the fee and obtain a revised 1099 in his son's name. Without any further explanation, Mr. Richards instead asked me if he should prepare a 1099 in his son's name showing that he paid the $35,000, acting as the boy's agent. I strongly advised against this course of action. If this was noticed and subsequently questioned, the IRS would ask for full documentation, including a contractual agreement and canceled checks. But Mr. Richards, acting like the perfect Type C, insisted that he knew better and refused to heed my advice. I knew it would be useless to argue further. He prepared the 1099 form showing the $35,000 payment to his son.

Six months later, when the IRS detected the existence of two apparently related 1099 forms, both belonging to Mr. Richards, they contacted him and, not satisfied with his explanation, proceeded with a full-scale audit. The audit encompassed all of Mr. Richards's personal and corporate activities, which were substantial, since he was a highly paid executive. An audit lasting more than three years culminated in Mr. Richards paying the IRS $140,000 in tax, interest, and penalties, plus $25,000 in accounting and legal fees. To this day, Mr. Richards still insists that he knows best, and his behavior has not changed one iota, despite the fact that if he had listened to me in the first place, it would have made his life a lot easier and saved him thousands of dollars.

Finally, the most crucial ability for taxpayers to have, which they cannot acquire on their own, is the ability to understand how the IRS thinks, operates, and responds. This is definitely something you as a taxpayer want to learn about and put into practice, yet it is rarely, if ever, made available.

In my interactions with countless clients and with the IRS, a great deal of unofficial information surfaces that is often more important than a specific tax law. In fact, quite often what is most important is not what a tax law says, but how the IRS interprets and acts on it. This knowledge, which tax pros gain from years of working in the field and interacting at all levels with the IRS, is what enables them to complete your return and know how the IRS will respond to each individual item recorded. This is the kind of information I will be revealing in this book. Here is a typical case:

Early in 2000, a Mr. Graham, who owned an interior design business, came to me for the preparation of his 1999 tax return. In reviewing his file, I saw that both his 1997 and 1998 returns had been audited. On the basis of what I knew about how the IRS thinks, it seemed to me that the audits were triggered by two items: First, Mr. Graham's gross income for each year was over $150,000, which in itself increases the chances of an audit. Second, in both years Mr. Graham claimed about 30 percent of his gross income, an unusually large amount, for entertainment, auto expenses, and travel, as reported on his Schedule C, Profit or Loss from Business (Sole Proprietorship). IRS regulations require anyone who is an unincorporated sole proprietor to file this schedule.

I knew that my approach would have to be based on presenting Mr. Graham's expenses from one perspective: in case he was audited. Any good CPA employs this kind of thinking automatically, but in this case it was more crucial because of the two previous audits. In addition, I had to eliminate, or reframe, whatever I could that had been previously questioned.

When my client and I set to work examining his business diary for 1999, one thing consistently kept showing up: Meal expenses on most days were for breakfast, lunch, and dinner. There is a rather obscure IRS regulation that some meals must be considered personal in nature. In other words, the IRS does not take kindly to three meals a day taken as a business expense. Mr. Graham was operating under the illusion that because these meals were business expenses, he would be able to reduce his overall tax bill by listing them that way. But he did not know that he was treading upon a favorite IRS attention getter: entertainment expenses.

I told my client about this regulation and promptly reduced Mr. Graham's business-related meals to two a day. To offset this loss, I also told him of another IRS regulation that would allow him to expense meals under $75 without a receipt if his business diary noted the person, place, and date of the meal, along with a brief description of what was discussed. With these additional diary entries, entertainment expense was back to its previous total, but because of the way it was presented on his return (and in backup material), I knew he would be safe if he was audited. I also insisted that my client substantiate every entertainment item above $75 with a receipt or canceled check, a practice he had previously been lax about.

Next, Mr. Graham's business diary showed $16,000 for out-of-pocket expenses but only $7,000 worth of checks made payable to himself. With his history, I knew the IRS would grab this in a flash. With a little investigation, I uncovered the source of the missing $9,000—cash gifts from his parents made during the year. In this case I used as documentation a section from the Internal Revenue Code (IR Code) that allows each taxpayer to personally give $10,000 (now $11,000) annually to any other person without filing a gift tax return. Now we could prove the source of the $9,000, and best of all, gifts of this nature are nontaxable. However, to clear him even further, I advised my client to have his parents write and sign a one-sentence letter that documented the fact that they had given him the money during the year as a gift.

Finally, to save Mr. Graham from ever again filing a Schedule C that would place his entertainment, automobile, and travel expenses under scrutiny, I strongly recommended that he change his business from a sole proprietorship to a new small business corporation, an S corporation. By doing this, Mr. Graham accomplished the following: He substantially reduced his chances of being audited (i.e., his $150,000 in personal income would not light up the IRS computers); as an S corporation, he had available to him new techniques for reducing Social Security costs that he didn't have as a sole proprietor; and he had all the other advantages of being incorporated (e.g., limited liability to creditors). The end result was exactly what I had hoped for: Mr. Graham's personal and business tax returns since 1999 have not been selected for audit by the IRS.

YOUR TAX-SAVING STRATEGY

Although the IRS no longer requires receipts for business transportation and entertainment unless the expense exceeds $75, detailed entries in your business diary are a must. Expenses for lodging require detailed receipts regardless of the amount. See Chapter 8 for more on S corporations.

Now, I have two requests of all taxpayers who read this book. First, I would like you to extract from the material all the points that have some personal relevance. Bring these points to the attention of your tax professional and ask for comments. If your tax professional says, for example, that you are too small to become an S corporation, ask for specific reasons to support that conclusion. If you are not satisfied with the response, get a second opinion.

My second request applies only after you have finished the book. When that time arrives, go back to your tax professional. Ask what it will take to make you a Type A client. Encourage your tax pro to let you know how successful you have been in following his or her advice. I'm sure he or she can pull some specific examples out of the files. Walk through one or two together to assess how your behavior held up. Were you cooperative? Did you listen carefully? Follow instructions? As a result of your way of responding to your tax professional's advice, did you gain a stronger tax position, or did you end up with a loss that could have been avoided?

If your tax professional claims not to know what a Type A client is, suggest he or she read this book.