How to Best Handle an IRS Audit

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Editor's Note: I hope that ranch managers make enough income to pay income tax. I also know that they make innocent mistakes. This article is very informative on what to do if something does go wrong.—Peter V. Jackson, Executive Vice President, SRM

By now we have all seen the significant impact that the 1986 Tax Reform Act has had on the cattle and other livestock industries. The reverberations have affected the industry with such new issues as the Material Participation Test, the elimination of preferential treatment for capital gains, the limitation on losses in limited partnerships and other "passive" investments, and restrictions on the use of the cash method of accounting.

The new tax law underscores the introduction of a "free market" philosophy: Instead of encouraging socially bene-

official activities by tax incentives and write-offs, the Act tends to guide people and corporations by the marketplace. "No longer will people invest for tax purposes. They will invest in things that have real value in the marketplace," according to Sen. Bill Bradley (D.-N.J.).

One of the more mystifying aspects of tax reform is how returns are selected for audit by the IRS. Today, each regional office of the IRS conducts a computerized screening of all returns on the basis of programmed selection criteria, called Discriminant Function System (DIF). This method measures the probability of tax error in each return. Substantial claims for deductions, often the case in the cattle industry, will often result in selection for an audit. However, the number of returns selected for audit always exceeds the audit capability of the IRS, and each district appoints expe-

 Libya's efforts to develop its rangeland resources and achieve self-sufficiency in red meat production in the shortest possible time received a major setback from the drop in world oil prices. Insufficient progress in the development of its institutions and natural resource policies has prevented the realization of sustained use objectives on these lands. Lack of control over livestock grazing and land cultivation has prevented the achievement of these objectives and has caused the loss of much time, labor, and capital spent on developing rangeland resources.

Renewed efforts towards achieving lasting range resource development are hampered by the continued rapid increase in population and livestock, declining rainfall in North Africa and the Middle East (Bradley et al. 1987), and low oil prices.

**Literature Cited**


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rienced revenue agents to pour over the computerized selections in order to reduce the number of audit cases.

If you are selected for audit, usually the letter requesting your appearance will ask for substantiation of specific items, and only those documents that will explain the disputed items should be taken into the office audit. The revenue agent has the right to audit your entire return beyond those issues raised in the letter, but if no information concerning other items has been taken to the office audit, the agent will seldom pursue the other items, since his case load is too large for protracted negotiations.

A major tactical consideration is whether you, the taxpayer, or your lawyer should attend the office audit. Almost always it is wise to have your representative go alone, on the premise that he can conduct the interview in a more objective and less emotional setting, and better control the flow of information by providing straightforward answers, backed up by documentation, without arousing the curiosity of the agent as to other potential audit issues.

Sometimes it is advisable to request a field audit, which means that the agent will come out to your farm or home and see the nature of your cattle operations. This can be advantageous because the auditor will have the opportunity to see the businesslike manner in which you are conducting the cattle activities. Keep in mind that most revenue agents are not familiar with the livestock industry, and by visiting the farm they can be in a better position to understand the unique factors of this industry.

Revenue agents have a primary function of raising revenue, and while the IRS strongly disavows the existence of a "quota" system for evaluating agents, it is also known that agents are promoted on the basis of their overall effectiveness and the volume of cases they close. Although it is the policy of the IRS to encourage agents to seek partial agreements, primarily in order to reduce the workload of appeals, quite often agents will make an "all-or-nothing" determination, leaving little room for negotiation.

In the case of nonagreement with the agent you may request a conference with the agent's supervisor. If no settlement is reached, the IRS will send you a "30-day letter," which explains the appellate procedures available to you and to urge you to reply within 30 days.

In almost all cases it is best to appeal the agent's decision, for several reasons. The IRS Appeals Division is a different department with different procedures. The appeals officer is usually a highly skilled tax professional. Your lawyer can present testimony of witnesses in an informal setting, and submit new facts and documentation. The major function of the Appeals Division is to keep tax cases out of Tax Court, and the officers have broader authority to settle cases than at the audit stage. For example, you can "trade" issues—they will concede an issue to you if you will concede another issue. Appellate officers recognize that in many cases there is no absolute right or wrong answer.

If you are unable to reach a compromise or settlement in the Appeals Division, you must decide whether to pay the tax and end the controversy, or to litigate the issue. The next step at this point is usually to file a petition in Tax Court if your lawyer feels you have a good case. The biggest advantage of going to Tax Court is that you will have an administrative law judge who is impartial and who is very familiar with the judicial decisions and precedent that apply to your case. Moreover, once the petition is filed the case is assigned to a government attorney, and from this writer's experience, there is always a good opportunity of reaching a reasoned settlement at this stage, even if the situation looked bleak in the Appellate Division. In many situations, technical issues can be explained and discussed with the government attorney more effectively than in the Appellate Division, and more credence is given to the legitimate legal arguments presented on your behalf.

This article has outlined some of the primary features of being audited by the IRS, but it should be kept in mind that overall planning of your livestock tax and business affairs with an expert is always of fundamental importance in laying a foundation for the future in the event you are audited.

Water Quality. . . (continued from pg. 166)

number of plant species that make up a healthy watershed. For example, moderate to heavy grazing for a short period of time when the seed is ripe on desirable plant species will shatter the seed heads, scatter the seed, and by hoof action, bury and cover seeds. The effect is to plant the seeds. Rest from livestock grazing for seedling establishment the following spring season then allows overall plant density to increase. A system of repeated treatments in regular cycles has been successfully used to improve watershed quality and increase forage production for grazing by wildlife and livestock.

Light to moderate grazing stimulates some grass plants to produce new shoots at the base of the plant, increasing overall ground cover. Shrubs respond to light to moderate grazing by increasing the number of leaders produced.

TOTAL PROTECTION OF THE LAND FROM ALL USES BY MAN is not the universal answer to improving water quality from public rangelands. In many arid rangeland areas, the potential natural or climax plant community may well be sagebrush or juniper with very little understory vegetation. Such plant communities generally lack the soil binding and water retention characteristics of plant communities with a grass and forb understory or plant communities that are predominately grasses.

In summary, to maintain and improve the quality of the water yield from public rangelands require a long-term commitment to multiple use management of the land. Those land uses that cause surface disturbance must be done in a way that will keep soil and vegetation disturbances and water runoff as low as possible. As the action is completed, the soil surface must be stabilized and vegetation reestablished to restore a healthy watershed. Livestock grazing is a powerful force that can be used to manage the vegetation for a number of purposes, including watershed improvement. We have made substantial progress in improving the condition of the public rangelands in the last 50 years. Range scientists have observed that the public rangelands are in better condition today than at any time in the past century. We are committed to continue to practice the management methods we know will work and to take advantage of new technologies that are developed. We expect the improving trend in the condition of public rangelands to continue into the future. The result will be stable and improving watersheds and improving water quality.