Tax Notes

What You Should Know When Your Corporation Faces an IRS Audit

By James S. Rollinson, Jr., CPA, MST, Tax Director

As the COVID-19 pandemic struck the U.S hard in March of 2020, with its effects likely to remain impactful as we approach 2022, we are seeing less corporate tax audits at this time. The IRS still has a huge uphill battle processing a very heavy volume of taxpayer correspondence, returns, payments, and refunds. In addition, with the host of many tax law changes such as the CARES Act, and other further legislation, a significant shortfall in IRS staff at this time compounds the problem.

One of the agenda items under the Biden administration is to add 87,000 IRS agents in order to increase enforcement efforts. Corporations and high net worth individuals will have a much greater chance of selection for an IRS audit going forward.

Initial Notice

So, what can you expect when a corporate tax audit comes your way? In the initial notice, you will be given a time period to respond. Do not hesitate to call the agent and let them know you will have someone represent your corporation. For the IRS, this is standard procedure. The taxpayer representative, by means of a Power of Attorney, should handle all communication with the IRS after the initial contact. There are exceptions where an officer of the corporation will be required to participate in a conference meeting to explain general corporate governance and operations. The representative should be present in the conference meeting as well.

Information Document Requests (IDR)

The IDR is the document that gets the IRS audit moving along. The agent gives the taxpayer (and the representative) a time frame to respond to a list of items needed for the audit. The time frame for responses in most situations can be negotiated between the IRS agent and the taxpayer representative.

Depending on the size of the audit and what is provided with the first IDR, there may be a number of additional IDRs issued by the agent. Each additional IDR expands on areas from the first IDR. For larger size corporations that fall under the Large Business and International group (LBI), those audits appear more issue driven. These are corporations with assets greater than $10 million dollars. No matter what the size of a business, there is always a chance of an audit.

Finally, in response to IDRs, it is best to give only what is asked for in the IDR to help move the audit along. Sometimes “less is more” as they say.

Hot Topics of IRS Audits

Below are some hot areas seen in IRS corporate income tax audits. Please note that this list is not all-inclusive.

- **Related-Party Transactions** (including international tax as well):
  - Compensation
  - Shareholder loans (to/from corporation and related entities as well)
  - Transfer pricing
  - Buy/sell agreements

Family owned corporations or any corporations that are considered closely held can almost always expect to have related-party type questions on their corporate IDR. Shareholder tax returns may be asked for by the agent and usually are not audited in most cases unless there are corporate level adjustments affecting the shareholders' tax returns. Corporations that have related-party transactions with affiliates outside the U.S. may expect transfer pricing and issue-based matters to come up in the audit. With the U.S. corporate tax rate currently at 21%, any tax rate increase in the future makes it more likely we will see an increase in transfer pricing audit risk..

On a very large scale, Amgen is disputing a $3.6 billion dollar deficiency with the IRS relating to transfer pricing matters. Bottom line: corporations of any size can face challenges in this area if they have related-party transactions especially international. Corporations also need to be aware of the numerous foreign informational forms that can carry significant penalties if not filed.

- **Research and Development Credit –** For corporations that claim the Research and Development Credit beware. This seems to be a favored selection by the IRS given the very subjective nature of the credit. Documentation and understanding is key in this area to mitigate risk of adjustments. (**Note:** matters pertaining to IRS corporate audits of the Research and Development Credit will be addressed in a future newsletter.)

- **Travel, Meals and Entertainment –** Entertainment is not tax deductible as of January 1, 2018. Corporations should segregate meals and entertainment into two separate general ledger accounts. For meals, depending on the date and/or circumstances, can be either 50% or 100% deductible in some cases. Refer to the Consolidated Appropriations Act for more recent changes. Companies should maintain accountable plans for all employees to help avoid many payroll tax and income tax matters.

- **Other IRS Audit Areas –** Finally, given the numerous changes as a result of the Tax Cuts and Jobs Act (TCJA) and the Coronavirus Aid, Relief, and Economic Security (CARES) Act, we may expect to see future IRS corporate audits addressing items such as, but not limited to, the following:

  - IRC Section 965 Transition Tax
  - Global Intangible Income Tax Calculations
  - Foreign Tax Credits
  - Net Operating Loss Carrybacks
  - Interest Deductions Subject to IRC Section 163(j) Limitations

Closing an IRS Audit

What happens when the corporation and IRS do not agree? All IRS audits have an assigned team so if connecting with the agent is not working out, it may be best to coordinate with their supervisor/manager as well. After that, there is also an appeals process.

Contact Us

Let us work together so we can help address matters before they become an issue in an IRS corporate tax audit. Please reach out to your PKF O'Connor Davies client tax team with any questions or concerns you may have regarding your company or to:

James S. Rollinson, Jr., CPA, MST
Tax Director
jrollinson@pkfod.com

Michael F. Ganino, CPA, CFE
Partner
mganino@pkfod.com

About PKF O'Connor Davies

PKF O’Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, fourteen offices in New York, New Jersey, Florida, Connecticut, Maryland and Rhode Island, and more than 1,000 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O’Connor Davies is ranked 27th on *Accounting Today'*s 2020 “Top 100 Firms” list. It is also ranked among the top 20 best accounting employers to work for in North America by *Vault*.

PKF O’Connor Davies is the lead North American representative in PKF International, a global network of legally independent accounting and advisory firms located in over 400 locations, in 150 countries around the world.