THE AUDIT

There are things worse in life than an IRS audit; however, at the moment I cannot think of what those might be. Admittedly, the audit is right up there in the top five, certainly top ten, crisis moments of adult life sending everyone's blood pressure right off the charts. That said, let's first look at how an audit might occur.

BACKGROUND

There is a group of IRS employees (we think actually a rather small group) who are undeniably smart, very computer savvy and more secret than nuclear launch codes. Who they are, where they are, how they were hired, how they think, is the best kept secret within the IRS. Their job is to creatively and analytically look at massive amounts (terabytes) of IRS data about taxpayers and look for anomalies. So what is an anomaly? Something about your particular tax return that causes you to stick out from the norm. Or, more likely, some set of anomalies where your return is scored with "weirdo points"; your return had four anomalies for a total weirdo score of 13; therefore, you just became an audit candidate. And, all of this happened electronically without human intervention. Furthermore, the IRS will not disclose your weirdo score to you and most likely the IRS examiner sitting across the table from you does not know what it is.

Conversely, this author has zero evidence that taxpayers who commence SEPP plans get any weirdo points. Why would you? Aren't you simply availing yourself of a statutory right as contained in IRC §72(t)(2)(A)(iv)? Of course you are. We have no clue, much less any evidence, about how you were chosen. Therefore, we have no hints to provide to you about how to avoid this situation. We wish we did but we don't.

Here is what we do know. Once selected for audit, the examiner will quickly zero in on your SEPP plan and will examine it in minute detail. You will be required to "prove up" two sets of information:

A. Plan design issues: methodology selected, IRA beginning balance, age at commencement, interest rate selected. Each one of these data elements will be required to be supported by external evidence. Conversely, evidence created by you will be considered insufficient. Generally, any document on someone else's letterhead is sufficient including your opinion letter from your tax attorney / CPA from four years ago.

B. Plan execution issues: (A) above says you were supposed to distribute $60,000 per year for the last four years; prove you did it with account statements and 1099R's from your trustee / custodian. Your objective here is to reverse the "proof of evidence." If your account statements and 1099R's are correct you are most likely done. When the auditor responds: "that's not what our records indicate." Your response is very simple: "that's not my problem, it is your problem. Further, it is

now your responsibility (not mine) to resolve any records and documents dispute."

WHAT NOT TO DO

Many accuse the IRS of being a dysfunctional and institutionalized organization. This may be true but is irrelevant. The IRS computers have perfect memory. They will not forget you. Therefore, absolutely do not ignore the audit letter you have received even though it arrived by regular mail. The IRS will never call you and they will never just show up at your front door. You will however receive what is clearly a computer-produced letter, double sided, ranging 4 to 6 pages in length.

WHAT TO DO

First, calm down. Second, read the letter slowly and very carefully; maybe more than once. The most important items and issues to note are:

1. Who is being audited?
2. What tax year(s) are being audited?
3. What appears to be the audit point(s)? Is it just your SEPP plan or are there lots of other issues?
4. Does the letter propose dollar adjustments? Or, is this a general inquiry letter?
5. Dates:
    a. What is the date of the letter?
    b. When did you receive the letter?
    c. What is your latest response date as identified in the letter?
6. Gather all of your information regarding your SEPP plan:
    a. Opinion letter from a tax attorney or tax CPA if you have one.
    b. IRA account statements:
        I. Beginning statement that established opening value.
        ii. Subsequent year-end statements.
    c. All correspondence (written letters / screen shots) between you and your trustee.
    d. 1099R's issued to you by your trustee / custodian.
    e. Any and all worksheets that computed your annual distribution.
    f. Print-outs of the web search you originally did to get the applicable federal rates.
    g. Printout of the life expectancy table you used.
7. Does the letter appear to be nonsensical or in error compared to what you believe to be correct? This would typically occur in the case of missing or errant data in the IRS computers.

STEP TWO

First some good news. The IRS computers send out ten's of thousands of letters

per week. Depending on how you choose to measure accuracy, at least 50% of these letters are either: (1) just plain old wrong, or (2) they are on a fishing expedition.

How could this letter be wrong? Simple, the IRS computers only work with and process the data they have received. Even in your case, the data housed in the IRS computers has been touched by dozens if not hundreds of human hands. Therefore, almost every data element about you and your return is capable of being mis-processed / lost / doubled / placed in the incorrect tax year, etc.

The IRS computers actually reach a logical conclusion based on the data it has and pumps out a letter because it has been programmed to look for numbers out-of-wack[1]. The same computer does of very poor job of attempting to diagnose why is something wrong — only that it is — therefore, you the taxpayer are the primary culprit.

STEP THREE

Understand your objective which is make this matter go away with one piece of correspondence. Up to this point, your file has been untouched by human hands — a computer did it all. Your response needs to be: timely, professional and on-point as it relates to the apparent issues raised in the original letter. Your response will get read, most likely within 90 days by a human. Your objectives and responses will be several-fold depending on your detailed specifics such as:

(1) Your computers have somehow received incorrect data. The correct data is...
(2) Your computers did not receive certain data...
(3) Your assumptions are incorrect...
(4) Your computations are incorrect...

A good closing statement would be to say that: "Our data (as enclosed) and/or our opinion letter from [your previously engaged professional] indicate that we are in theory and in practice 100% compliant with IRC §72(t)(2)(A)(iv). Therefore, no additional surtaxes, interest or penalties are due. Further, given the evidence in our possession, your assertions in letter dated... are incorrect. As a result, we further assert that we have done all as necessary to respond and that therefore, you, the IRS are now responsible to produce any and all further evidence or theory that is contrary to that which we have provided. Otherwise, we will consider this matter closed and request a closure letter from you to that effect."

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[1] "Out-of-wack" is a technical CPA term that generally means A does not equal B when it should. Since you, the taxpayer, supplied "A" and some financial institution supplied "B", the IRS computer defaults to the presumption that you, the taxpayer, are wrong.

Next, decide on how (not if) to respond. In this regard you will have two fundamental choices: (1) respond directly to the IRS by yourself; (2) hire someone to represent you before the IRS and do so usually with 30 days. There are advantages and disadvantages to both routes:

Going it alone is certainly quick, easy and inexpensive. In the most simple of situations, such as errant, missing or wrong data as evidenced by the letter, you may be able to point out the error in a quick responding letter and get the issue closed.

Hiring someone else (a tax attorney or tax CPA) to represent you in all but the most simple of situations is probably better choice for several reasons: (1) they are better versed on how to communicate with the IRS; (2) they are more likely to understand the hidden traps in your response; (3) they are more capable of handling the escalation / appeals processes if needed; (4) last, but not least, you are perceived as more serious because you have hired an outside professional[2].

Most SEPP plan audits start as "correspondence" audits. If this is your case and it grows to an "in person" audit we strongly advise against self-representation.

STEP FOUR

Wait at least 90 days and maybe as long as 180 days. Further, you may receive one or more intervening letters from the IRS that effectively say: "we have received your responding correspondence on this matter and require more time to review it and evaluate the file and your response before responding back to you. Please give us ## additional days to respond."

This is actually good news. It means you are in the system; nothing untoward is going to happen; you have responded in a timely manner; none of your escalation / appeals rights have been abridged...we will get back to you shortly. Some time later, one of three things will happen:

(1) You will get a second letter which effectively says that the IRS disagrees with you; send money. Probability — 10%.

(2) You actually get a closure letter stating "no additional taxes due". Probability — 10%.

(3) You hear nothing. Probability — 80%. You are probably safe to assume that the matter is closed if you receive no correspondence within 180 days of your

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[2] To be blunt about it; when you have a written opinion letter and you have hired an outside professional to represent you; you are sending a very clear message — go fishing elsewhere.

response.

STEP FIVE

Let's assume the worst 1st round response: the IRS is adamant that the error / screw-up is your fault and you therefore are responsible for payment of all kinds of surtaxes, interest and penalties. What should you do?

(1) If you haven't already, it is time to hire competent outside professional help.

(2) Remember that Revenue Notice 2022-6 (the current and prevailing IRS writing on SEPP plans) is:

(A) NOT LAW. Congress did not write it. No President signed it. Some lawyers in Washington, DC on the IRS payroll wrote it and literally issued it without any external comment from any of the independent practitioners in this field. Just because they wrote it is a two-edged sword: one, they are the eight hundred pound gorilla in the room; two, sometimes their writings are sloppy, vague and potentially just wrong!

(B) WRITTEN AS A SAFE HARBOR NOTICE. Translated into English, this means that if you, the taxpayer, follow all of the rules as outlined in Notice 2022-6, you are protected from application of IRC §72(t)(4) which applies the surtaxes, interest, etc. Therefore, just because you may not have followed all of the Notice's rules or you interpreted a rule in the Notice in a new way does not make your plan non-compliant. It just means that your plan is not automatically safe-harbored — let the fight begin.

(3) Usually an audit is conducted by an IRS field office near you. On complex matters, such as a SEPP plan with all of its higher math and detailed rules, the training and experience of field office examiners becomes very suspect. When the IRS examiner you are dealing with "just doesn't get it", you can demand that your case be immediately reviewed and potentially transferred to the Tax Exempt & Government Entities division of the IRS Assistant General Counsel's Office in Washington, DC. At least your case will get in front of the people who wrote the Notice.

STEP SIX

90% or more of all SEPP plan audits end before getting to step 6; you have managed to prove you are right, or at a minimum you have demonstrated to the IRS that their

potential road to victory is questionable and risky. 10% of the time the IRS does continue to press. Thus, once you have exhausted the internal IRS reviews and appeals you most likely face a fork in the road with three choices: (1) pay up; (2) litigate; (3) make a deal. Each of these choices has its own pluses and minuses as discussed following.

PAY UP is certainly quick and easy (but for writing the check) and your retained professional is your best counselor in this regard. If you have just "plain-old screwed up" and the amount due is digestible then it may be your best course of action both in terms of time and economics.

LITIGATE is at the other end of the spectrum from PAY UP. It is very expensive. I cannot think of circumstance where the total costs to litigate would have less than five significant digits to the left of the decimal point. Further, you have two choices in where to litigate:

(1) US Tax Court. There are approximately 40 US Tax Court trial locations throughout the country. Some are big enough to have permanently located judges. Others are smaller and therefore cases are heard on a scheduled / rotating basis.

Three key issues to consider: (a) virtually all US tax cases are heard by one judge who is a very experienced tax law scholar; (b) juries are not permitted; (c) you do not pay the IRS assessed tax in advance, instead you are suing the IRS to vacate their assessment of amounts owed.

(2) US District Court. There are almost 100 U S District Courts throughout the United States.

Issues to consider are: (a) your case can be heard by a single judge or at your request a jury; (b) you must pay the IRS assessment of amounts due in advance and you are therefore suing the IRS for a refund of those amounts previously paid.

There is a line of thinking that when your arguments are fundamentally technical in nature and law based you would rather have a technical master listening thus suggesting US Tax Court; conversely, when your arguments are more interpretative and logical / reasonable conclusion based you may be better served by a jury trial, thus using US District Court. Needless-to-say, there is no hard and fast rule here and you will be best served by the counsel you have retained.

MAKE A DEAL is a middle ground. We would always suggest that you seek professional representation; either a tax attorney, a tax CPA or an Enrolled Agent versus self-representation. The purpose of MAKE A DEAL is at least twofold:

(1) The obvious, without the admission of any wrong-doing, reach a dollar amount to which both parties can agree is the best result to essentially avoid future costs and

exposures.

(2) Force your opponent, the IRS, to think about your derivative arguments in your favor from two perspectives:

(A) Time and money that IRS will need to spend if your case is litigated. Actually, this argument may be persuasive in private litigation matters but will tend to work against you here. Why? Because you will be up against a team of tax attorneys employed by the U.S. government who have nothing better to do. Said another way, you a playing no-limit poker against an opponent with an unlimited bank roll.

(B) More importantly, make the IRS consider the derivative consequences of losing your court case. It might set precedent on a small but important issue that has the future potential to become big enough for a division of marines to march through. In this regard, pay extremely close attention to the basis of your counter-arguments:

(I) If you are challenging the US Tax Code; IRC §72(t) and related sub-sections; we would suggest that your probability of prevailing is extremely low. Many a US Tax Court judge has ruled: "the plaintiff's arguments are both logical and maybe emotionally persuasive; nonetheless, the purview of this court is to interpret the law, not make the law which is a duty reserved to the legislative branch. Therefore, this court finds in favor of the defendant, the IRS."

(ii) Conversely, if you are challenging the contents of Revenue Notice 2022-5; we would suggest that your probability of prevailing is reasonable depending on your specific circumstances. The IRS has the right and responsibility to write Revenue Ruling & Notices every day of the week. They are, so to speak, the 800 pound gorilla in the room. Nonetheless, they are not elected, they are human, they are opinionated, they are some times pressed for time AND they are sometimes just flat out wrong.

Just as an example, were you to argue that IRC §72(t)(2) was fundamentally flawed or that the IRS was somehow out-of-bounds in the basic writing of Revenue Notice 2022-6, we would suggest you have a non-starter on your hands. Conversely, were you to develop a new SEPP plan theoretical-technical design not previously considered, and such new design held conceptual and practical value, we think the IRS would go to extreme lengths to NOT litigate out of fear of those marines above.

In summary, we like MAKE A DEAL as a cost effective mechanism to make the

issue go away particularly when you can zero in on (2)(B)(ii) immediately above.

CONCLUSION

Without question, there is absolutely no way we can envision that an IRS audit can be viewed in a positive manner. Just accept that your day in the rain without an umbrella has arrived — the audit letter and today's weather are closely related. In particular, IRC §72(t) and related sub-sections are precarious and often subject to multiple correct interpretations. The IRS often takes a position on an issue that X is a right answer (and it most likely is a correct answer). Further, the IRS will almost always take the position that X is the only correct answer. We emphatically disagree. Substantially equal periodic payments are theoretically somewhat difficult; they are practically a ten on the difficulty scale and thus usually open to a variety of practically correct answers.