University of Michigan Law School
Program in Law and Economics

Year 2011 *Paper* 37

Real Time Audit – It is the Time to Act?

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Abstract

The U.S. is facing one of its hardest economic crises. Its economy has not recovered from the 2008 downturn, and the light at the end of the tunnel is far, far away. The government and the Internal Revenue Service ("IRS") are seeking revenue sources in order to reduce its budget deficit. However, raising the income tax rates is politically difficult and may lead to further loss of jobs. In this political situation, it is important to try to find ways to raise more revenue without raising tax rates. One possibility of doing so is "real time audit": Auditing transactions when they occur, rather than months or years later.

DRAFT 6/28/11

Real Time Audit – It Is The Time To Act?

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The U.S. is facing one of its hardest economic crises. Its economy has not recovered from the 2008 downturn, and the light at the end of the tunnel is far, far away. The government and the Internal Revenue Service ("IRS") are seeking revenue sources in order to reduce the budget deficit. However, raising the income tax rates is politically difficult and may lead to further loss of jobs. In this political situation, it is important to try to find ways to raise more revenue without raising tax rates. One possibility of doing so is "real time audit": Auditing transactions when they occur, rather than months or years later.

Auditing a transaction as close as possible to its closing date is sometimes a key factor for real and accurate taxation of the transaction. Allowing a time gap from the day the transaction had been closed to the date the parties to the transaction have to disclose the facts to the IRS may increase the opportunities for tax planning in order to reduce the tax liabilities resulting from the transaction. These opportunities might be available during the tax year in which the transaction took place. Indeed a taxpayer should, can, and even has to, structure a transaction to be associated with as few tax consequences as possible[3] as long as the tax planning does not become the only rationale for the transaction.

According to section 6072(b) of the Internal Revenue Code (the "Code") a corporate taxpayer has to file its annual tax return for the tax year no later than the 15th day of March following the close of the calendar year. Any other taxpayer has to file a tax return no later than the 15th day of April following the close of the calendar year.[4]

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[3] See Gregory v. Helvering, 293 US 465 (1935).
[4] Sections 6081(a),(b) allow an extension for up to six months to the dates required under section 6072.

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Therefore, a transaction, or series of transactions, that occur on the first month of the tax year will be disclosed a year to 22 months after the transaction had actually closed. Moreover, the IRS might not audit the transaction at the date the return has been filed and there is an average chance of 99.1% that the return will never be audited.[5] According to section 6501(a) of the Code the statute of limitations grants the IRS a period of three years from the date the return was filed to audit it.[6] Therefore, in some instances it might be almost five years from the day the transaction occurred to the day it was audited. It is not inconceivable that at that point in time the taxpayer no longer exists whether due to bankruptcy, reorganization, inversion, or any other reason.

Finding a deficiency in the taxpayer's return in relation to a transaction or concluding that the tax planning associated with a transaction is unacceptable or to be challenged might result in a revenue collection by the IRS, but might as well not. The deficiency might be disputed by the taxpayer and appealed to the Tax Court, in which case the tax in dispute remains at the taxpayer's disposal because there is no obligation to pay the tax prior to filing a Tax Court challenge.

Transactions involving the sale or exchange of capital assets that results in capital gains or losses are usually the transactions that have the biggest tax consequences. Those transactions usually take a lot of time to negotiate and to be closed by the parties. They encompass a lot of details and are dealt with a lot of caution. The attorneys drafting the agreements work around the clock in order to achieve the best results for their clients, and it is likely to assume that the tax lawyers' role is significant as well. Almost all the parties to the transaction are involved in the details of the transaction from its genesis and are the key

[5] According to the IRS 2010 data book, 0.9% of all returns were audited in 2010; 1.4% of corporate returns were audited and 1.1% of individuals' returns. The numbers vary in accordance to the size of the business - 98% of the corporation with total assets over $20B had been audited, 16.1% of the corporation with total assets between $250M-$500M and 13.4% of the corporation with total assets between $10M-$50M. see Internal Revenue Service 2010 Data Book at http://www.irs.gov/pub/irs-soi/10databk.pdf

[6] Section 6501 and the regulation thereunder provide exceptions to the general rule. See 6501(b),(c)

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players in structuring the transaction. Almost and not all, as the negotiations do not include a key partner in the transaction that has a 35% interest in the outcome of the deal.

As discussed above, the need for revenues is here and now, but drafting a tax reform and enacting it with all the political efforts associated with it takes a lot of time. The goal as we see it, without abandoning the need for a deep and comprehensive tax reform, is to collect taxes today, or one even may say yesterday.

Deferring the tax payments by the taxpayer from today to the next few years gives the taxpayer not only time to think how to plan the transaction or even structure the business in order to reduce its tax liabilities; it also includes the time value of money from the tax deferral.

We find it inconsistent that the government combats tax deferral to the extent the deferral is related to foreign income, and is much less militant when the deferral is related to U.S. source income. Viewing foreign source tax deferral as the biggest enemy and combating it accordingly resulted in the enactment of harsh anti deferral and enforcement rules such as FATCA, PFIC, CFC etc. But, when it comes to domestic source income, deferral gets less attention, and a taxpayer might end up deferring the tax by up to five years with a chance of 99% to defer it forever.[7]

The government should act fast on this issue. To address it, it does not need to increase tax rates nor change the source rules. All it has to do is to eliminate the tax deferral on certain transactions. The way to do so is to impose a filing obligation on certain transactions that involve the sale or exchange of capital assets (including real estate) as close as possible to their closing date, in order to give the IRS the option to audit the transaction in real time, when the information is fresh and authentic, and when the parties to the transaction are available for

[7] Admittedly, foreign deferral does not involve an interest charge (unless the PFIC rules apply) while domestic deferral does. However, (a) domestic deferral does not involve an interest charge until March 15 of the year following the transaction, and (b) the interest rate charged by the government on domestic deferral is low and the taxpayer can make arbitrage profits by investing the funds saved by deferring the tax at a higher rate of return.

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audit and collection. Moreover, we suggest that those reportable transactions will be considered as closed only after the IRS issued its approval for the transaction.

This procedure is in fact happens currently when the transaction involves the sale or exchange of real properly. Why not extend it to a sale or exchange of other capital assets? Some countries do so.[8] We suggest that the government will demand that the parties to the transaction, the seller and the purchaser, will file a return including all relevant documentation supporting the transaction to the IRS office in the seller's district no later than 45 days from the transaction, and pay the tax accordingly. The taxpayers should have the right not to file such return; however, in this case a 30% tax on the gross amount of the transaction should be paid rather than filing the return as an advance payment for taxes due on the transaction. The IRS will have the authority to assess the return and the transaction as if it was an annual return.

In the meanwhile, and until such a law is enacted, the IRS can use its power under section 6861 and get involved in a transaction as soon as it is brought to its attention. These days, with the availability of information, some transactions are disclosed to investors in their early stages, and that should be the point where the IRS will have the right to play its role as an equal partner, receive the documents and the information on the transaction, review them and issue its opinion.

It is of course not suggested that every transaction will be dealt with in that early stage, but some transactions should. It will accelerate the government's revenue collection on the one hand, and will provide certainty and acknowledgment to the taxpayer as to the final tax consequences to the transaction on the other. One may say that we suggest that the IRS should issue a tax ruling on every large transaction, but in this case the service is the one to choose the transactions to examine and it does not have to pay any user fee.

[8] See for example section 91(d)(1) to the Israeli tax code that demands filing a report and paying the resulting taxes on capital gains within 30 days form the closing of a transaction. Section 91(d)(2) allows the tax authority to audit such a report separate from the annual report.

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