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Re: Avoiding the IRS's Attention

Dear Clients, Colleagues, and Friends:

Periodically the “Dailey Tax Service” reports a case that one shakes their head at because of a comedy of errors. Nevertheless, these cases can be instructive. *Drah v. [IRS] Commissioner (2017)* is one of them. It illustrates what a taxpayer should have done to avoid the IRS’s attention¹ and once in the IRS’s cross hairs, how not to respond.

Mr. Drah was an independent contractor delivering packages for Federal Express. He incorporated his delivery business and paid himself a \$32,000 salary. His corporation, S Drah Courier, Inc. (“SDC”), filed its tax return. Mr. Drah filed for a personal extension, but never filed the actual Form 1040 return. The IRS however, had in its data base the record of his company salary and a \$30,000 Form 1099 from Fed Ex in *his social*. Ultimately the IRS filed a “substitute return” reporting the W-2 and Form 1099 income and of course no deductions. Significant taxes and penalties were now due. Mr. Drah apparently was unaware he was in the beginnings of the IRS’s formal collection process.

Mr. Drah made four threshold mistakes attracting the IRS’s attention. One, he failed to file his personal taxes. Two, he ignored IRS notices that he needs to file. Those notices should have been Mr. Drah’s first clue he may be audit bait.² Three, he failed to recognize if he did not file, the IRS could file a return for him. ***Tax Tip!*** Thus, if you have W-2s, 1099s, gambling winnings, etc., make sure all of those earnings are accounted for on a timely filed return. Four, although Mr. Drah ostensibly utilized a corporation to report the Fed Ex income, apparently his ‘paper work’ with Fed Ex was not correct. Fed Ex issued him a *personal*, and *not corporate*, Form 1099. ***Tax Tip!*** If you have a corporation, make sure 1099s are issued to it and not you.

The case went to court. In court Mr. Drah conceded the W-2 income and the \$30,000 Form 1099 from Fed Ex. He claimed, however, his sole-proprietorship had around \$36,000 of deductions against the \$30,000 income. That started a second round of mistakes. Mr. Drah still did not recognize the IRS was suspicious of him. Granted many times large deductions are

¹ Mr. Drah had six IRS strikes against him: (a) not filing, (b) failing to respond to notices, (c) failing to account for 1099s/W-2s, (d) a sole proprietorship, (e) poor ratio of expenses to income, and (f) large deductions.

² Similarly, late filed or amended tax returns can also draw the IRS’s attention.

certainly allowable, but Mr. Drah marched forward with *unusually* large deductions. **Tax Tip!** If a taxpayer is on the IRS's radar, generally deduct the typical and reasonable expenses under the circumstances, unless a story and documentation supports large deductions.³ It helps convince the IRS to pass further investigation and move on to someone else. Mr. Drah did not know that.

He deducted 'contract labor', 'depreciation (Sec. 179)' and 'repairs and maintenance.' The contract labor was suspicious right off the bat. Typically a taxpayer delivering packages reporting income of \$30,000 will have negligible side help. But, Mr. Drah deducted a lot of contract labor...over \$10,000! When it got down to it, Mr. Drah had no support for the contract labor. **Tax Tip!** If your business pays contract labor, issue the recipient a Form 1099.

The IRS next challenged his \$20,000 depreciation expense for his commercial truck. Depreciation on a delivery truck seemingly is a reasonable deduction under the circumstances, even if it was large. Nevertheless, a single \$20,000 write-off against \$30,000 income requires care, and especially when the IRS is watching you. It turned out Mr. Drah did not own the truck, he leased it; and it appeared SDC deducted the lease payments. Of course he lost on the truck depreciation. Mr. Drah's case further collapsed with his \$5,446 repairs and maintenance expenses. The IRS ended up prevailing on everything including about 45% more for penalties.

Taxpayers certainly do not want a *Drah* result. Mr. Drah was seemingly implementing a good tax strategy. He incorporated his business, paid himself a salary, and filed a corporate tax return. But, he tripped into the IRS's web and exasperated his problems with poor responses.

Mr. Drah should have quickly responded by filing a correct personal tax return. If the \$30,000 Fed Ex income was not his, but rather SDC's earnings, he should have filed a personal tax return listing the \$30,000 and making a "reclassification deduction" for a net of zero. The re-class deduction could have been bolstered showing SDC reported it, and a letter to Fed Ex asking for a corrected Form 1099. If the \$30,000 was not reported on SDC's return, then he should have amended SDC's return reporting it. SDC may have owed additional corporate taxes, but it would have been less than his personal taxes considering the 25% personal late filing penalty.

If the \$30,000 was Mr. Drah's personal income, and considering he was under the IRS's microscope without receipts, he should have reconstructed his actual out of his pocket expenses and deducted a reasonable estimate. Then he should have considered the viability of abating the penalties. The final step would be to pay the tax or enter into a payment plan and move on.

In conclusion, as an Attorney/CPA, we have a long history keeping our clients off the IRS's radar with aggressive, but prudent deductions. There are times, however, a taxpayer unwittingly, and sometimes randomly, attracts the IRS's attention. When the IRS is 'knocking at the door', with my 34 years' tax experience, we work with taxpayers to devise a strategy to help make the IRS go away, including making sure the IRS understands the strength of our cases. Nevertheless, staying off the IRS's radar generally starts with timely filing tax returns, and quickly responding if the IRS has questions. Thus, if we can help you with your taxes, please call us at (918) 599-7755 or see our website, PaulHBurgess.com.

³ An experienced attorney/CPA with their legal and accounting training is the best source to help taxpayers weigh the strength of their evidence and documentation against what the IRS expects.