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Greetings from the IRS

A look at how the IRS determines which tax returns it will audit—and the chances your return could be among them.

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FIRST IN A THREE-PART SERIES

The words "Internal Revenue Service" cause heart palpitations for most Americans, especially when combined with the word "audit." Part of that response may be justified, but part stems from not understanding the role of the IRS and how it

goes about doing its business.

When the IRS comes calling, it is not on your side. It's best, therefore, to prepare your return in a way that will lessen the chances of an audit. If you are nevertheless selected for an audit, you should know how to deal with the IRS.

In this, the first part of a three-part article, we explore the scope of the IRS's power and how the agency selects the returns it will audit.

Friend or foe?

The IRS is not in the business of being your friend, but it isn't necessarily your enemy either.

The relationship between you and the IRS is a lot like the relationship you may have had with your teachers in high school. If you followed the rules, didn't cheat and kept a relatively low profile, the teacher typically left you alone.

But if you didn't follow the rules, cheated or otherwise stuck out from the crowd, the teacher likely would have noticed you, and you may have been disciplined. You may have regarded the teacher as your enemy, but she was just doing her job.

Similarly, the IRS's job is to enforce the tax laws. The activity that concerns most people is the agency's role as a watchdog, making sure that taxpayers pay the correct amount of tax due. To accomplish this, the IRS has the power to:

- audit tax returns;
- examine a taxpayer's records;
- demand payment of unpaid tax;
- take measures to collect tax that a taxpayer neglects or refuses to pay;
- impose various tax penalties.

How does the IRS pick returns to audit?

For a taxpayer, the idea of being audited is about as welcome as the plague. Currently, though, less than 1 percent of personal income tax returns are selected for audit. This statistic is comforting, at least until you're the one selected.

How does the IRS pick which returns to audit? One method is the Financial Status Analysis Program (FSAP). Under the FSAP, the IRS selects returns for

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Lend me your credit

Before extending credit to any patient, you need to know the consumer lending laws. In "Billings and Collections," the author notes that federal and state laws treat credit extensions as loans—and prescribe costly penalties for violations. *Page 3.*

A tale of trouble

A dental patient chronicles events leading up to her decision to file a malpractice lawsuit against her dentist. The patient says she never would have gone forward with the suit if the dentist had taken certain steps to show he cared. *Page 4.*

Editor's note

Sexual harassment is addressed under Title VII of the 1964 Civil Rights Act. But suppose both the harasser and the harassed are of the same sex? In such cases, the law isn't quite so clear-cut. *Page 6.*

Legal Briefs

A dental discount is ordered to cease operations, and a state is told it statute violates a federal ban on balance billing. *Page 6.*

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audit when there is an indication of income not subject to information reporting, such as revenues reported by business and the self-employed. Taxpayers selected under this program generally find it to be a distasteful experience.

The audit is thorough. The IRS requests a "personal living expenses" form to be filled out. The agents probe into the taxpayer's lifestyle to determine if the reported income bears the expected relationship to the taxpayer's net worth and manner of living. If the IRS believes the taxpayer is living too large in light of the reported income, a more rigorous review is likely to follow.

If selected for an FSAP audit, e.g., you are asked to fill out a personal living expenses form, you should hire a tax professional to represent you. FSAP audits are often more tedious and time-consuming than you may be willing to deal with.

A second audit selection technique is the Discriminant Function System, or DIF. This system uses mathematical formulas to classify returns according to the likelihood of collecting additional taxes.

Your return is assigned a score based on its characteristics. The higher your score, the more likely it is you will be audited. For obvious reasons, the IRS does not disclose which characteristics are most important. Nonetheless, there are major characteristics that increase your DIF score and therefore your chances of being audited.

First, as the amount of your gross income increases, so do the odds of being audited. These odds rise substantially once your income exceeds \$50,000. If it does exceed that amount, your chance of an audit increases to about 1 percent. If your gross income exceeds \$100,000, your



audit risk goes up to about 3 percent.

Second, if you're self-employed, as most dentists are, you face a higher audit risk. The risk is higher still if you have substantial income and deductions from your self-employment, or if your business involves strict cash receipts.

Third, if you itemize deductions, rather than using the standard deduction, your chances for audit increase. This is especially true if your itemized deductions exceed the average amount of deductions for other taxpayers within your income level.

Fourth, if you've been audited before, and it resulted in additional taxes being owed, the risk of being selected again rises. It jumps still further if you have a history of poor audit results. In 1997, the IRS is emphasizing review of individuals who have had a history of non-filing.

Returns with a DIF score above a specified minimum are carefully

reviewed to determine which ones merit attention. That review process is not an audit. It's simply a means for picking returns that eventually will be audited.

Returns are selected for audit when the reviewer concludes that the return is likely to have errors, leading to increased tax revenue. In addition, returns with specific characteristics are most likely to be selected for an audit. Examples include returns missing certain schedules not provided by the taxpayer after being contacted by the IRS, and returns that ask for refunds of \$200,000 or more.

The IRS uses a variety of other methods for audit selection.

One method involves computer matching. The IRS will compare data on information returns (examples: Form W-2, Form 1099) filed by employers, banks and insurance companies with the amounts reported by you on your tax return. An audit may result if there is more than a minor difference between the two amounts.

Another method involves audits of related taxpayers. For example, if the IRS audits one individual's tax return that claims deductions for payments made to another person, the IRS may audit the return of the alleged recipient of the payments to make sure that the income was properly reported.

Example: During 1997, Dr. Andrews made cash payments of \$5,500 for various supplies to Dental Supply Co., owned by Mr. Jones. Dr. Andrews properly deducted the payments on his 1997 income tax return as a business expense.

The IRS selects Dr. Andrews' return for audit. After verifying the accuracy of his \$5,500 deduction, the IRS might check Mr. Jones' 1997 return to make sure that Mr. Jones properly reported the \$5,500 as gross income.

Another selection method arises out of information the IRS obtains from miscellaneous sources. These include other federal agencies, state agencies, newspaper and television reports, and informants.

Example: Sam files for divorce. During the course of the divorce proceedings, Sam's wife discloses that her husband keeps large amounts of cash at home in a locked metal box.

Newspaper and television accounts widely report this information. If this information comes to the attention of the IRS, it may audit Sam's tax returns to determine whether the cash came from taxable sources, and if so, whether it was properly reported.

These are the methods the IRS uses to determine which tax returns will be audited. The second part of this series will explore what to do if you're unlucky enough to be one of the chosen few.

Data (continued from page one)

professional society.

Q3: If I refund fees to a disgruntled patient or make a payment to him or her to avoid a malpractice claim, will I have to report this to the data bank?

A: Individual practitioners who refund fees or make payments out of their personal funds to resolve a malpractice claim are not required to make a report to the data bank. But note: payments made by a professional corporation or other business entity on behalf of an

individual practitioner must be reported.

Q4: If a lawsuit is filed against me, will it be reported to the data bank regardless of its outcome?

A: No. The data bank contains information on payments made as a result of malpractice claims, including both settlements and judgments. A report to the data bank is not required merely because a claim is made, a lawsuit filed or your insurer put on notice. If a claim is resolved with no payment being made, no report to the data bank

is required.

Q5: Besides information on payments made in malpractice cases, what other information does the data bank collect?

A: The data bank also collects reports of adverse actions on licensure, clinical privileges and professional society memberships. This information is also treated as confidential, and is generally accessible only to hospitals, clinics and medical and dental associations that have an interest in ensuring that their members are competent, licensed and in good standing.

WHAT DENTISTS CAN LEARN FROM THIS ARTICLE:

- The National Practitioner Data Bank has rigid reporting requirements and narrowly defines the types of information it will accept and store.
- Access to the data is strictly controlled.
- Dentists can check that the information stored in the data bank is accurate by submitting a Request for Information Disclosure form to the data bank.

Greetings from the IRS

In this, the second part of a series, the different kinds of IRS audits are explored, along with need-to-know information on how the agency works.

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SECOND OF THREE PARTS

You'll know you're being audited when you get a letter from the Internal Revenue Service that says it wants to meet with you to "verify the accuracy of your return."

Though the letter doesn't use the word "audit," you are indeed one of the chosen few.

An audit letter is not the same as correspondence from the IRS's verification branch. Initially, the agency checks all tax returns for mathematical accuracy and for items that are clearly in error. (An example of an item clearly in error: you forgot to subtract your allowable personal exemptions in arriving at taxable income.)

If these verification procedures



disclose any errors, the IRS sends the taxpayer revised numbers and either a bill or a refund for the difference between the corrected amount of tax and the amount already paid by the taxpayer.

Example: Sandra's 1997 taxable income is \$60,000. In computing her tax liability, Sandra makes a mathematical error and understates the amount she owes the government by \$1,500.

If the IRS catches this mistake,

it will send Sandra a letter explaining the error and indicating the amount due. The letter does not mean that Sandra's 1997 return is being audited.

If the IRS letter asks for more tax, don't assume you necessarily owe the additional amount. It's possible that the agency has made an error in its own verification procedures. Review your return to make sure the IRS' calculations are correct and that you were the one who made an error. If you did make an error, you have little recourse but to pay up. But if you didn't make an error, then you or your tax advisor should write an explanatory letter to the IRS.

Office audit vs. field audit

The IRS uses two different types of audits: office and field. Office audits frequently are conducted by an IRS representative at the IRS, but they also may be conducted by mail.

Typically, the taxpayer must prove a particular deduction, item of income, or credit claimed, by presenting evidence

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like checks, sales receipts and invoices. Most audits of individual taxpayers are handled this way.

Field audits are typically conducted by an IRS agent at the taxpayer's place of business, at the taxpayer's home or at the office of the taxpayer's tax advisor.

Generally, a field audit involves a more complete review by the IRS than the office audit. The field audit is commonly used for corporations, as well as for individuals who run their own businesses. A field audit is likely when the IRS engages in a "financial status audit." In that type of audit, the agent reviews the taxpayer's lifestyle, in addition to the four corners of the return.

The agent seeks to show that the taxpayer has an impressive lifestyle relative to the amount of income reported. It is not unusual for the agent to appear at the taxpayer's personal residence.

Example: Perry owns a dental practice operated as a sole proprietorship. If the IRS audits Perry's return, it may conduct the audit at his dental office or residence or both. This would allow the IRS greater access to Perry's business records to verify his reported income and deductions. It also would permit the IRS to observe his dental office first-hand and his lifestyle, to make sure that Perry's income matched his standard of living.

As time goes by

Suppose that you've filed your return and cashed your refund check. Or you've received your canceled check for the additional taxes you paid with your return. A few weeks or months go by, and you don't hear a word from the IRS. At that point, you may think you have avoided an audit. But the IRS can still try to get additional taxes from you anytime within three years of the return filing date or, if later, from the date the return was due.

Example: Jackie filed her 1996 federal income tax return on March 1, 1997. The due date of the return is April 15, 1997. The IRS can try to collect additional taxes from Jackie for the 1996 year until April 15, 2000. (If Jackie had filed her 1996 return after the due date, for example on Aug. 15, the IRS would have had until Aug. 15, 2000, to audit her 1996 return.)

Generally, the IRS is not allowed to impose additional taxes after this three-year period. But there are exceptions to this rule. First, if you fail to report a large amount of gross income, the period is extended to six years. (The amount must be in excess of 25 percent of the gross income reported on the return.) Second, if you fail to file a return, or you file a fraudulent return, the IRS can come after you at any time.

Example: The IRS audits Ursula in March 1996 for the tax

year ending Dec. 31, 1993, and concludes that her 1993 return was correctly prepared. But during the course of the audit the IRS also discovers that she failed to file an income tax return for 1985, and that \$19,000 of gross income was improperly omitted from her 1991 income tax return. Gross income reported on the 1991 return was \$67,000.

Can the IRS, in 1996, seek additional taxes from Ursula for the 1985 and 1991 tax years? Yes, for both years. For Ursula, 1985 is open to audit forever because no return was filed. The 1991 return can be audited because a six-year period applies. Ursula failed to report \$19,000. This amount exceeds \$16,750, which is 25 percent of the reported gross income of \$67,000.

Despite the 3-year and 6-year rules, the IRS has a policy not to audit individual returns more than 26 months after the return is filed. If you haven't heard from the IRS by that time, it's unlikely that you will be audited.

Is your attorney well-versed on writing wills?

You can find out about that by asking certain pointed questions. If the answers are unsatisfactory, start shopping for a new lawyer.

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A will is an essential element in your estate planning. It allows you to express your wishes as to how your property should be distrib-

uted and who should be the guardians for your children.

Because a well-written will is so important for your family, creating it requires attention to detail. You should begin the process by knowing what you need to put into your will and how to do it.

What kind of property can I will away?

Only probate property is subject to distribution under the terms of your will. Other, nonprobate property passes outside of the terms of your will.

Nonprobate property passes to beneficiaries according to the following special rules:

- if property is in a living trust, according to the terms of the trust;
- if the nonprobate property is a life insurance contract, to the beneficiaries named in the life insurance policy agreement;
- if the nonprobate property is in joint tenancy with right of survivorship, to the surviving joint tenant.

Example: Byron owns his

home in joint tenancy with his wife Anne. Byron also owns a \$100,000 life insurance policy, with Anne named as beneficiary. In addition, Byron puts his stocks and bonds into a living trust. The trust provides that the trust property will be distributed to Anne on Byron's death. Byron also owns a vacation home, a certificate of deposit, some furniture and a car.

In his will, Byron leaves his property to Anne. When he dies, his joint tenancy interest in the home will pass automatically to Anne, outside the probate process and will. Likewise, Anne will receive the \$100,000 life insurance proceeds directly from the insurance company, once she presents proof of Byron's death.

Also, Byron's trustee will transfer
(See Will page 4)

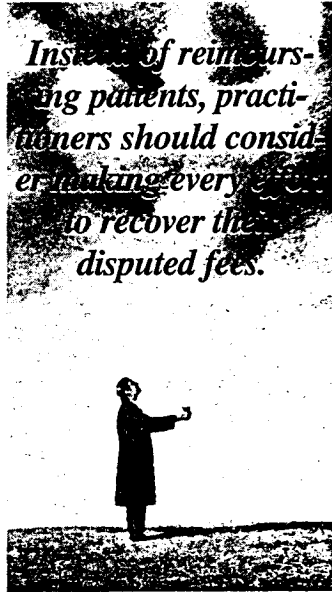
Patient (cont. from page one)

and that they properly document in their records that the risks and benefits of treatment, as well as those of alternative treatments, were discussed.

What about outstanding bills?

In my view, a dentist should never forgive an outstanding balance or reimburse a patient who is dissatisfied with treatment. It has been my experience that when dentists take this position, patients view it as an admission of wrongdoing, and thus an invitation to a potential dental malpractice claim.

Negotiating a compromise or settlement agreement in this situation is probably a waste of time. An agreement that is negotiated by the practitioner and signed by the patient as part of a reimbursement or discharge of a bill—and that



releases the dentist of any liability—generally will not hold up in court.

Although the law favors and seeks to encourage the private set-

tlement of disputes, the law also favors the just compensation of those who are victimized. The courts in most states permit avoidance of a release that was not executed knowingly by the patient. In this way, the courts protect patients who have literally signed away their rights of judicial recovery, especially when it is not clear whether the patients understood what they were signing away in return for a quick settlement.

Because we live in a litigious society, discharging an outstanding balance or reimbursing a dissatisfied patient is no guarantee that the patient will refrain from ever bringing a dental malpractice claim.

Instead of reimbursing patients, practitioners should consider making every effort to recover their disputed fees, allowing them to maintain adequate professional liability coverage.

WHAT DENTISTS CAN LEARN FROM THIS ARTICLE:

- Most, if not all, states recognize that dental treatment may not be successful.
- A dentist who has not been negligent, and has informed his or her patient of the risks and benefits of treatment, as well as those of alternative treatments, is unlikely to be held liable for treatment that has failed.
- Instead of forgiving an outstanding balance or reimbursing a dissatisfied patient who later may bring a dental malpractice action, dentists should try to recover their fees and maintain adequate professional liability coverage.

Greetings from the IRS

This, the third part of a three-part series, explores the kinds of penalties the IRS can assess, and other information you need to know before you go into an IRS audit.

THIRD IN A THREE-PART SERIES

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Assume that the audit is done, and the IRS has concluded that you owe tax. "All right," you say, "I'll pay the extra tax, and that will be the end of it."

Not quite. You still have to worry about interest and potential penalties. These penalties can be

civil, meaning that you may owe additional money, or criminal, meaning that you may owe even more money in fines—and may have to spend time in jail.

Payback With Interest

If the IRS says you owe additional tax, it also will impose an interest charge on the underpayment. Interest compounded daily begins on the due date of the return and runs until the tax is paid. The rate of interest is set by the government and



Illustration by Doug Quicker, courtesy The Stock Illustration Source

adjusted four times a year. In the first quarter of 1997, for example, this interest rate was 9 percent.

Example: Sarah files her 1996 federal income tax return on April 1, 1997. Sarah inadvertently fails to report \$2,000 of income she earned on a bank certificate of deposit.

On May 15, 1997, the IRS finishes a review of Sarah's return and determines that she owes additional tax of \$620. Sarah pays the tax on June 15, 1997.

In addition to the tax, Sarah must pay interest. The interest, computed on \$620, runs from the due date of the return, April 15,

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IRS (continued. from page 2)

1997, until the payment date, June 15, 1997.

Civil penalties

Besides interest, the IRS also may impose penalties if you fail to file a return, or if you fail to pay the correct amount of tax. Civil tax penalties can occur if you:

- fail to file a tax return by the due date;
- claim withholding allowances based on false information;
- substantially overstate value (or basis) for income tax purposes;
- negligently or fraudulently fail to pay tax by the due date.

Criminal Penalties

Civil tax penalties are limited to a monetary fine. But criminal tax penalties may result in imprisonment. A taxpayer convicted of a criminal tax offense can be held responsible for a civil penalty for the same act.

Tax crimes include:

- tax evasion;
- intentionally failing to file a return;
- intentionally not paying tax;
- knowingly making a false statement to an IRS agent;
- filing a false return;
- assisting in the preparation of a false return.

If a taxpayer is convicted, the potential penalty depends on what the taxpayer did wrong. For example, if convicted of tax evasion, a taxpayer is subject to imprisonment of up to five years, a fine of up to \$100,000, or both, plus prosecution costs.

Don't panic

Currently less than one percent of individual income tax returns per year are audited, so the odds of being chosen for

audit in any particular year are not high. Realistically, though, the chances are that you will be called before the IRS sometime during your lifetime.

How should you react to an audit letter? First, don't panic. An audit does not necessarily mean that you will be taxed into bankruptcy or hauled off to jail.

Assuming that you tried in good faith to follow the tax laws, the audit is not likely to disclose anything but minor, honest mistakes. In that case, the worst that will happen is you will have to pay the tax shortfall plus interest. You may have even erred on the side of the government, in which case you'll get a refund of the tax overpayment plus interest. (Believe it or not, this is the result in almost 5 percent of all audits.)

How should you prepare for an audit? First, determine whether the audit is a field or office audit. If the letter announces that the IRS is sending its representative to meet with you, this is bad news. Field audits are more intrusive and tend to be broader in scope than office audits, and therefore more painful.

Second, check the specified date and time of the audit. If either is inconvenient, contact the IRS and request a different date or time. Often, the IRS will grant your request.

Third, identify what papers the IRS wants to review. In the case of a field audit, the IRS will want to see most financial and tax records for the audit year. In the case of an office audit, the letter normally will instruct you to bring a copy of your tax return for the year under audit, a copy of your return for the preceding year, and any records you have to support the income, deductions, credits and other items you used to arrive at your taxable

income for the audit year.

Should you go it alone?

The next step: decide who should attend the audit. You can represent yourself, but if the issues are complex or involve substantial amounts of tax, you should hire a tax lawyer or CPA to represent you.

If you do represent yourself, be prepared. Organize your records so you can clearly and quickly answer questions. Your conversation with the IRS representative should be businesslike. Be pleasant, but direct. If you're asked a

One note of extreme importance: if at any time during the audit an IRS representative introduces himself or herself as a "special agent," go no further.

question, make your answer as precise as possible. Don't say any more than you're asked for. A long-winded response may disclose facts that pique the examiner's interest, and lead to an expanded audit.

One note of extreme importance: if at any time during the audit an IRS representative introduces himself or herself as a "special agent," go no further.

Don't respond to any questions or comments made by the special agent. This advice also applies if a special agent shows up asking questions at your home, place of employment or anywhere else. Special agents are part of the IRS's Criminal Investigation Division, the CID. The only time the CID gets involved with audits is when the IRS suspects that you have committed a tax crime. If this happens, contact an attorney.

Once the audit is over, the IRS will report its findings to you. If you agree with these, the pain is over—except perhaps for writing a check in the amount you owe the government.

If you disagree with the IRS's findings, however, you have two options. First, you can request a meeting with your examiner's supervisor. It's possible that the supervisor will agree with your position and resolve the matter in your favor. If not, your second option is the IRS's Appeals Division.

At this point, you should involve your tax advisor because the appeal process is complicated. For example, an appeal request is usually made by filing a written protest. Drafting the protest is best left to a tax professional.

Most matters don't go beyond the Appeals Division. About 85 percent of the cases taken to appeals are settled at that level. Typically, the settlement involves a compromise between the taxpayer and the IRS.

But if you can't resolve the matter at the appeals level, you must decide whether you want to take your case to court. If the controversy concerns a relatively small amount, you may not want to hire an attorney and go to court. The court costs and attorneys' fees may end up exceeding the amount in dispute. Worse yet, you could lose the case. Some taxpayers have ignored this kind of cost/benefit analysis and litigated small claims as a matter of principle. But those cases are rare.

If the amount in controversy is substantial, however, it may be worth your while to fight the IRS in court. Your decision depends on your chances of winning. To make an informed decision, you should examine closely the strength of your case, the potential costs and the litigation odds you face.