Tax Audit Insurance Available

With Tax Laws as Complicated and Confusing as They Are, Some Contractors Turn to Insurance as a Viable Protector

by: Amos Rafferty, C.P.A., M.B.A

What is heralded as a most innovative way to mitigate the effects of an IRS audit is coverage for assessments up to $100,000 per covered return and up to $1000 for professional representation.

Thus, for a modest premium, ranging from $100 to $600 per return (depending on income, dependents, kind and number of deductions, and the types of schedules filed) wall and ceiling contractors can be protected against both assessments and legal and/or accounting fees.

Do you need this type of protection?

You might argue that you can save the premium and not buy this type of new insurance coverage because statistically you only stand a small chance of being audited. Only 1.14 million individual returns out of 95.6 million returns filed for 1982 will be audited.

However, this statistic is misleading. Many of the 95.6 million returns filed contain 1040s, 1040EZs and many millions for which the IRS doesn’t even give a second look after a check for mathematical accuracy.

Mr. Paul L. Genecki, Senior Vice President of the Victor O. Schinnerer & Co. Inc. organization, developers and managers of the new tax audit insurance, says: “The odds of a residential fire are even greater, yet most persons buy insurance against that eventuality.”

IRS data indicates that the average office audit results in additional taxes of $579 being assessed, while a field audit results in an average of additional taxes assessed of $6,374 per return.

The program developed by the Schinnerer organization is called TAXRIGHT (registered Service-mark). It has already caused a sensation in accounting circles and has been focal point of articles in nationally distributed newspapers and magazines.

Subject to Questions . . .

You need this insurance because the most meticulously prepared returns are subject to questions about the adequacy or propriety of the documentation and substantiation which you have accumulated and maintained. Also, of increasing concern today is the added uncertainty as to how courts will decide complicated provisions not only in the new tax laws but also in statutory provisions that have existed for years.

With insurance, a taxpayer is free to take aggressive-but honest-positions on tax matters. And with a client having such insurance, the tax preparer is going to feel freer “to decide on the correct positions, based on their knowledge, skill and experience, and not place so much emphasis on what impact the next court decision will have on his client,” says Walter T. Coppinger, a CPA with Arthur Young & Co.

There are requisites to obtain this new coverage. You must submit an application for a return which was prepared or reviewed and signed by a Certified Public Accountant or an attorney who is engaged in federal tax practice. And the preparer must not be under suspension of the right to practice before the Internal Revenue Service either at the time the return was prepared or at the time the application is submitted. And, the taxpayer who is applying must not have been prosecuted for any fraud pertaining to the tax laws or for income tax evasion.

Also, the professional tax preparers will be assumed to be in compliance with the ethical standards of their pro-
You need this insurance because the most meticulously prepared returns are subject to questions about the adequacy or propriety of the documentation and substantiation which you have accumulated and maintained.

fession and meet the requirements of Circular 230. The taxpayer will be expected to meet the reasonable record-keeping requirements of other taxpayers similarly situated in the same fashion as he or she would act if the return were not to be insured. In effect, the insurer is calling into play the concept of “due diligence.”

Policy coverage is divided into two separate features. One is to indemnify you against losses arising out of an IRS examination of the tax return you have filed.

The second feature is to provide for a thousand dollars of upfront money to reduce the initial impact of a Service contract on an insured return. This basic coverage is supplemented by payment of all litigation costs occurring after the point at which the insurance company decided that the issue should be contested; plus the payment of all statutory interest accruing from the date of any delay in settlement, either as a result of litigation or consultation delays caused by the company.

Indemnity Feature . . .

The most important aspect of the policy provides for an indemnity feature whereby you are made whole for a net, out of pocket, economic loss. Because the policy insures against an additional tax liability arising from disallowed deductions or good faith exclusions of income, some interesting results are obtained. For example, you could have a refund due as a result of an IRS examination and still collect under the terms of the policy. This would occur, for example, when the IRS examiner makes adjustments that decrease tax liability but also disallows some claimed deductions. The policy will reimburse you for lost deductions at the top bracket as if there were no unrelated adjustments decreasing tax liability.

Of course there are limitations on the reimbursements of losses. The standard policy provides for an indemnity limit of $100,000 for each covered return. If you qualify for coverage for your most recent tax return, you may be eligible for coverage of your two prior years’ returns if a notice of audit or deficiency has not been received.

Insurance coverage is effective from the date of the application, if accepted by the company, and the later of three years after the covered return is due.
or is filed. This period can be extended with the written consent of the insurance company. All returns to be insured have to have an adjusted gross income (or an adjusted gross income with all negative entries deleted) of less than $500,000.

Since the philosophy of this insurance coverage is to insure returns that would meet a due diligence test, those assessments that fall outside this concept are not covered. Specifically the policy would not cover as a loss any of the following as finally determined by the Internal Revenue Service or a United States Federal Court:

1. Any amount of penalty, interest and similar payment, except for interest otherwise provided by the policy.
2. Any amount arising from acts which would result in a penalty to you. For example: fraud, negligence, over-valuation or substantial underpayment.
3. Any amount arising out of a transaction which is without economic substance or out of a transaction the principal purpose of which is the avoidance or evasion of tax.
4. Any amount arising out of an omission or failure to report gross income (not including good faith omission or exclusion).
5. Any amount arising out of mathematical or clerical errors.

Also, effectively excluded, because of the concept of indemnity insurance, are the deficiencies that arise out of adjustments that are timing issues or the transfer of income or deductions between related parties. However, the theory of indemnification would provide for some allowance in these offsetting type claims based on the time value of money or the difference in tax rate between related parties. For example, if an expense believed to be deductible in 1982 is disallowed by the IRS on the basis that it is deductible in 1983 or later years, the insured would be reimbursed at the existing prime rate for the accelerated tax payment using the effective tax rate for the year of disallowance.

What are the mechanics of filing or settling a claim? The insurance company will adhere to a claims settlement policy that encourages the lowest possible level without undue delay.

Therefore, one of the conditions of the policy is that the $1000 coverage for professional tax assistance during initial stages of an audit will be paid only to the preparer of the covered return unless the insured secures the written permission of the company to engage someone else. Even beyond the initial examination contact stage it is expected under normal circumstances the preparer will represent the insured during the entire examination and administrative appeals stage with the company becoming involved at its own expense by attendance at conferences or in supplemental representation only in unusual or extraordinary cases. Such involvement by the company will be through similarly qualified professionals but may be sup-
plemented by professional experts and others who might qualify by reason of their capability to provide expert testimony during the appeals or litigation process.

Claims are to be submitted to Victor O. Schinnerer & Company through its Washington, D.C. office for initial processing. Most claims will be quickly disposed of following the receipt of “proof of loss” document prepared by the taxpayer’s representative, plus a copy of the IRS examination report, and the appropriate waiver of restrictions on assessment executed by the taxpayer.

But what happens when the insurance company decides that a proposed deficiency should not be paid? At that point all future expenses (including interest on any deficiencies finally determined) will be assumed by the insurance company. The only action on the part of the taxpayer is to offer full cooperation with the representatives of the insurance company. Similar in nature to the right of subrogation contained in most auto insurance policies, and other policies, this gives the insurance company the right to fight deficiencies it does not believe to be warranted.

An important factor is what does the IRS think about this form of insurance? Will it hamper you, cause you any harm when the fact of coverage becomes known to the IRS?

The underwriters of this policy emphatically state that the insurance plan has not been created for the purpose of permitting taxpayers to take advantage of the U.S. system of tax administration.

It, in fact, will assure the government that settlement of the issues in tax cases will not be delayed simply to avoid payment. In addition, on settlement, funds for prompt payment are guaranteed and government collection problems are eliminated. Other benefits will also accrue to the tax administration process. Once a line of reasoning in litigated cases develops contrary to past theory an insurer is unlikely to continue testing cases as unrelated taxpayers do. Rather the trend will be to settle without trial other similar cases. The existence of insurance will also remove much of the tension between taxpayers and IRS representatives, smoothing the process.

Full details of this new insurance plan have been discussed in depth with IRS officials in Washington, D.C. and in field locations. Copies of the insurance policy and other key documents have also been submitted to the IRS. Comments by Service officials have been helpful in designing policy provisions and exclusions to reduce the opportunity for taxpayers to abuse the coverage or take advantage of the system of tax administration. The insurance company has taken into account suggestions by the IRS and future plans include doing those things necessary to merit public policy approval and still maintain consistency with tax policy objectives.

How are rates determined? The cost of the policy has been determined after study of the risks involved. Premiums are computed for each policy based on an analysis of the risks inherent in each return as disclosed by the answers given in the application.

TAXRIGHT will be marketed nationally through independent agents and brokers. For information contact your local agent for information on policy terms, conditions, limitations and premium. These agents and brokers can furnish application forms. If you have trouble securing sufficient information locally, write to John W. Colmer, General Manager, Taxright Division, Victor O. Schinnerer & Co. Inc., 5028 Wisconsin Ave., NW, Washington, DC 20016.