

Practice

Basic Audit Techniques: Taxpayer Interviews

By *Charles P. Rettig and Kathryn Keneally*

Requests to interview the taxpayer and return preparer during an otherwise normal IRS examination have become somewhat common. During an examination where the government is in possession of potentially incriminating evidence, such requests are routine. Near the inception of the recent IRS Voluntary Disclosure Program relating to previously undeclared foreign accounts,¹ the IRS examining agents were instructed to “utilize the full range of information gathering tools ... with special emphasis on detecting unreported income ... including interviewing taxpayers, making third party contacts and timely issuing summonses to taxpayers and third parties” as well as requesting foreign-based information through treaties and tax information exchange agreements. Examining agents were also instructed to “be alert to the badges of fraud and consult with Fraud Technical Advisors in developing cases for criminal referrals or for the assertion of the fraud penalty.” Essentially, the IRS required interviews of taxpayers who knocked on the door of IRS Criminal Investigation desiring to pursue a voluntary disclosure leading to the amendment of previously filed tax returns for the stated purpose of developing fraud issues and referrals. The amended returns of those who came forward were not deemed trustworthy.

During the examination, the taxpayer’s representative is typically trying to determine the nature and scope of the examination, gather responsive documents and information, *etc.* It is nearly impossible for the representative to be able to determine why an examination commenced, but a good starting point is to simply ask the examining agent. A typical response may be that the return was randomly selected for examination.² However, there are actually few random audits. Examinations are typically focused on issues, areas or industries having a historically high rate of noncompliance. Other examinations begin because the



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IRS received information from a related examination of another taxpayer, or perhaps someone purposely provided information to the IRS relating to the taxpayer. Informants usually include disgruntled employees, ex-spouses or business partners, competitors or financial mercenaries seeking a whistleblower reward.³

Code Sec. 7602 authorizes the IRS to examine books and records and to take testimony under oath. A taxpayer has the right to resist an examining agent's request for an interview. Pursuant to Code Sec. 7521(c), the taxpayer's representative may represent the taxpayer before the examining agent and is not required to produce the taxpayer for questioning, unless an administrative summons has been served on the taxpayer. A question often presented is whether the taxpayer and others should consent to interviews, force the issuance of Summonses or invoke various Constitutional protections. There are several considerations that the taxpayer's representative should weigh before allowing the taxpayer to submit to an interview, especially if potential fraud issues are involved.

The government may seek to interview one or any of the following corporate officers in a corporate scenario; the Tax Matters Person (TMP) and designated person most knowledgeable in a TEFRA or S corporation scenario; and the member-manager of the LLC, the general partner of the partnership or officer/shareholder most knowledgeable of the S corporation in the non-TEFRA scenario. Certainly, if there are extremely sensitive (*i.e.*, potentially criminal) issues, the taxpayer should not consent to an interview and should invoke the Fifth Amendment privilege against self-incrimination. It is always preferable for a taxpayer to avoid providing incriminating information when compared with the possibility of propelling a civil tax examination into a criminal tax investigation/prosecution.

Representatives should rarely consent to having the taxpayer interviewed, especially before having a sense of the nature and scope of the examination and a feel for the reason the return was selected for audit. Even then, taxpayer interviews should rarely occur near the commencement of an audit, if at all. Taxpayers engage representatives to prepare returns and handle any examinations of the returns due to the expertise and sophistication of the representative to provide such services. Few taxpayers understand why their presence might be required if the representative was in possession of supporting information to prepare the return and sign it as the preparer. Taxpayers desire to conduct their business and expect the representative to represent them in the examination.

It is usually not a confidence-builder for a taxpayer to be advised that he or she will have the opportunity to meet the examining agent.

Interviews of the taxpayer serve a dual purpose: (i) to further the tax examination, and (ii) to identify violations by a tax return preparer.⁴ During the initial interview and throughout the examination process, the examiner can be expected to ask questions regarding the return preparation as appropriate to the case and issues being developed. Whether through the interview process or other documentation, the examiner will also be determining whether return preparer penalties might be appropriate to the situation. Interview questions are often tailored to the individual taxpayer and situation.

Questions that may be asked include the following: Did you meet with the preparer? What documentation was provided to the preparer? Did you receive a copy of the return or claim? How was the preparer compensated? Are you aware of any errors, omissions or mistakes on the return under examination? Did you disclose this transaction on your tax return? Why? Why not? Were there any concerns about how the transaction was reported? What sort of process is used to address those concerns and on what basis are decisions made? Was there any discussion regarding potential penalties? Was there any discussion regarding whether the transaction is subject to disclosure?

When interviewing the taxpayer or preparer, the agent may ask if any other services have been provided by the preparer's firm and how long the preparer has been preparing returns for the taxpayer. These questions provide insight into the extent of the preparer's knowledge regarding the taxpayer's financial situation/status and may alert the agent to the applicability of penalties. A tax return preparer who has been preparing a client's return for a number of years is more knowledgeable than a firm that is preparing a client's return for the first time.

Preparation for the Interview

In preparing for the interview, agents are instructed to review all available information and categorize it as information that can be documented, and need not be discussed; information that may be documented, but needs to be discussed; and information that must be developed by testimony.⁵ Their interview file should contain only data or information arranged in the order it is to be discussed or covered during the interview so as not to distract or confuse the agent during the interview.

The representative should try to obtain actual questions, or areas that the agent will question, in advance of the interview. This will substantially assist the representative in preparing the taxpayer for the interview, especially for the “hard questions.” The taxpayer should be strongly cautioned against lying, making damaging admissions or giving an explanation that does not fit within the overall parameters of the defense to the fraud issue.

Timing of the Interview

Agents are instructed to conduct an initial interview as soon as possible after opening a case, and subsequent interviews if all requested information is not provided, more detailed explanations are required or a review of the progress of the examination is necessary.⁶ The pre-audit analysis should include the preparation for the taxpayer interview. The representative should attempt to obtain as much information about the issues, the information within the agent’s possession and the agent’s position with regard to the issues, before agreeing to submit the taxpayer to an interview. Ideally, the interview should occur toward the end of the audit, possibly with an understanding that if the taxpayer submits to an interview and answers the questions, the agent will proceed to close the audit. However, the representative must take extreme caution, since such an understanding is probably not a basis for challenging the use of statements in a later proceeding.

Place of the Interview

The location of interviews will be set by the examining agent.⁷ In general, the IRS will determine if an office or field examination is to be performed. Office examinations will be conducted at the closest IRS office to the location of the taxpayer. Field examinations can be conducted at the taxpayer’s residence, place of business or where the taxpayer’s books and records are kept.⁸

The taxpayer’s representative should attempt to have the interview at the representative’s office. This is a much more supportive environment for what could be an extremely agonizing experience for the taxpayer. Conversely, the taxpayer should be less intimidated and should hold up better under the pressure of the agent’s questioning if the taxpayer is not in the unfamiliar confines of an IRS office. Also, the representative should in most instances attempt to keep the interview from occurring at the taxpayer’s

place of business, to help ensure the taxpayer is better focused for the interview and also to avoid the intrusion in the taxpayer’s daily activities.

Asserting the Fifth Amendment Privilege

If fraud issues are manifest, it may not be possible for the taxpayer to answer questions relating to problematic transactions without self-incrimination. In this situation, tax counsel must consider having the client assert the Fifth Amendment privilege against self-incrimination. Unfortunately, invoking the Fifth Amendment privilege will, in most instances, dramatically increase the odds of a referral to IRS Criminal Investigation. However, it is almost always better to allow the taxpayer to claim the Fifth Amendment and place the burden back on the government to prove its case, rather than allowing the taxpayer to provide damaging, irreversible admissions. For obvious reasons, this is usually the most difficult judgment call to make during a sensitive civil audit.

Recording the Interview

All participants must consent to the recording of the interview.⁹ Taxpayers may request to tape record an interview proceeding as long as 10 calendar days’ advance notice of intent to record is provided to the IRS. In addition, the taxpayer must supply the recording equipment. The IRS has the right to simultaneously produce its own recording and has the right to reschedule the interview if the IRS does not or will not have equipment in place. The IRS can initiate an audio recording provided it notifies the taxpayer 10 calendar days in advance of the interview using Pattern Letter 2156 on Area Director letterhead. The Field Territory Manager must approve all IRS initiated recordings.

Interview Techniques

Interviews are designed to provide information about the taxpayer’s financial history, business operations, and books and records that are not available from other sources. They are to be used to obtain information needed to make informed judgments about the scope and breadth of the examination and correctly resolve issues, to obtain leads, develop information and establish evidence. Agents are to maintain control while establishing the pace and direction of the interview. If at any time during the interview or any other phase of the examination process, the taxpayer

indicates he or she wants to obtain representation, examination activity must be suspended and the taxpayer must be allowed a minimum of 10 business days to secure representation.¹⁰

Agents are instructed to conduct the interview in an environment where the taxpayer feels comfortable.¹¹ To establish a rapport with the taxpayer, when introducing themselves the agent is to maintain a friendly and professional demeanor; explain what will happen during the examination; be prepared to explain return selection procedures, rights to representation and appeal rights; recognize that an IRS audit is often a once-in-a-lifetime experience for the taxpayer and therefore the taxpayer may be tense or nervous; exhibit openness, honesty and integrity and be calm and objective; and listen carefully to all details, be receptive to all information volunteered, regardless of its nature, and be patient and persistent in extracting the facts necessary to achieve the goals of the interview.¹²

Government representatives have been trained to utilize various interview techniques, including the need to make appropriate eye contact; put the taxpayer at ease; use appropriate types of questions (probing, leading, open-ended, *etc.*); use "silence" appropriately; paraphrase or restate comments received; listen; pace the interview; know when to move on to the next question; maintain a calm manner; have the taxpayer demonstrate the flow of transactions; read the taxpayer's nonverbal language (body language); be aware of the agent's nonverbal language; be conscious of note taking so as not to distract the taxpayer; use humor when appropriate; be courteous; be business-like and firm in their approach; consider issues in the proper order (volatile versus nonvolatile); schedule the interview at a convenient time and allow adequate time for completion; appear interested in responses; control the interview; appear confident; maximize the value of what they know (such as various audit technique guides); and adapt the agent's appearance to be appropriate for the circumstances.

Additional interview techniques are to provide feedback to the taxpayer; be observant; feign (act dumb) when appropriate (there are different levels of training for this); be prepared; use spontaneous follow-up questions (react when they receive new information); know their limitations; read the taxpayer (know when they have lost the taxpayer's attention); read the taxpayer's perception of the agent; attempt to dispel any negative image of the agent; be on time; use appropriate small talk and easily understood language (single syllable words are generally the best); not anticipate answers; clarify responses received; use reflection; ask for ex-

amples; recognize the agents' biases; be assertive and persistent; avoid debate or argument; give the taxpayer an opportunity to ask questions; express appreciation; verbally pin down the taxpayer on important issues when appropriate; have an open mind; maintain composure; adapt questions to the situation; have the taxpayer explain their terminology; be precise; come from a position of knowledge; work to establish rapport with the taxpayer; respect the taxpayer's views; know their authority; make a positive first impression; maintain an inquisitive mind; contain their excitement (and surprise ... "You didn't report what?!?!"); note unusual hostility or irritability on the part of the taxpayer; consider the need to question both spouses; not interrupt the taxpayer; be methodical; and refresh the taxpayer about important points in prior interviews.

Agents are trained that, no matter how important the question, it is irrelevant if the response is not accurately understood.¹³ As such, they are to demonstrate an interest in the responses from the taxpayer and make sure that their nonverbal communication contributes to a comfortable atmosphere. If they appear overly relaxed and are not looking at the taxpayer, the taxpayer may believe they are not interested and will respond accordingly. Agents should not interrupt the taxpayer and should allow a brief pause at the end of a response.

The types of questions should be varied to establish a conversational atmosphere. When developing questions, agents are to focus on four types of questions: open-ended, closed-ended, probing and leading. Open-ended questions are framed to require a narrative answer. They are designed to obtain a history, a sequence of events or a description and are often asked regarding the taxpayer's business, employment, education and sources of income that may not be reflected on the return. The advantage of this type of question is that it provides a general overview of some aspect of the taxpayer's history. The disadvantage is that this type of question can lead to rambling. Closed-ended questions are specific and direct, intended to identify definitive information such as dates, names and amounts. They are frequently asked for personal background information such as the number of dependents or current address and are useful to help focus the taxpayer with any difficulty giving a precise answer. They are also useful to clarify a response to an open-ended question. The disadvantage to closed-ended questions is that the response is limited to exactly what is asked and can make the taxpayer uncomfortable. Probing questions combine the elements of open and closed-ended questions and are used to pursue an issue more deeply. For example, when questioning a taxpayer's

travel expense, the agent may ask, “How many miles is it from your residence to your practice, and where do you first travel to in the morning?” The advantage of this type of question is that the taxpayer’s response is directed, but not restricted. Leading questions suggest that the interviewer has already drawn a conclusion or indicate what the interviewer wants to hear. Agents are to limit the use of leading questions and typically will only use them when looking for confirmation, since the answer is stated in the form of a question (for example, “So you did not keep a log or other written record of your auto expenses?”).¹⁴

Summary

It is generally advisable to attempt to resolve an examination at the earliest opportunity. A lengthy audit may be costly from the perspective of the expenditure of time and effort involved, as well as the taxpayer’s

degree of frustration with the normal administrative process. Further, a prolonged audit is more likely to uncover potentially sensitive issues that could generate increased tax deficiencies, penalties or other sanctions.

Every examination is different—different taxpayer, different agent, different facts and issues, *etc.* Representation during an examination entails knowledge of the administrative process as well as the personal ability to handle each stage of the examination. However, most examinations can be expected to involve a request to interview the taxpayer. Taxpayer representatives should not routinely agree to such a request without first determining whether the information can otherwise be provided without the interview, or the nature and scope of the intended interview questions. Testing the heat of the examination waters before allowing the taxpayer to enter may be the difference between a quick resolution and a criminal tax referral.

ENDNOTES

¹ In a memorandum dated March 23, 2009, from Deputy SB/SE Commissioner Faris R. Fink, Deputy LMSB Commissioner Barry B. Shott, and Deputy Chief of Criminal Investigation Victor Song, to SB/SE Examination Area Directors, LMSB Industry Directors, and CI Directors of Field Operations (the “Case Routing Memorandum”), the IRS stated that voluntary disclosures concerning offshore issues will continue to be screened in the first instance by Criminal Investigation “to determine if the taxpayer is eligible to make a voluntary disclosure.” After a preliminary determination is made, “voluntary disclosure requests containing offshore issues . . . will now be forwarded by CI to the Philadelphia Offshore Identification Unit (POIU) for civil processing.” Any voluntary disclosures that were already in process prior to March 23, 2009, were also to be forwarded to the POIU.

In a separate memorandum dated March 23, 2009, from Deputy SB/SE Commissioner Faris R. Fink and Deputy LMSB Commissioner Barry B. Shott, to SB/SE Examination Area Directors and LMSB Industry Directors (the “Case Development Memorandum”), the IRS stated that it was acting “to ensure that examinations with offshore transactions and/or entities continue to be emphasized and receive priority treatment during the examination process.” The memorandum stated: “Offshore cases sent to the field are work of the highest priority.” In developing these cases, IRS examiners were instructed to “utilize

the full range of information gathering tools . . . with special emphasis on detecting unreported income.” The Case Development Memorandum recommended “interviewing taxpayers, making third party contacts and timely issuing summonses to taxpayers and third parties” as well as requesting foreign-based information through treaties and tax information exchange agreements. Examining agents were also instructed to “be alert to the badges of fraud and consult with Fraud Technical Advisors in developing cases for criminal referrals or for the assertion of the fraud penalty.”

In the third and certainly the most significant of the March 23, 2009, memoranda, from IRS Deputy Commissioner for Services and Enforcement Linda E. Stiff to LMSB Commissioner Stephen Miller, and SB/SE Commissioner Chris Wagner (the “Penalty Memorandum”), the IRS announced a “penalty framework” for those taxpayers who come forward as part of a voluntary disclosure to address offshore issues. The penalty framework was initially to be in place for only six months from March 23, 2009 (until September 23, 2009), but was subsequently extended to October 15, 2009.

² The examining agent may not actually know what triggered the examination. However, Section 3503 of the IRS Restructuring and Reform Act of 1998 (“RRA 98”) and IRM §4.10.2.10.3 (May 14, 1999), *Advising Taxpayers of the Reasons for Their Examination*, require the publica-

tion of the general criteria and procedures for selecting taxpayers for examination. Publication 1 has been revised to provide an overall explanation of how returns are selected and providing this publication to the taxpayer may be deemed to satisfy Section 3505. However, IRM §4.10.2.10.3 (May 14, 1999) provides that as a matter of policy, if a taxpayer under examination requests the specific reason for his/her examination, the examiner will provide the taxpayer with a response that is as accurate as possible, without revealing restricted use information.

³ Code Sec. 7623. If the IRS uses information provided by an informant, the informant can receive up to 30 percent of the additional tax, penalty and other amounts collected.

⁴ IRS LMSB Memorandum, *Procedures for Tax Return Preparer Penalty Cases* (April 2008).

⁵ IRM §4.10.3.2.3 (Mar. 1, 2003).

⁶ IRM §4.10.3.2.4 (Mar. 1, 2003).

⁷ The authority is provided in Code Sec. 7605(a) and Reg. §301.7605-1. See also IRM §4.10.3.2.2 (Mar. 1, 2003).

⁸ *Id.*

⁹ Code Sec. 7521(a); IRM §4.10.3.2.6 (Mar. 1, 2003).

¹⁰ IRM §4.10.3.2.7.1 (Mar. 1, 2003).

¹¹ *Id.*

¹² *Id.*

¹³ IRM §4.10.3.2.7.3 (Mar. 1, 2003).

¹⁴ IRM §4.10.3.2.7.2 (Mar. 1, 2003).