

# Practice

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## Handling the Sensitive Issue IRS Audit

*By Charles P. Rettig*

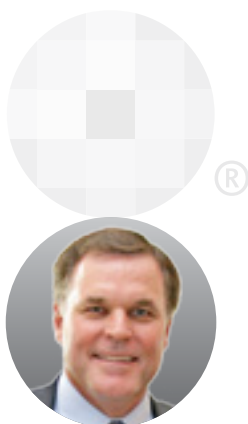
**N**otwithstanding extreme resource challenges, the IRS remains well equipped to identify potentially fraudulent returns as a result of increased transaction and information reporting, better developed audit plans and techniques that focus on specific industries, substantially increased access to computerized data banks and an overall increased level of scrutiny of the taxpayer, the taxpayer's business, the taxpayer's standard of living and how these relate to issues reported—or not—on the return under examination. The potential fraud/criminal exposure is often based on items such as unreported income, improper deductions or some other false or inaccurate statement on the return or the overall economic lifestyle of the taxpayer.

A civil examination involving potentially sensitive issues where civil or criminal fraud potential exists requires the utmost of judgment, discretion and caution. The primary examination objectives are to limit the scope of the inquiry, to avoid the presentation of false or misleading information, to avoid false statements by the taxpayer or the taxpayer's representative and to limit the information provided so as to avoid the waiver of the privilege against self-incrimination. In these examinations, the taxpayer's potential criminal exposure is often a more significant concern than the dollar value of any potential adjustments on the return.

### The Role of Counsel in the Examination

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In civil tax audits that include potentially sensitive issues, the attorney serves as a quarterback for a team that includes the attorney, the taxpayer and a forensic accountant. The attorney advises the client and helps make judgment calls on how the information will be provided to the agent. The attorney also directs the accountant to analyze books and records for purposes of identifying sensitive areas, to prepare schedules for internal use or for presentation to the agent and to engage in other supportive services. There must be the ability to “handle the hard questions” without misleading the agent while attempting to position the examination in a manner calculated to take advantage of whatever luck or fortunate breaks may occur during the audit which, in turn, could prevent the occurrence of a referral for an IRS criminal investigation.



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## Use of a Kovel Accountant

In civil tax audits that include potentially sensitive issues, counsel will often engage a team of representatives, including a forensic accountant. Engagement of the accountant by counsel should be designed to extend the attorney-client privilege to communications and rendered by the accountant pursuant to the engagement.

Although Code Sec. 7525 extends common law protections of confidentiality to tax advice rendered between a taxpayer and a federally authorized tax practitioner (to the extent such communications would be considered privileged if they occurred between a taxpayer and counsel), this statutory privilege only applies to noncriminal tax matters before the IRS and noncriminal tax proceedings in federal court. The protections afforded by Code Sec. 7525 are not available when truly needed the most—when a civil tax proceeding moves into the criminal arena. It also may not be available in state-related tax proceedings, or nontax civil litigation.

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Pursuant to *Kovel*,<sup>1</sup> the attorney-client privilege is extended to an accountant retained specifically to assist an attorney in rendering legal services to a client, both during the investigative stages of the case and if necessary, during trial. If the accountant is appropriately engaged by counsel, the common law attorney-client privilege will apply to all communications rendered in furtherance of the legal services being provided to the client, both during the examination stages of the audit and, if necessary, during any subsequent civil or criminal proceedings.

A critical inquiry is often whether counsel should retain the taxpayer's prior accountant or a new accountant. Many practitioners prefer to engage a new accountant to avoid the necessity of delineating between nonprivileged communications (communications prior to counsel's engagement of the accountant) and privileged communications (communications following counsel's engagement of the accountant). Retention of a new accountant avoids issues relating to whether information possessed by the accountant may have been obtained prior to the accountant's engagement by counsel.

Counsel's engagement of the accountant should be in writing and should indicate that the accountant is acting under the direction of counsel in connection with counsel's rendering of legal services to the client; communications between the accountant and the client are confidential and are made solely for purposes of enabling counsel to provide legal advice; the accountant's work-papers are held solely for counsel's use and convenience and subject to counsel's right to demand their return; and the accountant is to segregate their work papers, correspondence and other documents gathered during the course of the engagement and designate such documents as property of counsel.

## Counsel's Role During the Examination

The attorney is charged with the responsibility of making decisions on how to handle matters that come up during the meetings with the examining agent. In some situations, the fact an attorney is involved might not be revealed to the examining agent. The attorney must employ an overall strategy with the goal of avoiding a criminal referral, but must also be flexible enough to react and change the strategy as the examining agent develops the issues throughout the course of the audit.

The attorney and accountant should maintain a record of all conversations with the agent, since the agent is maintaining a record of all conversations that occur. The attorney, with the assistance of the accountant, should ascertain the nature of the audit from interviews with the client, the return preparer or other witnesses having knowledge of the subject transactions or whom may have been contacted by the examining agent.

The attorney and accountant should obtain copies of all records known to have been obtained by the examining agent through informal means or through the issuance of administrative summonses. The attorney and accountant should assemble relevant documents and copies of documents given to the examining agent, so the attorney knows at all times at least what the examining agent has received from the taxpayer on a particular issue.

Especially in fraud investigations, the attorney should try to limit the scope of the examining agent's inquiry, limit the information provided (without simply refusing to provide information, which could be viewed as an indicia of fraud) and avoid providing an explanation to the agent that cannot be supported. To do so is to lose credibility with the examining agent, possibly placing the taxpayer one step closer to a criminal referral.

## The Accountant's Duties

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The accountant should be prepared to provide general accounting and tax support and analysis with respect to each of the issues raised during the examination. These duties should include:

- The accountant must be thoroughly familiar with the taxpayer's books and records in order to comment on circumstances surrounding journal entries and to explain potential problem areas in the general ledger.
- The accountant should analyze the taxpayer's bank accounts in an effort to reconcile them to the taxpayer's return. As part of the analysis, interbank transfers and other nontaxable sources must be determined.
- The accountant may also be called upon to review the work-papers of the return preparer used to prepare the taxpayer's returns, plus related information. This task would include the review of source documents such as bank statements, canceled checks, invoices, receipts and other documents pertaining to income and deductions claimed on the returns.

## The Accountant's Assistance in Indirect Method Audits

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Historically, conventional audit techniques have been discovered to be grossly inadequate for the purpose of demonstrating an understatement of taxable income. In such event, the government has often resorted to one or more indirect methods of detecting unreported income by essentially auditing a taxpayer, rather than a return.

The use of indirect methods of proving income, also referred to as the IRS Financial Status Audit Techniques (FSAT), is not prohibited by Code Sec. 7602(e). If the examiner has a reasonable indication that unreported income exists, the IRS has the authority to use an indirect method of reconstructing income to determine whether or not the taxpayer has accurately reported total taxable income received. The indirect method need not be exact, but must be reasonable in light of the surrounding facts and circumstances.

The use of a "formal" indirect method, however, is not precluded by the presentation of books and records. Use of a formal indirect method is often supported by circumstances that, individually or in combination, would support the following: (1) a financial status analysis that cannot be balanced, *i.e.*, the taxpayer's known business and personal expenses exceed the reported income per the return and nontaxable sources of funds have not been identified to explain the difference; (2) irregularities in

the taxpayer's books and weak internal controls; (3) gross profit percentages change significantly from one year to another or are unusually high or low for that market segment or industry; (4) the taxpayer's bank accounts have unexplained items of deposit; (5) the taxpayer does not make regular deposits of income, but uses cash instead; (6) a review of the taxpayer's prior and subsequent year returns show a significant increase in net worth not supported by reported income; (7) there are no books and records (examiners should determine whether books and/or records ever existed, and whether books and records exist for the prior or subsequent years. If books and records have been destroyed, determine who destroyed them, why and when); or (8) no method of accounting has been regularly used by the taxpayer or the method used does not clearly reflect income.

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Indirect methods include a fully developed Cash-T, percentage mark-up, net worth analysis, source and application of funds or bank deposit and cash expenditures analysis. However, examiners must first establish a reasonable indication that there is a likelihood of under-reported or unreported income. Examiners will then request an explanation of the discrepancy from the taxpayer. If the taxpayer cannot explain, refuses to explain or cannot fully explain the discrepancy, an FSAT may be necessary. The government routinely uses the various indirect methods to reconstruct income including specific item, net worth plus expenditures, bank deposits and a combination of the above methods. The accountant may be called upon to analyze indirect methods used by government to develop unreported income.

Relevant inquiries include the standard of living of the taxpayer. What does the taxpayer and their dependents consume economically? How much does it cost to maintain this consumption pattern? Is reported net income sufficient to support this standard of living? What are the possible sources of funds to support these expenditures?

What is the accumulated wealth of the taxpayer? How much has the taxpayer expended in the acquisition of capital assets? When and how was this wealth

accumulated? Has reported income been sufficient to fund the accumulations? What is the economic history of the taxpayer? What is the long-term pattern of profits and return on investment in the reported business activity? Is the taxpayer's business expanding or contracting? Does the reported business history match the changes in the taxpayer's standard of living and wealth accumulation? Is reported interest income increasing or decreasing?

What is the business environment for the taxpayer's industry? What is "typical" profitability and return on investment for the taxpayer's market segment and locality? What are typical patterns of noncompliance in the taxpayer's market segment? What are the competitive pressures and economic health of the market segment within which the taxpayer operates?

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Has the taxpayer made assertions to receipts of funds, which were considered to be nontaxable? Do claims of nontaxable sources of support make economic sense (cash hoard credit history)? How credit worthy is the taxpayer in view of the taxpayer's assertion that funding was secured from loans? In situations where the taxpayer has asserted that funds were received from other than conventional lending institutions, what was the lender's source of funds? Was it a disguised loan of funds that originated with the taxpayer?

The accountant's responsibility in analyzing the above indirect methods of proof may include analyzing bank statements and financial information; assisting the attorney in interviewing witnesses; developing a cash-on-hand figure; assisting the attorney in developing questions for the agent that may highlight weaknesses in the government's position and joining the attorney in meetings with the examining agent in an attempt to further explain and highlight weaknesses in the agent's position. Ultimately, the accountant can be expected to be called as a witness to testify in the weaknesses in the government's methodology in the event the case is litigated or otherwise referred for criminal prosecution.

## Advice to the Taxpayer

The taxpayer is often undergoing the first sensitive audit in the taxpayer's lifetime. Therefore, the taxpayer often simply

does not know how to cope with the situation. Some persons may adopt the point of view that their charm or intelligence has made them successful so why shouldn't they be able to persuade the IRS that they have done nothing wrong? The attorney must suppress such urge by the taxpayer to try and talk his way through the problem. Other persons might feel that if they confess the problem to the examining agent, the agent will understand, be sympathetic, appreciate the taxpayer's forthrightness and simply close the audit asserting only additional tax. Although possible, the foregoing scenario should not be anticipated in every case!

The attorney and the accountant should instruct the taxpayer not to independently speak to or furnish any documentary evidence to any representative from the IRS. Moreover, misstatements or attempts to mislead a government agent may be used as evidence of the client's intent that may constitute a separate offense.<sup>2</sup>

Counsel should instruct the taxpayer not speak to any potential witnesses about the case and that the taxpayer's statements may constitute admissions, which can be used against the taxpayer. The attorney should instruct the taxpayer not to destroy, conceal, fabricate or backdate any documents or records, especially those to be provided to the examining agent pursuant to an Information Document Request or administrative summons.

Later filed returns must be as *perfect* ("bulletproof") as possible. It is, however, often useful to place returns on extension during the course of an audit in an attempt to identify as many issues as possible in the audit before any subsequent returns are filed. This will provide a focus for the attorney and the taxpayer for reviewing the subsequently filed return and assist in determining whether and in what circumstances a disclosure statement may be appropriate. If there are other concerns about a self-incrimination, they may require the filing of a return that protects the privilege against self-incrimination.<sup>3</sup>

The taxpayer should be advised to make full disclosure to the attorney, even though in some cases the taxpayer may provide information on issues that do not pose any significant fraud exposure. In other words, it is better to receive too much information than to have too little or to be surprised by an agent about yet another sensitive issue in the audit.

The taxpayer should be advised not to make any arrangements to compensate witnesses in any manner in exchange for testimony. The taxpayer should know that such action could constitute obstruction of justice, a separate crime and may also provide evidence of willfulness in a subsequent criminal proceeding.

The taxpayer should be cautioned that if the taxpayer is contacted by third parties who have been called

by the examining agent, the taxpayer should refrain from discussing the matter with the third parties and should refer those persons to the taxpayer's attorney. The attorney, in turn, can then be in a position to appropriately handle the discussion with the third parties and debrief the third parties about their conversations with the agent.

## Audit the Taxpayer, Not the Return

Electronic information reporting and basic internet searches have enhanced the ability of the IRS to ferret out potentially sensitive issues. With respect to taxpayers involved in cash-intensive businesses (restaurants, bars, *etc.*), or Schedule C businesses, there has been a movement away from the mechanical examination of a return in

favor of a somewhat generic investigation of the taxpayer's overall financial activities.

The approach of auditing a taxpayer, rather than a return, represents an attempt by the IRS to increase compliance and search out potentially fraudulent situations. Appropriate preparation involves a detailed review of the taxpayer's standard of living, accumulated wealth, economic history, the business environment and activities of the taxpayer, nontaxable sources of income available to the taxpayer, system of internal controls, an effort to reveal transactions with related taxpayers, *etc.*

### ENDNOTES

- <sup>1</sup> *L. Kovel*, CA-2, 62-1 USTC ¶9111, 296 F2d 918, 922.
- <sup>2</sup> See 18 USC §1001.
- <sup>3</sup> See *M.S. Sullivan*, SCT, 1 USTC ¶1236, 274 US 259, 263-264, 47 Sct 607 (1927).

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