

Tax Practitioners Guidebook: Picking Up Table Scraps

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Supposedly, humans learn from their experiences while other forms of life tend to repeat their mistakes. If literally true, how does one explain the absence of a learning curve for many taxpayers or those who should be taxpayers? The government wants transparency. Taxpayers believe the whale gets harpooned only when it comes up for air. Tax practitioners must learn to walk the line between the inquiries and desires of the government and the demands of their clients, without getting their feet wet . . . or drowning. So what have we learned that could possibly help future tax practitioners?

General Advice

Trust no one other than those within your innermost circle of family, friends, and colleagues. Those outside the circle should be given the opportunity to fail in demonstrating their personal integrity, credibility, and honesty — once. Throughout your career, remember that you have few true friends. If you somehow feel the need for a friend, get a dog.

Assume that others are actually attempting to do their best within their field of vision based on their life experiences. Do not pass judgment on others, particularly when you have not lived their life, walked in their shoes, or experienced their experiences. Stereotyping others and passing judgment will only lead to assumptions that may or may not have a basis in reality but will cause you to be less prepared when preparation counts the most — while you're toiling away in the tax trenches.

Be wary when a new client begins complaining about his prior representative — you may be included in that list when he's meeting with his next potential representative. When interviewing a client, ask the same question in different forms, again and again and again. . . . You will find there is actually a reason someone is a client — their ability to be forthcoming with all relevant information in response to what you may perceive as a simple question will likely demonstrate their immediate need for your assistance. There is a reason we call people clients, as well as a reason that clients need representa-

tion. It's your responsibility to control the damage from their past mistakes and help them avoid making similar mistakes in the future.

Engagement letters should specify the scope and terms of the engagement. Services rendered should be within the scope of the engagement as clearly set forth in the engagement letter. If additional services are to be provided, additional engagement letters should be obtained. Matters beyond your experience or expertise should be referred elsewhere — costly mistakes are more likely to happen when you venture off the reservation. If a client relationship is terminated for any reason, written confirmation of the termination should be promptly provided to the client. If the government has been involved, the government should also be clearly advised of the termination of the professional relationship. Follow the rules of your profession in terminating the relationship in a manner that does not cast adverse aspersions on the client or their situation.

Near the commencement of an engagement, attempt to get a sense of the most important, critical issues involved. Most of your initial efforts should be focused on the issues that, if resolved, may also resolve the lesser-included issues. If new to a dispute or pending litigation, consider a prompt meeting with the opposition. It is often more important to learn about your case from the opposition (and determine what they feel are the strengths and weaknesses) than to have a client or their adviser provide critical information that may later be determined to be, at best, less than accurate. Those contacts may help streamline your efforts in accelerating the potential resolution of the dispute. Confirm discussions with clients or the government in writing.

If your client takes you to lunch and pays in cash, be concerned (you're likely deductible!). When having returns prepared for a Schedule C taxpayer or a taxpayer involved in a cash-intensive business (restaurant, bar, and so on), require the preparation of a simple bank deposit analysis. The analysis should add deposits for the 12-month period under consideration and for the month immediately preceding and following the period involved. That figure should then be divided by 14 and multiplied by 12 to determine an approximation of an amount deposited during the year. If the total deposits bear no relation to reported gross receipts, that may warrant further inquiry, which might include a more in-depth bank deposits analysis, a cash expenditures analysis, a net worth analysis, or a markup analysis.

When involved in the preparation of tax returns for a taxpayer having other return filing requirements (sales tax returns, returns for related business entities, and so on), request copies of all other relevant returns for the tax periods at issue and related entities. Often, businesses prepare some returns internally and seek to have others prepared by their outside tax advisers. "Gross receipts"

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on sales tax returns for the same tax period as an income tax return should be somewhat comparable. If you haven't received copies of all related returns, ask for them — in writing.

Following receipt of an audit notice, the representative should thoroughly review the returns to be audited and attempt to determine if there are any potentially sensitive issues that may arise during the course of the audit. The representative must also review and reconcile the taxpayer's books of account, income statements, balance sheets, general ledgers, summary records of business operations (cash receipts and disbursements journals, sales journals, and so forth), and the taxpayer's state and federal returns. If not prepared, postpone the commencement of the examination. Do not proceed unless and until you're adequately prepared — do not get surprised during an examination, ever.

There are many publicly available audit guidelines that have been prepared by the IRS. Be familiar with the guidelines when providing tax advice, preparing tax returns, preparing for an audit or examination, or preparing a client for an interview by the government. The audit guidelines and the government's specialization of examiners has improved tax compliance. Each audit guideline instructs the agent on typical methods of auditing a particular group of taxpayer, including typical sources of income, questions to be asked of the taxpayer and their representative during the audit, and so forth. These groups have been defined by type of business (gas stations, grocery stores, and so on), technical issues (passive activity losses), types of taxpayer (for example, returns lacking economic reality), or method of operation (for example, cash businesses). A representative should not proceed with an audit without being generally familiar with any potentially relevant IRS audit guidelines. Often, it may be beneficial to review these guidelines earlier in the process . . . perhaps while preparing the return. Anticipate where the examination is likely to go, and get there first.

The administrative process should not be abused merely because of the taxpayer's desire to delay the determination and collection of any potential liability. Collection-related issues should be sorted out through the available collection procedures such as an installment payment arrangement that would be negotiated through the normal collection process following conclusion of the audit process.

Interviews

A question often presented is whether the taxpayer and others should consent to interviews by the government, force the issuance of summonses, or invoke various constitutional protections. Certainly, if there are extremely sensitive (that is, potentially criminal) issues, the taxpayer should not consent to an interview and should invoke their 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.

The government typically seeks to interview taxpayers near the commencement of an examination. Unfortunately, at that time, the representative typically does

not have sufficient information to determine whether there are potentially sensitive issues that might arise during an interview of the taxpayer. If possible, it is often preferable to postpone a taxpayer interview if the representative is otherwise able to provide prompt responses to relevant inquiries. If it occurs, the interview should occur toward the end of the examination, possibly with an understanding that if the taxpayer submits to an interview and answers the questions, the government will proceed to close the examination. However, the representative must take extreme caution, since such an understanding is not likely a basis for challenging the use of statements from the interview in a subsequent proceeding against the taxpayer.

If a taxpayer interview is necessary and otherwise unavoidable (it is always avoidable in a potentially criminal, sensitive-issue case), be prepared and make sure the client has been appropriately prepared. Ask probing questions of the client in advance (being aware of various privilege limitations), even if they seem irrelevant. If not appropriately prepared, the interview should be postponed. The interview should occur far into the audit process such that the representative can appropriately assist the taxpayer in preparing for the interview. The representative should attempt to obtain as much information about the issues, the information within the agent's possession, and the government's position regarding the issues, before agreeing to submit the taxpayer to an interview. Under any situation, the representative must prevent presentation of false or misleading information or the presentation of false statements by the taxpayer or the taxpayer's representative. Presentation of false statements or documents significantly enhances the potential for penalties and a possible criminal investigation/prosecution (that may also warrant an investigation of the representative!).

Government agents use a wide variety of interview techniques, including:

- making appropriate eye contact;
- putting the taxpayer at ease;
- using appropriate types of questions (probing, leading, open-ended, and so on);
- using "silence" appropriately;
- paraphrasing or restating comments received;
- listening;
- pacing an interview appropriately;
- knowing when to move on to the next question;
- maintaining a calm manner;
- having the taxpayer demonstrate the flow of transactions;
- reading the taxpayer's nonverbal language (body language);
- being aware of the agent's nonverbal language;
- being conscious of note taking so as not to distract the taxpayer;
- using of humor when appropriate;
- being courteous;
- being businesslike and firm;
- considering issues in the proper order (volatile vs. nonvolatile);
- scheduling the interview at a convenient time and allowing adequate time for completion;
- appearing interested in responses;

- knowing how to control the interview;
- appearing confident;
- maximizing the value of what the agent knows (such as various audit technique guides); and
- adapting the agent's appearance to be appropriate for the circumstances.

Additional interview techniques agents use include:

- providing feedback to the taxpayer;
- being observant;
- feigning ignorance (acting dumb) when appropriate (there are different levels of training for this);
- being prepared;
- using spontaneous follow-up questions (knowing how to react when new information is received);
- knowing their limitations;
- reading the taxpayer (knowing when they have lost the taxpayer's attention);
- reading the taxpayer's perception of the agent;
- attempting to dispel any negative image of the agent;
- being on time;
- using appropriate small talk and easily understood language (single-syllable words are generally the best);
- not anticipating answers;
- clarifying responses received;
- using reflection;
- asking for examples;
- recognizing the agent's biases;
- being assertive and persistent;
- avoiding debate or argument;
- giving the taxpayer an opportunity to ask questions,
- expressing appreciation;
- verbally pinning down the taxpayer on important issues when appropriate;
- having an open mind;
- maintaining composure;
- adapting questions to the situation;
- having the taxpayer explain his terminology;
- being precise;
- coming from a position of knowledge;
- working to establish rapport with the taxpayer;
- respecting the taxpayer's views;
- knowing their authority;
- making a positive first impression;
- maintaining an inquisitive mind;
- containing their excitement (and surprise . . . "You didn't report what?!?");
- noting unusual hostility or irritability on the part of the taxpayer;
- considering the need to question both spouses;
- not interrupting the taxpayer;
- being methodical; and
- refreshing the taxpayer about important points in prior interviews.

Learn how to best use your personal attributes while interacting with others — maintain an unflappable demeanor during interactions with others.

Audits

It is generally advisable to attempt to resolve any civil tax dispute at the earliest opportunity. Some believe that if you have to negotiate, you're losing. However, it's

often advisable to leave something on the table if necessary and move on. A lengthy audit may be costly in terms 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 the possibility of criminal sanctions. Certainty in a result, even a less-than-perfect result, is sometimes an outstanding resolution.

If highly sensitive issues are manifest, it may not be possible for the taxpayer to truthfully 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 may dramatically increase the potential 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. The taxpayer should be cautioned (over and over again) against making any false or misleading statements, or making damaging admissions. There is no explanation for a false statement.

Positions presented during the course of the audit should be well documented. All relevant information to be provided to the government must be closely scrutinized to determine plausible and supportable explanations for any potentially sensitive issues, whether or not such issues are set forth on the return. Although there may be plausible explanations for potentially sensitive issues that arise during the course of an audit, responsive statements by the taxpayer should not merely be repeated to the government. Any potential explanation should be supported by credible evidence to avoid further inquiries arising from the explanation. The government has reason to believe you've done some minimal process of verifying information they receive from you. There is no explanation for the submission of a false or misleading document.

All requested documents and information should be provided in a timely and orderly fashion. However, it is obviously not always possible to provide documents within the time frame set by the government. When a request is received, promptly respond with your anticipated time frame for delivery of the requested information. Don't wait until after the requested response date for your first response.

During the course of an audit, the representative should reasonably attempt to limit the scope of the inquiry and limit the information provided so as to avoid the waiver of any potential privileges. If matters are privileged, the correspondence and relevant files should be appropriately labeled. It is generally recommended that separate files be prepared for relevant documents that might be requested by the government and documents that contain potentially confidential, privileged information. Be aware of any potential privileges that may apply and make sure not to inadvertently waive a

privilege to maintain the appearance of cooperation. Cooperation is generally the proper course of action, but remember to ask yourself where such cooperation is leading you and your client.

Although the representative may already have copies of documents being provided, copies of any requested documents should be made in duplicate — one copy for the government and an extra copy to be maintained in a separate audit file specifically identifying documents provided during the course of the audit. It is important to know exactly which documents are of importance to the government.

It is often a good practice to provide an extension of the applicable statute of limitations during the course of any audit or examination. However, it is also good practice to have extensions signed by the client, rather than the client's authorized representative (even though authorized by the power of attorney). Years later, the client may not recall having authorized you to extend the statute of limitations. If his signature is on the extension (Form 872), the situation will not likely escalate. Actually, it's a good practice to get the taxpayer's signature on any document affecting his rights and liabilities. Further, it is almost always preferred to sign a limited extension with a specified expiration date (Form 872) rather than an indefinite extension for an unspecified term (Form 872-A).

It is often advisable to submit a Freedom of Information Act request following the unagreed resolution of a federal tax examination. It should also help tailor your discussions at the next administrative level while providing insight into what the next government representative assigned to the case will be reviewing. The process is relatively simple and inexpensive. Relevant information regarding the submission of a FOIA request is readily available at <http://www.irs.gov> by searching, "FOIA."

Privileges

A better-equipped IRS has been able to ferret out potentially sensitive issues in a manner often compromising the relationship between a taxpayer and his nonlawyer tax representative. If there are potentially sensitive issues, the taxpayer should be interviewed by counsel to determine whether there is a need to fully preserve potentially privileged information. In turn, counsel should consider engaging the accountant to coordinate the examination on behalf of the taxpayer. Under the doctrine of *United States v. Kovel*,¹ the investigative accountant may be clothed with an extension of the attorney's privilege.

If asked, the taxpayer will often state that he gave everything to his return preparer and that he doesn't understand why the return preparer failed to appropriately report it. Remember, clients do not make mistakes. Better to get this cleared up between the taxpayer and counsel than to have the taxpayer make such statements (if untrue) to the government.

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 his work papers, correspondence, and other documents gathered during the course of the engagement and designate those documents as property of counsel.

The statutory privilege set forth in IRC section 7525 is not available when truly needed the most — when a civil tax proceeding moves into the criminal arena. It also may not be available in some state-related tax proceedings or in nontax civil litigation. However, if the accountant is appropriately engaged by counsel under *Kovel*, the common-law attorney-client privilege should apply to all communications rendered in furtherance of the legal services being provided to the client, both during the investigative stages of the audit and, if necessary, during any subsequent civil or criminal litigation. This privilege does not extend to the actual return preparation.

The critical inquiry is often whether counsel should retain the taxpayer's prior accountant or a new accountant. Many representatives prefer to engage a new accountant to avoid the necessity of delineating between nonprivileged communications (communications preceding counsel's engagement of the accountant), and privileged communications (appropriate communications following counsel's engagement of the accountant).

Criminal Referrals

Although there are various "badges of fraud," civil agents and IRS fraud technical advisers (brought in to assist the agent in the determination of whether to make a criminal referral) are more inclined to consider a referral to CI if there is a substantial unexplainable understatement of taxable income, fictitious or improper deductions, accounting irregularities (occurring in more than one year and thereby demonstrating a "pattern"), acts or conduct of the taxpayer relating to false statements, attempts to hinder the examination, destruction of books and records, transfers of assets for purposes of concealment, or patterns of consistent failure to report or underreporting of income. Some behavior patterns on the part of the agent may indicate that he is considering a criminal referral: excessive time devoted to the audit; extensive copying of basic financial records, bank records, accountant work papers, and so on; or attempts to determine the taxpayer's net worth over a period of several years. If he asks a question it's either because he doesn't know the answer or, perhaps more importantly, he knows the answer and wants to know how you or your client will respond.

If special agents from CI show up at your office, do not think that it might somehow be a random, unimportant visit — they don't have the personnel or resources to simply knock on every other door. Special agents do not go fishing; they're hunters following a trail — which is why they're knocking on *your* door. Your position may not be easily identified at the time of the first visit. The race is sometimes lost because of the horse, not the jockey.

¹*United States v. Kovel*, 292 F.2d 18 (2d Cir. 1961).

They are there for a reason, a reason that may include you as a possible witness, subject, or target of their investigation. In this situation, being a “witness” is a good thing; being a target is not a good thing. Being a subject has placed you on the proverbial fence between being a witness or a target . . . which way you fall may depend on information discovered during the investigation. At this point in an investigation, your effort to “help” a client further a “story” might be deemed obstruction of justice. Do not try to help anyone. Do not mislead, affirmatively or otherwise, anyone at anytime.

Typically, if the special agents clearly state that you are merely a witness, it is likely that you can rely on their representation, particularly if it's in writing. If it is not clearly stated that you are a witness, when visited, receive whatever information they are willing to provide while politely indicating that you will promptly respond to them at a later date. Then contact competent criminal tax counsel. Special agents are highly trained criminal investigators looking into a potentially serious matter with even more serious consequences. Although they may begin by thinking your client is the source of the problem, that impression may well change during the course of their investigation. Be polite and professional in your interactions with the special agents. They will be most professional in their interactions with you.

If a matter may have sensitive issues (possibly leading to a criminal investigation or prosecution), it is important for the nonlawyer representative to be appropriately engaged by counsel. Do not inadvertently exceed the scope of your license or experience. At a minimum, a nonlawyer representative should strongly recommend that a client consult counsel with the admonition that discussions held between a client and a nonlawyer may have to be disclosed in case of a criminal investigation or prosecution. Section 7525 does not protect information provided to the nonlawyer representative from disclosure in a criminal investigation or prosecution.

Final Thoughts

Always maintain the appearance of reasonableness . . . even when others appear to be anything but reasonable. If you have problems with an agent during the course of an examination, ask to speak to his manager. If you have problems, it is likely that other representatives have previously had similar discussions with the agent's manager. While the manager may appear to be supporting the agent when meeting with you, it is also likely that the manager will have a direct conversation with the agent outside your presence and that your future interactions with the agent will be significantly improved. Throughout, treat the government representatives with respect and act like the professional that you want others to know and respect.

You cannot know everything that your client will expect you to know. However, you should be able to “issue spot” matters within your field of expertise and, to a lesser extent, matters outside your field of expertise. The Internet may be your best resource. There is a tremendous amount of information available on the Internet sites for the IRS and various state taxing authorities. Get comfortable in accessing their sites. Tax people need to be sensitive to nontax issues. Otherwise, in

providing a tremendous tax-related result you may have inadvertently set up, for example, a securities case or a money-laundering structuring case against your client. Learn the appropriate currency-related reporting requirements. Always control client anticipations — do not report a conclusion to a matter before the ink has dried on all the signatures.

Your career will be enhanced by the professional relationships you develop. Many experienced, sophisticated tax practitioners continue to be involved with community and professional organizations. If asked, they will almost always provide extremely valuable insight and advice on issues that could be extremely important for you, your client, and your reputation. If you do not have the experience or know the answer, find a competent colleague who should be willing to assist you. If asked for assistance or a quick review of something for a colleague, take the time to help out. In time, you also may find yourself needing an assist from a colleague.

“Karma” is more than a five-letter word . . . good things often find good people doing good deeds. Consider helping those who are otherwise unable to help themselves. Pro bono services, discounted services, and sometimes “involuntary pro bono” services can actually be personally rewarding. The only thing you bring to the table is your reputation for integrity and your personal credibility. Never do anything to possibly put even the slightest dent in that armor. Act as though what you do would make you proud if published on the front page of your local newspaper. If you get up in the morning and have pride in the tasks you are asked to do, everything else should be fine.

Your client may not care much about the government, but the government may well care about your client. When the government cares about your client, the client has just had a very bad day. If your client is too busy to meet and seems unable to provide sufficient information within a reasonable period of time, be concerned. You will spend a considerable effort “chasing” the client with marginal success.

Finally, if the client is unwilling to accept and follow your advice, strongly consider terminating the engagement. Never do something simply because the client wants you to do it. Always do what you believe should be done on behalf of the client. Life is short and the headaches of trying to convince someone to do the right thing may simply not be worth your effort. If you are going to work for free, work at home — not for a disrespectful or possibly undeserving client. Let them go, move on, and go mow the lawn. Ninety-eight percent of the problems come from 2 percent of the clients. If you learn to identify problems and problem clients in advance, you should have a thoroughly enjoyable, stimulating practice. You cannot be all things to all people . . . regardless of the effort and personal sacrifice.