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Are Your Clients Prepared for an IRS Audit?

TAX TIP Part II

With proper planning and a clear understanding of what to expect, your client can emerge relatively unscathed.

By Andrew J. Weill, *Weill & Mazer*

Last time we looked at some astounding statistics surrounding the increased audit potential for our clients. We talked about having an internal audit plan, useful resources to consult, and understanding the audit notice. We continue now by looking at basic guidelines on preparing for, conducting, and appealing the results of an audit. While no guidance can guarantee a favorable outcome, these guidelines can minimize the problems and risks associated with an audit.

4. Preparing for the Audit.

Decide who will handle the audit. The correct answer usually is: anyone but the client. The client cannot be expected to understand how to respond to IRS requests to be sure that they stay within limits. All too often, the client brings the agent some papers in a misguided effort to be helpful, only to find that the IRS response is to widen the audit. A representative acts as a buffer between the IRS and your client, since the rep can more easily remain detached, levelheaded and stick to the facts and issues. Ideally, a tax attorney or CPA well versed in dealing with the IRS should act as the sole interface with the IRS. A non-attorney can also do the job, as long as the representative is unflappable, familiar with the tax return in question, can speak to the issues in its preparation and filing, and is grounded in the audit basics. However, if at any time things are not going well or there is an indication of fraud, the representative can and should demand a recess to consult a tax attorney.

Get Acquainted with the Return Under Review. After you and your client have decided who will handle the audit, that representative should get a thorough understanding of the contents of the return in question, paying close attention to records that would support the items questioned by the IRS. The goal is to be prepared to the extent that relevant questions can be honestly and succinctly answered. If your client is involved in a field audit, consider hiring a tax professional (such as a CPA experienced in audits) to conduct a pre-audit review of all books and records to identify tax compliance issues and other areas of exposure.

Organize Your Client's Documents. The examination process can proceed more smoothly if documents and records are gathered and organized before any interviews. Always make copies of the requested documentation. Do not relinquish original documents. If any requested documents are missing, your clients are allowed and encouraged to reconstruct them before the audit (i.e., contact bank and credit card companies to get copies of statements or receipts). Never mail copies of, or bring to an office audit, or have on the premises during a field audit, any documents that do not pertain to the specific year under audit or that were not specifically requested by the audit notice. This is a surefire way to expand the audit into other tax years. Lastly, keep track of all correspondences from the IRS and always keep an exact copy of any documents your clients produce.

Request the IRS File. Consider requesting any information or documents accumulated by the agent during the pre-audit investigation. This information could help you assess the basis for the audit, as well as help prepare your client's defense.

Request a Transfer of Location. Because the average adjustment for a field audit is $17,000, compared to the $4,000 average for office audits, it is in your client's best interest to keep the IRS from holding the audit at the dealership. Field audits will generally be conducted where the books and records are located, but a request to transfer the audit to another location will be considered (see Treasury Regulation 301.7605-1(e)). Try offering to bring all books and records to the IRS office or to an agreeable offsite location like your firm's conference room.

Prepare Others. If the audit occurs on your client's premises, instruct all employees not to talk about the business or the audit with the IRS agent, unless told otherwise. Inquiries from the IRS agent should be referred strictly to you (or to whomever was designated to handle the audit).

5. Conducting the Audit.

Slowing Down an Audit. More than likely your client's audit notice will be dated somewhere between 12 and 18 months after he or she filed the return, because the Internal Revenue Manual directs auditors to complete audits within 28 months of when the return was filed. Keep in mind that the IRS must not only begin an audit but must also complete the audit within three years of the filing date (assuming your clients are not being accused of understating their income by 25% or more or of fraud). With this in mind, you can see how slowing down the audit process may work in your client's favor. Request more time whenever your client needs it, perhaps to get records in order or for any other business reason.

Office Audit Etiquette. During the office audit, stay calm and try to keep casual conversation to a minimum. This is especially important if your client is handling or is present during the audit. Only bring the requested documentation and do not leave the originals with the IRS.

Field Audit Etiquette. If the location cannot be transferred to the IRS's office, determine which of your client's facilities the examining agent(s) will use during the audit. Make sure agents have adequate space without giving them unrestricted access to other records, your client or the client's employees. In this situation, it is best to establish a working relationship with the auditor early, in an effort to get them out of your client's space as soon as possible. To this end, determine the agenda, timeline and which employees will need to participate in the audit, if any. Remember that inquiries from the IRS agent should be referred only to you (or to whomever was designated to handle the audit).Avoiding Common Audit Mistakes. (1) Do not allow unrestricted access to information during any type of audit, but especially during a field audit. (2) If computer-based records are requested *(i.e.,* QuickBooks backup files), make sure the files do not contain data for tax years outside of that being audited, or any other valuable and confidential business information. (3) Prior to allowing the IRS to interview your client, consider asking why an interview is necessary or consider going in his/her place, since initial interviews are not mandatory under current policy. I usually decline to produce the client, and I tell the IRS that's because I can provide accurate responses to their inquiries much faster than any client interview. (4) While a little negotiation never hurts, negotiating and bickering over every aspect of the audit should be avoided. (5) Always inquire whether interest or penalties can be abated or waived. Closing the Audit. Never allow your client to sign anything before you or his/her representative have had a chance to review it. Signing certain documents, such as Form 4549, could forfeit your client's right to an appeal. Your clients should not feel pressured to accept the auditor's findings, because they are well within their rights to request more time to review any proposed changes for discrepancies or questionable issues.

6. Appealing the Results.

If your clients have been prepared and grounded in these audit basics, hopefully they have emerged relatively unscathed from the audit. If, on the other hand, a client is unable to live with results, you should discuss with your client whether an appeal is necessary. But before considering such measures, decide whether you should set up a meeting with the auditor or the auditor's manager to see if a compromise can be reached. If an appeal is necessary, consider working with a tax attorney to determine the best approach. If your client lodges an appeal with the IRS appeals division, the appeals officer will likely consider factors such as the time and expense of trying your case in court. Because of this, your client may have leverage to reach a favorable settlement agreement. If this is not possible, and your client still disagrees with the decision of the appeals officer, he or she may file a petition to the U.S. Tax Court. As an alternative, your client can pay the amount of tax due and file a suit for refund with either the U.S. District Court or the U.S. Claims Court.The foregoing is of course just a general guide. Hopefully it has given you enough background to help your client understand the nature of a typical audit and to consider his or her state of preparedness. Intelligent foresight can make the difference between a mildly annoying audit and a devastating one. ■

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