Practice Tips in Audit Representation

By Karen Neville

Audits are an inevitable and necessary evil of the federal and state tax systems. They can be a fear and panic inducing experience for taxpayers. When a taxpayer gets selected for audit, their first phone call will likely be to a tax professional’s office. Audit representation is a necessary component of your professional practice, and an existing or prospective client will inevitably seek your assistance for audit representation.

Handling an audit can be a stressful experience not only for the taxpayer, but also for the tax practitioner. Preparation is the key not only for addressing tax technical issues, but also for practice management and professional responsibility issues which may arise during audit representation. Following are some practice tips based on recurring issues we see in our tax practice.

Scope of Representation

At the outset, you should treat the audit representation as you would any other type of engagement, by setting out the scope of representation in an engagement letter. Doing so will not only protect you, but also manage your client’s expectations about the type of services which will be provided, the type of tax and tax years involved, and perhaps most importantly, the cost of such representation. Clients should be aware that audit representation is not inexpensive and during the course of an audit, the audit may be expanded to additional open years and professional fees could quickly escalate accordingly.

IRS Resources to Help Navigate an Audit

Preparation for an audit is also essential and a tax professional should be aware of the resources which are available to help navigate an audit. In particular, the IRS makes available several publications which you may consult for guidance during the examination process.

The IRS makes available its Internal Revenue Manual (“IRM”), which is essentially an IRS operations manual, setting out in great detail the IRS’s internal procedures, policies, and guidelines which must be followed by the Service and its employees. Part 4 of the IRM describes in excruciating detail the examining process and in particular, Part 4.10 specifically addresses the examination of returns. Each taxpayer is different and the IRM will not necessarily be a road map to the IRS’s audit process, however, familiarity with the IRM may help a tax professional anticipate potential issues which may be examined by IRS and plan the taxpayer’s defense.

The IRS also publishes several audit technique guides (“ATG”) under the Market Segment Specialization Program and which are available to the public via the IRS website. The ATG are industry specific and are primarily geared towards training IRS employees to audit
specific “market segments”. Market segments may include a common industry such as construction or even a highly esoteric industry such as the wine industry; professions ranging from architects, attorneys, child care providers, farmers, ministers, veterinarians; or specific issues such as capitalization, conservation easements, cost segregation, compensation, various tax credits, and passive activity losses. The ATG contain industry-specific examination techniques, and surveys various industry issues, business practices and terminology. Guidance is also provided on the examination of income, interview techniques and evaluation of evidence, and other information to assist examiners in performing examinations. If your client is being audited, it may be a good idea to check if the IRS has published an ATG which may pertain to your client’s activities. Even if your client is not being audited, the ATG may be helpful for tax planning purposes and may provide guidance when preparing tax returns to minimize audit risk.

**IRS Requests for Electronic Records**

One of the more common audit tips for taxpayers and practitioners alike is to control the flow of information to the IRS, i.e. ensure that any information document requests by IRS are made via the practitioner’s office and not to the taxpayer directly, stay focused on the issues which the IRS raises, and only provide what the IRS asks for in order to minimize the risk of opening up new issues. However, a practitioner’s ability to control the flow of information has been hampered in recent years by IRS requests for electronic records such as Quickbooks back-up files.

Treasury Regulations and case law guidance are very clear that the IRS may request electronic records in an audit and that the taxpayer must provide such records if requested. Ultimately, it is up to the taxpayer whether they will voluntarily provide such electronic records to IRS and the practitioner should confirm their client’s consent before turning over such files. If a taxpayer refuses to comply voluntarily, the taxpayer should be aware that the IRS can instead use its summons power to obtain those records.

The IRS has issued internal memorandum and also updated the IRM at Part 4 to provide guidance to its auditors about requesting and reviewing taxpayer electronic files, which should provide some clues as to what the auditor may look for during its examination. IRS representatives have also commented that electronic records and the underlying metadata should not be redacted or altered to an extent which would impact the IRS’s ability to verify the integrity and veracity of the electronic files provided. IRS FAQ #14 confirms that practitioners may provide backup files which “condense” prior-year information, using the “clean up” or

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1 See e.g. IRC Sec. 6001 and 7602(a), Treas. Regs. Sec. 1.6001-1(a), Rev. Rul. 71-20 and Rev. Proc. 98-25.
2 See SBSE-04-0911-086, Memorandum for Examination Area Directors re: Guidance on Usage of Electronic Accounting Software Records. See also IRM Part 4. 10.4.3.7.5 Evaluating Electronic Books and Records
“purge” feature, for dates prior to the years under audit, as long as they do not include transactions created or changed for time periods under audit, or for transactions from prior years that have an effect on the years under audit. Nevertheless, if the scope of an audit is expanded, the IRS may request another backup file that was created prior to the date the company file was condensed or request a copy of the archive file created during the condensing process.

A practitioner must balance these competing interests--taking care that they do not hinder the IRS examination, nor run afoul of their professional obligations under Circular 230, while at the same time protecting their client’s interests by controlling the flow of information to IRS from such electronic records. To the extent possible and permitted by the auditor, you should limit data to the year under audit by creating separate backup files for each tax year being examined. It may not hurt to ask the IRS auditor whether they will accept a printed copy of the general ledger files which were relied upon for tax return preparation, rather than the electronic backup file. Other options to limit data may be to condense prior year transactions or use software utility programs which will strip prior year data from the electronic file. However, taxpayers and practitioners should not be surprised if IRS objects to doing so, which could be viewed as less than full compliance with the IRS request.

Discovering an Error during the Audit

Perhaps the biggest fear of any tax professional during audit representation is discovering that you made an error in preparing the client’s tax return and facing the dilemma about disclosure of your error to the client and IRS. Applicable ethical standards for professional conduct make clear that it is the taxpayer, not the tax professional, who must ultimately decide whether or not to address an error on a tax return or disclose it to the IRS.

Treasury Department Circular 230 prescribes the rules governing practice before the IRS for tax practitioners such as CPAs, attorneys and enrolled agents. Circular 230 section 10.21 requires that tax practitioners who have knowledge of an error or omission on a client’s tax return must promptly notify and advise their client of the noncompliance, error or omission, and the consequences of such noncompliance, error or omission under the Code and regulations.

The AICPA Statements on Standards for Tax Services (“SSTS”) expands upon Circular 230 and sets forth the professional standards to be followed by AICPA members on tax engagements. SSTS No. 6 Knowledge of Error: Return Preparation and Administrative Proceedings, paragraph 8, explains the tax professional’s obligations upon discovering an error on a client’s tax return and specifically provides that it is the taxpayer’s responsibility to decide whether to correct the error.

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4 See IRS FAQs on Use of Electronic Accounting Software Records at http://www.irs.gov/businesses/small/article/0,,id=238525,00.html
SSTS No. 6 explains that while performing services for a taxpayer, a member may become aware of an error in a previously filed return. The member should advise the taxpayer of the error and the potential consequences, and recommend the measures to be taken. Similarly, when representing the taxpayer before a taxing authority in an administrative proceeding with respect to a return containing an error of which the member is aware, the member should advise the taxpayer to disclose the error to the taxing authority and of the potential consequences of not disclosing the error. Such advice and recommendation may be given orally.

SSTS No. 6 further provides that if the taxpayer does not correct an error, a member should consider whether to withdraw from the engagement and whether to continue a professional or employment relationship with the taxpayer. Although recognizing that the taxpayer may not be required by statute to correct an error by filing an amended return, a member should consider whether a taxpayer’s decision not to file an amended return or otherwise correct an error may predict future behavior that might require termination of the relationship.

A client’s refusal to take corrective action could expose the practitioner to penalties under Circular 230 Section 10.51, which provides for sanctions against practitioners who provide false and misleading information to the IRS or who willfully assist taxpayers to evade federal tax laws. Thus, you could find yourself at a crossroads between your professional obligations in practice before the IRS and your simultaneous obligation to your client’s confidentiality. Under these circumstances, the practitioner may have no choice but to follow the SSTS No. 6 suggestion to withdraw from representation.

Nevertheless, if a member obtains the taxpayer’s consent to disclose an error in an administrative proceeding, SSTS No. 6 recommends that the disclosure should not be delayed to such a degree that the taxpayer or member might be considered to have failed to act in good faith or to have, in effect, provided misleading information. In any event, disclosure should be made before the conclusion of the administrative proceeding.

**Discovering a Client’s Tax Fraud**

What if instead of an error, a practitioner discovers or has reason to believe that a client may have committed a tax fraud? Rather than inquiring further, you should refrain from questioning the client about a suspected fraudulent transaction. The tax practitioner or accountant-client privilege under IRC Section 7525 only extends to civil matters, not criminal matters. If an issue involves a criminal matter such as an allegation of tax fraud, the tax practitioner privilege no longer applies, and you could be compelled by an IRS summons or subpoena to disclose any statements or admissions made by your client.

Unlike the accountant-client privilege, a taxpayer will be protected in criminal matters under the attorney-client privilege for communications made to their attorney. Under certain
circumstances, the attorney-client privilege can be expanded to include the services of an accountant if certain formalities are followed. To do so, the attorney should *directly* engage an accountant to assist in the representation of the taxpayer. As a consequence, statements made by the taxpayer to the accountant *after* the engagement, and the accountant’s work product *after* the engagement, will be protected by the attorney-client privilege to the extent that the accountant furthered communications between the lawyer and client, and such communications or work product were *in furtherance of legal*, rather than accounting advice. This arrangement is often referred to as the Kovel doctrine, after the court case *United States v. Kovel*\(^5\) which held that the attorney-client privilege will not be waived by communications to an accountant who had been engaged by counsel. The Kovel arrangement should be memorialized by the attorney in an engagement letter or “Kovel letter”.

Whether tax counsel continues to work with the taxpayer’s existing accountant or retains a new accountant to act as the Kovel accountant may depend upon the circumstances. Hiring a new accountant will avoid any uncertainty as to whether or not statements made to the accountant are privileged, whereas continuing to work with the original accountant leaves open to disclosure any communications made by the taxpayer *before* the engagement (while statements made *after* the engagement will be protected). Nevertheless, it may be impractical to bring in a new accountant if the client’s tax situation is too complicated or if there has been a long-standing accountant-client relationship.

If a potential tax fraud issue is discovered, a practitioner should consider taking the following steps: (1) explain to your client that you have a concern about an item in the client’s tax return, (2) instruct the client not to make any disclosures to the practitioner unless there is absolute certainty that there is no indication of fraud; (3) advise the client that any statements made to the practitioner are not protected under the tax practitioner privilege under IRC section 7525, and accordingly, (4) recommend that the client retain an attorney experienced in criminal tax matters. Once an attorney is engaged, and if the attorney seeks further assistance from the practitioner, the terms of such assistance should be memorialized in a Kovel letter. Of course, if your client does not heed your recommendation to seek counsel, the practitioner should consider SSTS No. 6 guidance whether to withdraw from representation and terminate the relationship with the taxpayer.

**Know Your Limitations**

Coupled closely with discovering one’s own error during an audit or discovering a client’s tax fraud, is recognizing when you are in over your head. The Internal Revenue Code has become complicated even for accountants and it is impossible to know all the intricacies of tax laws. If the IRS auditor identifies issues which exceed the scope of one’s expertise, consider whether to bring in a specialist or tax attorney who is more experienced in negotiating with the

\(^5\) *United States v. Kovel*, 296 F2d 918 (2d Cir.1961).
IRS and can more efficiently resolve conflicts with the IRS. Ultimately, your client’s interests should be paramount to your own. Seeking outside expertise will not only be to your client’s benefit, but will also be in your best interest to minimize mistakes and prevent overlooking issues or defenses which you may not be familiar with. Although your client may balk at the high cost to hire a specialist, that cost may be offset by the ultimate tax savings from a good result in the audit and perhaps less time spent (i.e. less fees) trying to negotiate with the IRS for that good result.

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