

Tax Audit Survival Guide

~ Michael J. Wilson

Receiving a notice that you or your business has been selected for audit by the Internal Revenue Service (the “Service”) or the Florida Department of Revenue (the “Department”) can cause severe anxiety. You would probably prefer to have a root canal or endure some other form of physical pain than to have to go through an audit. However, the process does not have to be a complete nightmare. If you are prepared—and have experienced tax counsel—most audits are not too burdensome.

Fortunately, the Service and the Department audit only a small percentage of all tax returns. In 2010, the Service audited less than 1 percent of the tax returns filed and the Department audited less than 0.6 percent. The Service expects this figure to decline for tax returns filed in 2014. This




will be the lowest targeted audit rate since 2004 when it was 0.77 percent. However, you should not take too much comfort in these low percentages for two reasons. First, these audit rates do not include information return matching programs, which are designed to make sure that information reported to the Service on a Form 1099 by a payer corresponds to the income reported by the payee on his or her tax return. Second, high-income individuals and large corporations are audited at a much greater rate than the average. The audit rate for individual income tax returns filed in 2011 with an adjusted gross income of \$5 million or more was slightly greater than 50 percent, and the audit rate for corporations with more than \$250 million of assets was about 30 percent.

When representing clients being audited, whether by the Service or the Department, the goals of tax counsel are typically to (i) control the flow of information to the government, (ii) limit as much as possible the scope and duration of the audit, and (iii) reduce the exposure to tax, interest, and penalties.

Managing the Flow of Information

If you are subjected to an audit, the auditor will request documents or records from you. Although it seems crazy, the Service will almost always ask you to supply it with previously filed tax returns. The Service's systems and bureaucracy are such that it can take significant time for the Service to provide its own auditor with a requested tax return, so it's much quicker for the auditor to request it from you.

Apart from the tax returns, the other documents and records an auditor requests are a significant clue as to what issues the auditor is focusing on, at least at the outset of the audit. All requests and the delivery of documents and records should go through your tax counsel so the flow of information can be monitored and controlled. The general rule is to not give the auditors any more than they request. However, sometimes a specific requested document or record may not be helpful to



your position on a particular issue. If so, any documents that may be helpful on the same issue, even if such documents are not requested by the auditor, should be furnished at the same time. Also, if you know a specific issue that the auditor is examining, and it involves complex documents, it is often helpful to supplement the documents with a summary of the critical provisions and how they support your position.

Auditors will often want to interview taxpayers during an audit. You must be prepared for these interviews, and you should never participate in such interviews without the presence of your tax counsel. You and your counsel should review the auditor's likely questions and conduct mock interviews. Answers should be honest but as brief as possible.

Part of managing the flow of information to the auditor is analyzing whether you, the taxpayer, can withhold certain documents from the auditor on the basis of a legal privilege (i.e., privileged information is not subject to disclosure). Documents

may be withheld on the basis of the attorney-client privilege, the work-product privilege, and the tax practitioner-client privilege. A full discussion of the nuances of these privileges is beyond this article, but these privileges can be powerful tools in defending an audit.

Limiting Scope and Duration

Limiting an audit's scope means the auditor analyzes fewer issues or only engages in a shallow analysis of issues, and both are helpful to you. Limiting the duration of an audit reduces the time you are preoccupied with the audit and can also help limit the audit's scope.

Most auditors are just trying to do their jobs and work through their overloaded inboxes. Auditors face significant pressure from their managers to expeditiously complete audits because the Service and the Department are understaffed for their audit workloads. By being prepared and organized, you can help the auditor wrap up the audit quickly, potentially limiting its scope and duration.



Provide information to the auditor in an organized fashion so the auditor does not have to hunt through boxes or piles of unorganized documents. Forcing an auditor to wade through unorganized documents will lengthen the audit, damage the credibility of both you and your tax counsel, and can cause the auditor to inquire into additional issues and expand the audit's scope. Auditors are taught that non-cooperative behavior may be a sign that a taxpayer is trying to hide something and engage in fraud. Adopt a non-confrontational style. Once an audit becomes confrontational, it's difficult to regain any trust and goodwill previously established.

Negotiating the Best Possible Outcome

Some tax audits hinge on highly complex and technical tax issues, while others turn on less complex issues, such as whether you can substantiate certain expenses. In either scenario, among the most valuable assets in an audit or any other tax controversy are credibility and integrity. In my experience, tax counsel gains the confidence and trust of the auditor by being professional and

having complete command of the facts and technical tax issues involved in the audit. With these key ingredients, tax counsel can increase the likelihood of a favorable outcome for you.

Tax counsel should work hard to develop a good rapport with the auditor from the beginning of the audit. If you are fortunate, your tax counsel will have worked with the auditor on previous audits for other clients and can build on prior professional interactions with the auditor. The best approach is to be forthright and cooperative, but do not do the government's work. You are not obligated to point out or otherwise highlight the weaknesses of your positions for the auditor.

Tax counsel must demonstrate complete command over the facts and technical tax issues involved. This involves clearly and articulately describing how the facts apply to a complex tax issue and why the position advocated by tax counsel is correct. It's not too hard to write a memorandum for the auditor, laying out the taxpayer's position on complex tax issues, but it is difficult to make such a memorandum relatively easy to read and, therefore,



much more persuasive. It's also helpful to anticipate the issues the auditor is likely to raise and to be ready to respond quickly and authoritatively if and when they are raised.

Even if the auditor cannot be swayed on all of the issues, you want to win as many as you can at the audit stage, even if it's just agreeing to abate penalties. That way, if the case moves from the audit to the administrative appeals level, the disputed amount is lower and the case is much easier to settle.

Disagreement with the Auditor's Conclusions

If there is a disagreement with all or part of the audit determination, the next step usually is to administratively appeal the audit. At the conclusion of a Service audit with unresolved issues, you can file a protest with the IRS Appeals Office. Similarly, at the conclusion of a Department audit with unresolved issues, you can file a protest with the Department's office of Technical Advice and Dispute Resolution (TADR).

A protest is a memorandum, similar to a brief, setting forth the facts, the law, and your analysis applying the law to the facts. After submission of a protest, there is an opportunity to make an oral presentation. At the administrative appeals level, new issues are not supposed to be raised and issues resolved during the audit are not reopened—the administrative appeals process is not designed to be a continuation of the audit process.

The vast majority of tax disputes that reach the administrative appeals level are settled. Settlements can take many forms. A settlement could be a complete victory for you on all of the disputed issues (i.e., appeals completely agrees with you), a situation in which you completely win on some issues but not on others, or a situation wherein only a certain percentage of a deduction or taxpayer position is allowed (e.g., the Department agrees to treat only 30 percent of your transactions as taxable). Many factors are involved in achieving the best possible settlement for you, and having experienced tax counsel plays a significant role.



In the uncommon event that the tax dispute is not resolved at the administrative appeals level, then litigation is the only remaining option. Disputes with the Service are litigated in the US Tax Court, the US Court of Claims, or Federal District Court for the District where you are domiciled. However, you cannot initiate litigation in the US Court of Claims or Federal District Court without first paying the tax in dispute, filing a refund claim with the Service, and then suing. Because taxpayers can litigate in US Tax Court without first paying the disputed tax and waiting for the Service to respond to a refund claim, the US Tax Court is the most popular forum for litigating tax cases.

You have two alternatives for Department tax disputes not resolved at the administrative appeals level. You can file (i) a complaint in Circuit Court for the circuit where you have your principal place of business, or (ii) a petition for an administrative hearing under the Administrative Procedure Act. Under both options, you must pay all of the uncontested tax, interest,

and penalties before filing a complaint or petition. Failure to pay these amounts will cause a dismissal and an additional 25 percent penalty. Petitions for an administrative hearing are more popular than complaints to Circuit Court, because a Circuit Court action also requires posting a bond for the contested tax, interest, and penalties, unless a waiver is granted. In either event, appellate review would be to the appropriate Florida District Court of Appeals.

Conclusion

This article presents a few of the fundamental strategies for making the best out of a bad situation: a tax audit or other controversy. It's always great to have good facts, but there are other important elements too—controlling and managing the flow of documents and information (i.e., the facts), gaining the confidence and trust of the auditor, and having complete command of the facts and law so your case is presented in the best possible light. Having these key ingredients increases the likelihood of achieving a favorable result.



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