IRS Lawyer Audits: Review And Best Practices For The Business Lawyer's Small Or Solo Practice

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Although no one likes an IRS audit, lawyers may dislike dealing with the IRS even more than most people. Perhaps it is because an audit may mean that the IRS begins poking into the financial affairs of their practice or because by its very nature, law practice is confidential and keeping a client's confidences is of supreme importance. It should therefore be no surprise that the thought of the IRS looking at a lawyer's books could provoke concern for clients as well as the lawyer. These concerns may rest heavier on a solo practitioner or a small law group.

No lawyer wants to keep clients in the dark about the risk that their identities have been disclosed to the IRS. Yet no lawyer wants to risk having clients bolt by telling them the IRS has their names, either. Any interaction with the IRS will be an inconvenience, but some interactions with the IRS could be expensive or even carry grave consequences.

I. The IRS' Attorneys Audit Technique Guide

Some lawyers believe the IRS unfairly targets their profession, recalling the IRS's "Project Esquire" of several decades past.[1] More recently, the IRS released a new audit guide directing its agents on the proper procedures for auditing lawyers, the IRS Attorneys Audit Technique Guide (the "Audit Guide").[2] Much of the Audit Guide may be read as focusing on contingent fee practices, as opposed to business-oriented lawyers and law firms. However, all lawyers may benefit from the lessons provided by the Audit Guide and its application to practice.

A. General Best Practices Based on the Audit Guide

The Audit Guide contains interesting points for all lawyers about best practices of record-keeping and audit-related issues. Further, lawyers should consider taking steps now to protect their practice in the event of an audit. For example, some lawyers and law firms should strengthen their internal controls and documentation. Even items such as what documentation to require before issuing a check for firm expenses can matter. Consider:

- Requiring two signatures on checks over a certain amount;
- Requiring two partner signatures on trust account checks;
- Requiring payments against invoices;
- Having clear policies on what expenses can be charged to clients and what expenses can be charged to the firm;
- For outside consultants or independent contractors, requiring a written and signed contract before firm payments can exceed a certain level;
- Keeping use of firm credit cards to a minimum by restricting the types of charges permitted and the authorized users;
- Requiring advance approval of expenses of a certain size or type; and
- Keeping separate subject matter accounting files for such items as meal and entertainment expenses, consultant or independent contractor payments, insurance, etc.[3]

Billing records, client records, and documents can be another source of concern. It is usually a good idea to segregate records the lawyer considers protected by attorney-client privilege from those that clearly are not. That is one of the reasons billing records should generally be filed separately from the client's legal file that contains correspondence and documents. The bills may not be protected by attorney-client privilege. Bills sent from lawyer to client are privileged to the extent that they reflect the specific nature of legal services rendered. Otherwise, a statement for legal services is not privileged.[4]

B. Focus on Internal Accounting Practices

One of the primary messages of the Audit Guide for law practices is that the IRS expects lawyers to have good internal accounting and a good system of recording costs and expenses. Typical costs and expenses include such items as copying bills, printer costs, expert witness fees, FedEx and courier bills, court reporter fees, and many similar costs. Many lawyers, especially in small offices, feel they have little need for such systems. That choice can be a mistake.

The IRS expects billing software, of course, and it will want to examine it and its results.[5] The IRS is particularly interested in seeing the adjustment log that reconciles the output of the time and billing system to the appropriate accounts in the lawyer's or law firm's general ledger.[6] The IRS will want the accounting and general ledger to tie together.[7] If it does not, the IRS may go through bank records in excruciating detail.[8]

Lawyer's trust accounts are also vital sources of information.[9] Here, most lawyers are careful, although precisely what the IRS looks for surprises some lawyers. The IRS may be looking for revenue that is not booked as income and that is simply parked in the lawyer-client trust account. This focus makes common sense, for many lawyers have too much money in their trust account and are slow to withdraw amounts from the trust account to which they are entitled.

A lawyer is taxed on fees in his trust account in the tax year that the fees are earned by the lawyer.[10] It does not matter if the lawyer waits to actually withdraw the fees from his or her trust account until the following tax year. Many lawyers incorrectly assume that when a case settles and funds are wired to the lawyer's trust account in December, those funds are not taxable income until disbursed to the lawyer in January. This is incorrect because both the lawyer and the client are considered for tax purposes to have received the monies in accordance with their respective shares.[11]

C. The Attorney-Client Privilege During Audit

The IRS devotes significant attention to the issue of attorney-client privilege in its Audit Guide[12] because claims of privilege are common in audits of lawyers. Lawyers do not want to risk violating privilege by giving the IRS too much client information. At the same time, they want to cooperate and make the process go smoothly so they can complete it.

The IRS instructs its agents that the attorney-client privilege belongs to the client and not to the lawyer. Even so, lawyers commonly assert the privilege on behalf of their clients, knowing that the client is the only person who can waive it. The boundaries of the privilege are a complex and frequently litigated subject. In this context, though, there are some clear rules that may help lawyers prepare their practices.

The IRS Audit Guide states that the identity of clients and fee arrangements are almost never considered privileged.[13] There are narrow exceptions to the rule about client identity, but the IRS is correct that lawyers generally cannot fail (based on attorney-client privilege) to turn over the names of their clients, the amounts the clients have paid, or the particulars of their fee arrangements if it is material to the audit.[14]

D. Relevant Information: The Information Document Request

The materiality or relevance of requested information is a more commonly raised objection to the IRS's request for client information than is privilege. Information is generally relevant in an audit if it might have some bearing upon the correctness of the taxpayer's return.[15] In many cases, the names of clients and even the particulars of their fee arrangements may not be relevant. If these issues arise in an audit, it is almost always appropriate to have professional representation in negotiations with the IRS. The representative may be a CPA or a tax attorney, but many lawyers will feel more comfortable with a tax attorney given the sensitivity of legal practice.

Perhaps the most standard tool used by the IRS in audits is the Information Document Request ("IDR"). It is an informal type of document request in which the IRS will list the books and records it wants to examine. In the case of lawyer audits, the IRS encourages its auditors not only to issue IDRs but also to conduct personal interviews.[16] IDRs will often be issued to the lawyer for items such as organizational documents of the law firm, expense reimbursement policies and records, fringe benefit plans, retirement plans, and records of client disbursements and costs.

Although IDRs are informal and some taxpayers choose to ignore them, if the IRS has difficulty obtaining the documents requested in an IDR, it is likely to issue a summons. Some taxpayers may fear that voluntarily turning over documents—especially sensitive documents that could be privileged—is a mistake. For that reason, some taxpayers will refuse to respond to an IDR and wait for the IRS to issue a summons.[17]

After the summons issues, the lawyer can respond in court and may move to quash the summons based, for example, on attorney-client privilege, materiality, or other defenses. Courts may not enforce overbroad or unduly burdensome summonses.[18] However, any dealings with the IRS should be taken seriously. Cooperation is generally the preferable route, and having experienced representation is likely to make that process go more smoothly.

II. Audit Exams, Appeals, And Resolution

Fortunately, most examinations of lawyers and law firms are uneventful. The audit may reveal some errors, and there may be a proposed adjustment to the tax return(s). At that point, a well-defined set of IRS rules comes into play, including the right to protest.[19] Protesting a proposed assessment will transfer the tax matter to the IRS Appeals Office where a majority of tax disputes are settled.[20]

If the case cannot be settled at IRS Appeals, the IRS will issue a Notice of Deficiency, also called a 90-Day Letter. At this point, the taxpayer has 90 days to file a petition in U.S. tax court where the taxes can be formally disputed. Even when the case is in tax court, there are usually settlement possibilities.

Although most tax cases do not get this far, it is worth noting that occasionally problems can escalate at the examination level. Some of the problems emanating from examination can be quite serious. For example, a majority of criminal tax cases still originate through referrals from civil auditors in normal IRS civil audits. If an IRS auditor discovers something suspicious, he can notify the IRS's Criminal Investigation Division.

It surprises many lawyers that the IRS is not obligated to tell the taxpayer that this criminal referral is occurring. Normally, the civil auditor simply suspends the audit without explanation. Thus, the taxpayer might assume that the audit has been concluded or, more likely, that the IRS is busy and will eventually pick up the audit where it left off.

The taxpayer may have no idea that the IRS believes there may have been a criminal violation. The IRS can quietly investigate whether there are sufficient grounds to seek criminal charges against the taxpayer. By the time the taxpayer realizes there may be criminal charges brought, the IRS criminal investigation may be well under way.

Of course, criminal tax cases are rare. The IRS civil auditor may make a referral to the IRS Criminal Investigation Division based on something picked up in a civil audit. However, the Criminal Investigation Division may decline to pursue it or may be satisfied that there is little to investigate. But where these charges do occur, the consequences can be severe, such as where there is a practice of a business owner paying the owner's personal expenses from business funds.[21]

That practice is not unique to law. It can occur quite innocently, or it can be intentional and habitual. It can occur across a wide spectrum of small businesses. In fact, it is probably one of the reasons that individual tax returns with a Schedule C—on which sole proprietors report their business income and losses—are ***the most likely*** individual income tax returns to be audited.[22]

III. Best Practices Are Key To Audit & Legal Business Record Keeping

With lawyers, failure to differentiate between business and personal items in tracking expenses may be more common among solo or small-firm practitioners than in larger law firms. One reason is that more rigorous financial controls tend to be present in larger law firms and other large business enterprises. Many solo and small firm practitioners may see little reason to have written procedures and internal controls. An IRS audit can change their minds.

Indeed, wherever a lax differentiation between business and personal expenses occurs it is dangerous. Upon encountering the problem, the IRS usually redresses it by disallowing the claimed expenses and imposing civil penalties in addition to the taxes on the disallowed amounts. As with most any other tax problem, the problem tends to grow in size over time because an assessment of tax or penalties also accrues interest. Sometimes, however, the matter can become criminal.

In criminal tax cases, the IRS can pursue a felony charge of filing a false tax return.[23] This provision requires the IRS to prove beyond a reasonable doubt that the defendant filed a false tax return and that he did so willfully. Conviction is punishable by fine of up to $100,000 and imprisonment of up to three years. An even more serious felony charge is tax evasion under 26 U.S.C. section 7201. This provision requires proof of the same two elements for the crime of filing a false tax return, plus an affirmative act of tax evasion. Conviction is punishable by a fine of up to $100,000 and a term of imprisonment of up to five years.[24]

Criminal tax cases are rare, and the vast majority of lawyers will never have any interaction at all with that part of the IRS. Civil audits are another matter, and even though a lawyer might go an entire career without an audit, it is always best to be prepared. In fact, many lawyers and law firms would likely benefit from conducting their own internal audit of how they would fare if the IRS came calling.

It can be fruitful to ask how a general ledger would look to a trained observer. Another best-practices query is how the legal billing software and its records would appear upon inspection. One could examine records of billing adjustments, payments and disbursements, travel expenses, and other office-related items. Finally, in addition to the sections of the Audit Guide cited in this article, it may be useful for lawyers to review the Audit Guide in full and test the application of those principles to their own practice's record-keeping and document control policies. Many small legal practices would probably discover that they should make some improvements.

If an internal review leaves you with identification of some gaps and deficiencies, it may be time to self-correct or get some outside accounting help. In that way, you may have a much easier time when and if you or your firm are subject to a real rather than imagined tax audit. After all, even civil audits can be daunting, expensive, and distracting. Although lawyers certainly should not fear the IRS, they would be well advised to prepare for such interactions. ■

Endnotes

1 The IRS undertook Project Esquire during the 1990s to identify attorneys who failed to file federal income tax returns. Although most were given the opportunity to pay their taxes, some were criminally indicted. *See* Sherryl Stratton, *Attorney Non-filers Still Targets in Service's "Project Esquire,"* 66 Tax Notes, No. 52-7, at 1596 (Mar. 16, 1995).

2 *See* IRS Attorneys Audit Technique Guide (Mar. 2011), *available at* http://www.irs.gov/pub/irs-utl/attorneys_atg.pdf. For an HTML version that is searchable by table of contents, *see also* the Audit Guide, *available at* http://www.irs.gov/businesses/small/article/0,,id=241098,00.html. The IRS Attorneys Audit Technique Guide is hereinafter cited as "The Audit Guide."

3 *See id.*

4 *See Sobba v. Elmen*, 2007 U.S. Dist. LEXIS 29172 (E.D. Ark. April 19, 2007) (quoting *Chaudhry v. Gallerizzo*, 174 F.3d 394, 403 (4th Cir. 1999)) ("Typically, the attorney-client privilege does not extend to billing records and expense reports."); *see also Baker v. Dorfman*, 2001 U.S. Dist. LEXIS 378 (S.D.N.Y. Jan. 23, 2001) ("The attorney-client privilege protects confidential client information that is contained in legal bills, but fee statements that do not contain detailed accounts of the legal services rendered are not protected from disclosure.") (internal quotation omitted); *accord Pollard v. E.I. DuPont de Nemours & Co.*, 2004 WL 784489, at *4 (W.D. Tenn. Feb. 24, 2004); *DiBella v. Hopkins*, 285 F. Supp. 2d 394, 409 (S.D.N.Y. 2003).

5 *See* The Audit Guide at 4-5.

6 *See id.*

7 *See id.*

8 *See id.* at 5, 15-18.

9 *See id.* at 5-7.

10 *See Miele v. Commissioner*, 72 T.C. 284, 290-91 (1979) (taxpayer lawyer taxed on advanced fees in trust account in year of withdrawal right, regardless of choice not to exercise such withdrawal right until following taxable year); *see also* 26 C.F.R. § 1.451-2(a) (general rule regarding when income is credited to the taxpayer despite his use or possession of it).

11 *See* 26 C.F.R. § 1.451-2. This is one area where there may be distinctly different concerns for litigation attorneys (especially those with contingent fee practices) and business lawyers. Nevertheless, business lawyers may also have monies going in and out of their firm's trust account. Business lawyers, like contingent fee lawyers, may assume that as long as money is in their trust account, it is not income for tax purposes until disbursed. That is rarely true. *See id.* For this and other reasons, good records are essential.

12 The Audit Guide at 8-14.

13 *Id.* at 8-9 (relying on authority provided, for example, in *In re Osterhoudt*, 722 F.2d 591 (9th Cir. 1983)).

14 *Id.* at 13-14 (Exhibit 1-2 to the Audit Guide).

15 26 U.S.C. § 7602(a); *see also U.S. v. Arthur Young & Co.*, 465 U.S. 805, 814 (1984).

16 *See* The Audit Guide at 17-27. For an example of an IRS interview, *see* Exhibit 2-3 of The Audit Guide at 24-27.

17 *See U.S. v. Powell*, 379 U.S. 48 (1964) (enumerating the prerequisites to the enforcement of an IRS summons).

18 *See, e.g., id.* at 57-58 (the government "must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed").

19 *See* Robert W. Wood, "Ten Things to Know About Fighting an IRS Bill," Forbes.com (Aug. 5, 2010), *available at* http://www.forbes.com/2010/08/05/how-fight-irs-bill-assessment-personal-finance-tax-lawyer-wood.html; *see also* Robert W. Wood, "Got A Tax Notice? Here's What To Do," Forbes.com (Sept. 2, 2011), *available at* http://www.forbes.com/sites/robertwood/2011/09/02/got-a-tax-notice-heres-what-to-do/.

20 *See* Robert W. Wood, "Received An IRS Notice? 10 Simple Tips," Forbes.com (Aug. 26, 2010), *available at* http://www.forbes.com/2010/08/26/irs-notices-letters-10-tips-personal-finance-tax-lawyer-wood.html.

21 For an example of a tax nightmare, consider the indictment of Tennessee lawyer John Threadgill for tax evasion under 26 U.S.C. section 7201. His primary alleged crime was paying personal expenses from his law firm. The indictment alleged that from 1986 to 2004, Threadgill evaded $1.4 million in federal income tax. It alleges he paid $245,000 from his law firm for family educational expenses, $213,000 in personal real estate purchases, $69,000 for his daughter's wedding, and $52,000 for

personal travel. Threadgill is alleged to have used his law firm bank and payroll accounts to issue checks to third parties for personal expenditures, maintaining ledgers concealing the true nature of his personal expenditures, establishing bank accounts for nominee trusts to disguise assets, and titling personal residences in the names of nominee trusts to disguise their ownership and put them beyond IRS review. *See* Indictment in *U.S. v. Threadgill*, No. 3:11-cr-86 (E.D. Tenn. Jun. 21, 2011), *available at* https://www.documentcloud.org/documents/217149-indictment-filed-in-u-s-district-court-charging.html.

22 *See* IRS Statistics of Income Bulletin Summer 2011, IR-2011-86 (Aug. 26, 2011), *available at* http://www.irs.gov/pub/irs-soi/11sumbul.pdf.

23 *See* 26 U.S.C. § 7206(1).

24 Some lawyers facing criminal tax charges think the government will not be able to show that they acted willfully. Proving willfulness requires the government to show that the accused knew his or her tax returns were false by, for example, showing the taxpayer claimed deductions for obviously nondeductible items. However, it is often surprising how relatively innocuous the evidence can be that may nevertheless turn out to be considered a manifestation of willfulness. The government usually relies upon circumstantial evidence to prove the evidence of willfulness. Indeed, by the time the government has gathered enough information for an indictment, there is likely to be sufficient evidence to establish willfulness. *See* Internal Revenue Manual, Part 25.1, "Fraud Handbook" (Oct. 30, 2009) at 25.1.3.1, *available at* http://www.irs.gov/irm/part25/irm_25-001-003.html; *but see U.S. v. Moran*, 493 F.3d 1002, 1012-14 (9th Cir. 2007) (finding reversible error in the exclusion of defendant's testimony regarding willfulness when the defendant relied upon a qualified expert's opinion after full disclosure). For further discussion of willfulness and its statutory treatment, *see* Michael Louis Minns, "A Brief History of Willfulness as it Applies to the Body of American Criminal Tax Law," 49 S. Tex. L. Rev. 395 (2007).