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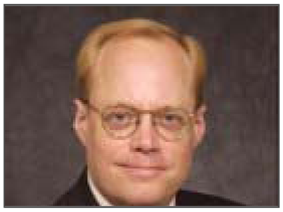

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Dear Lawyers: Get Ready For IRS Audits!

Image via kiplinger.com

Most lawyers don't relish the thought of the IRS rifling through their practice. Yet the IRS has long found lawyers to be a fruitful source of revenue and information. Some lawyers fear that the IRS unfairly targets them since several decades ago the IRS ran "Project Esquire" to audit lawyers.

The IRS recently released to IRS agents a guide to auditing lawyers. Most lawyers probably won't read this IRS audit guide. But those who do may find themselves feeling queasy.

It directs agents to look for good internal accounting, billing software, and to pay special attention to the adjustment log that reconciles the output of the time and billing system to the appropriate accounts in the general ledger. Lawyer trust accounts are also vital sources of information.

The IRS also devotes significant attention to attorney-client privilege. The privilege belongs to the client not the lawyer, but much is not covered, the audit guide states. For example, the identity of clients and their fee arrangements are almost never considered privileged, it says.

The IRS encourages auditors not only to issue Information Document Requests (IDRs) to the lawyer—these IDRs are standard to gather information in audits—but to conduct personal interviews as well. Even so, most examinations of lawyers will be uneventful.

Yet for an example of a true tax nightmare, take Tennessee lawyer John Threadgill who was indicted for tax evasion. His primary alleged crime was paying personal expenses from his law firm. According to the indictment he:

- Used his law firm bank and payroll accounts to issue checks for personal expenditures.
- Created and maintained ledgers concealing his personal expenditures;
- Established bank accounts for nominee trusts and used them to disguise assets; and
- Titled personal residences in the names of nominee trusts to disguise their ownership.

Having a business pay the owner's personal expenses is hardly unique to the practice of law. It occurs across a wide spectrum of small business. It is probably one reason individual tax returns with a Schedule C—on which sole proprietors report their business income and loss—are the most likely returns to be audited.

Upon encountering personal expenses masquerading as business, the IRS usually redresses it by imposing civil penalties in addition to taxes on the disallowed expenses. An assessment of tax or penalties also accrues interest. Sometimes, however, the matter can become criminal, as occurred with Mr. Threadgill.

A majority of criminal tax cases originate through referrals to the IRS's Criminal Investigation Division from civil auditors in normal civil audits. The IRS is not obligated to tell the taxpayer this referral is occurring and normally simply suspends the audit without any explanation. Thus, you might not know that the IRS thinks what you did may be criminal until a criminal investigation is well under way.

Even civil audits can be daunting, expensive and distracting. Be careful out there.

For more, see:

Avoid IRS Audit Triggers

Attorney Audit Technique Guide

When IRS Criminal Agents Come Calling

What's Your IRS Audit Risk?

10 Ways To Audit Proof Your Tax Return

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