

# What Do You Say When The IRS Asks For Electronic Records?

By Robert W. Wood

No one wants to wind up in a tax dispute. You want to file your returns and watch every income item match up, every claimed deduction or credit be approved, and every schedule pass muster. And you're willing to do everything you can to avoid an audit.

Still, some tax returns will be examined, although the nature and scope of audits is changing. Traditionally, some audits were full-blown office or field audits. Today, the vast majority of audits are by correspondence. Such audits are considerably less threatening and considerably less interactive, but they still require careful thought.

You don't have an unlimited number of chances to explain and justify what you've claimed before the proposed adjustments are written up and shipped off to the next level of the Internal Revenue Service. You want to provide timely and targeted responses. Unless it's absolutely necessary, you don't want to go to court over whether the IRS can get access to certain documents.

Most audits are handled informally through Information Document Requests (IDRs), memo-like notices issued by the IRS. You don't legally have to comply, but if you don't, the IRS will send a formal summons that could land you in court. You should consider providing checks, invoices, receipts and other supporting information if the IRS asks.

What if the IRS wants an electronic copy of your accounting software, say QuickBooks or something equivalent? In examining the returns of small businesses, the IRS is increasingly requesting electronic files for accounting programs. But why make it easy for the IRS to mine your own data?

You may need professional advice about your situation. So far, the law says the IRS can ask and, in general, you should comply. Still, advisers debate the nuances. In particular, you want to make sure that you are providing no more of your data than an IRS request reasonably covers.

Even something like multiple tax years can be a potential problem. In general, the IRS instructs its examiners to request electronic copies of accounting records for the tax year under examination. Sometimes, the IRS will request records of *other* years to verify a current-year item from prior or subsequent-year accounting.

Typically, taxpayer accounting software is fair game. But what if you have customer lists, personnel data and more embedded in your software? In some cases, you may be able to redact materials, but be careful how and what you address in this way. You want to cooperate with the IRS, but you don't want to turn over data that hurts your business or provokes inquiries into other areas the IRS isn't already considering.

If you express concern to the IRS that your off-the-shelf accounting software has materials in it that you aren't comfortable disclosing, the IRS can choose to issue a summons. That could mean you have to fight about it in court. There's nothing new about the IRS wanting electronic data.

Yet traditionally such inquiries involved big businesses. Small businesses are defined as those with assets less than \$10 million, and they often use off-the-shelf accounting software such as QuickBooks. In contrast, big businesses usually have customized accounting systems that facilitate providing the IRS only with what they want.

The American Institute of CPAs (AICPA) proposed allowing companies to redact accounting software to release only relevant data, but the IRS rejected the request. The IRS suggests that small businesses should back-up at year end, limiting IRS access to one year at a time. The IRS also said it would allow businesses to reduce the detail for years not under audit.

Still, providing electronic files is becoming the norm in audits and is therefore increasingly difficult to avoid. The IRS says that using electronic records to conduct examinations should make the audit more efficient for everyone. Examiners request these files in the majority of cases where the taxpayer already uses electronic accounting software to maintain their books and records.

However, if the audit is limited in scope, such as auditing one specific expense item, the examiner may determine that requesting the electronic accounting software file may not be necessary. Most of the time, though, it probably will be. You should not underestimate the data mining the IRS can do. Most accounting software programs can generate a large number of pre-set reports. Each report can be modified to fit the examiner's needs. The software also allows the examiner to test the integrity and veracity of the accounting records.

What if you refuse to provide electronic accounting records? Taxpayers are responsible for maintaining sufficient books and records to support the income and deductions claimed on their tax returns. They have to present this information to the IRS when requested in an examination. Section 7602(a)(1) of the tax code gives the IRS the authority to examine any books, papers, records or other data that may be relevant or material to a tax examination.

If you decline to submit the requested materials, the IRS has the right to issue a summons. What's more, the IRS can use indirect methods to reconstruct income and/or disallow the items reported for lack of substantiation. That means, in some cases, you will have no choice but to comply.

Privilege issues — including attorney-client privilege and work-product protection — require special handling. Attorney-client privilege protects communications between clients and their lawyers, whether or not they are dealing with anticipated litigation. Discussions with lawyers are privileged, but discussions with accountants are not unless the accountants are subcontractors of the lawyers. Work-product protection is different from attorney-client privilege.

The work-product doctrine provides that an individual or company need not turn over documents that were created in anticipation of litigation. See *Hickman v. Taylor*, 329 U.S. 495 (1947). The work-product doctrine has wide application, and isn't limited to tax litigation. Documents that will be used in the event of tax litigation and that relate to the strength or weakness of a tax position are covered by the work-product privilege.

As part of vetting a particular tax position, taxpayers often discuss arguments the IRS *could* assert that might undermine a claimed tax position. Understandably, you don't want to hand the IRS a roadmap of arguments to make against you. And attorney-client privilege may not cover everything you want to protect.

Many taxpayers show tax discussions and figures to their accountants. Accountants may run numbers assuming various tax outcomes. Unless the accountant has been engaged by a lawyer to bring attorney-client privilege, the accountant's work could only be protected under the work-product doctrine, which doesn't always apply.

There's no easy answer to the question of how to make an audit go as smoothly as possible. Still, one helpful idea is to plan ahead and to keep your financial records in good order, both electronically and on paper. Be prepared.



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