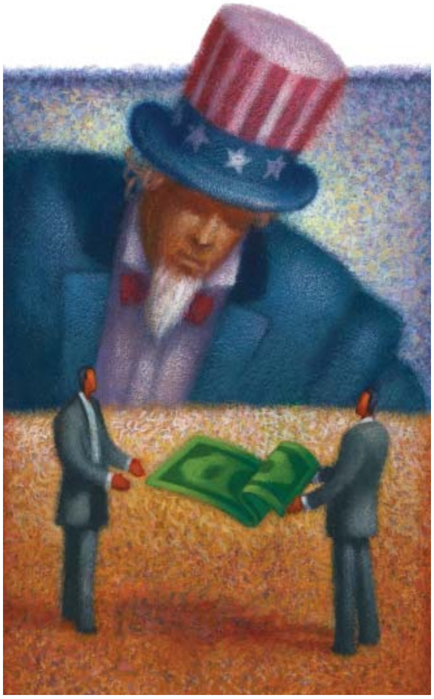
BY ROBERT W. WOOD



Robert W. Wood (wood@WoodLLP.com), a tax lawyer with a nationwide practice, is the author of more than 30 books, including *Taxation of Damage Awards & Settlement Payments* (4th Ed. 2009 www.taxinstitute.com). This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

What Every Lawyer Should Know About IRS Audits

No one likes IRS audits, and lawyers seem particularly to dread them. The mere thought that the Internal Revenue Service may commence poking into your books and perusing the financial affairs of your practice is downright unsettling. By its very nature, law practice is confidential, and keeping the client's confidence is of supreme importance.

It should be no surprise that clients who learn that the IRS is reviewing their lawyer's books may be concerned or even unnerved. If your clients get wind that you are undergoing an audit, they may voice concerns quite apart from your own. For that reason and many others, you should take any audit seriously and should attempt to minimize its financial and psychological impact. Audit risks are statistically low, but that is changing.

Indeed, the IRS has recently increased the ranks of its Revenue Agents, adding 3% in 2009 and 7% in 2010. The IRS audited 1,581,394 individual income tax returns in 2010, 342,762 of them in the field and 1,238,632 of them by correspondence. The same year, the IRS audited 29,803 corporate income tax forms (on Form 1120), 28,601 of them in the field and 1,202 of them by correspondence. Correspondence audits are far more easily controlled and far less threatening than field audits where the IRS visits you personally.

Get a Lawyer

A field audit begins with an IRS Revenue Agent sending a letter specifying the tax returns selected for audit, the day and time the audit is to begin, and the records the Revenue Agent wishes to examine. Rather than giving the Revenue Agent access to your office, hire a tax lawyer. The tax lawyer will likely move your records to his or her own office and have the IRS review the records there. That is far less disruptive for you, your staff and especially your clients.

In fact, as soon as you get any kind of IRS (or other) tax audit notice, a good first step is to consult with experienced tax counsel. You may have an accountant who regularly prepares tax returns for your practice or law firm. The accountant may well be able to handle the audit. However, consulting with a tax lawyer about the process and your particular facts can be a shrewd initial step.

In some cases it will pay to have a tax lawyer handle the audit from the start, rather than (as is common) waiting to bring in a tax lawyer at the conclusion of the audit for the ensuing administrative or court appeals. The tax lawyer may be able to head off trouble early and thus truncate the entire process. There is no universal answer to the question of who should handle your audit. Clearly, though, if the case involves potential allegations of fraud, a lawyer should represent you.

In fact, audits of lawyers may be especially sensitive. No lawyer wants to keep clients in the dark about the risk that their identity has been disclosed to the IRS. Yet no lawyer wants to risk having clients bolt by telling them the IRS has their names. Any interaction with the IRS will be an inconvenience, but it could be expensive or even carry grave consequences. (Some believe the IRS unfairly targets lawyers, recalling the IRS's "Project Esquire" of several decades past.)

The Audit Guide

More recently, the IRS has released a new audit guide directing its agents how to audit lawyers.[1] It contains interesting points even for lawyers who have no fear of dealing with the IRS and who would not expect an audit of their practice to give rise to any problems. Even those very secure in their practice and in its administrative and financial aspects may want to peruse it. Doing so will be unsettling for some.

Indeed, after reading this guide, some lawyers will find that they should beef up their internal controls and documentation. Lawyers may want to segregate records they consider protected by attorney-client privilege from those that clearly are not. One of the primary messages of the IRS audit guide for law practices is that lawyers are expected to have good internal accounting and a good system of recording costs and expenses. Many lawyers, especially in small offices, feel they have little need for such systems. That may be a mistake.

The IRS expects billing software, of course, and will want to examine it as well as its results. 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 general ledger. This too is noteworthy. The IRS will want the accounting and general ledger to tie together. If it does not, the IRS may want to go through bank records in excruciating detail.

That brings up lawyer trust accounts. Even if reviewing bank records isn't necessary to cross-check receipts and reported income, the IRS audit guide tells Revenue Agents that lawyer trust accounts are *vital* sources of information. Here, most lawyers are careful, although precisely what the IRS looks for may surprise some. Many lawyers have too much in their trust account and are slow to withdraw amounts from the trust account to which they are entitled.

Yet it is clear that if a lawyer is entitled to fees in his trust account, they represent income to the lawyer for tax purposes. It does not matter if the lawyer waits to actually withdraw the fees from the 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, it is not income until it is disbursed to the lawyer in January.

Attorney-Client Privilege

The IRS devotes significant attention to attorney-client privilege in its audit guide. There is good reason for this, since claims of privilege are common in audits of lawyers. Lawyers are a cautious lot and do not want to risk violating privilege by giving the IRS too much.

The IRS correctly instructs its agents that the privilege is the clients', not the lawyers'. Even so, of course, lawyers commonly assert the privilege on behalf of their clients, knowing that the client is the only person who can waive it. Yet precisely what kind of information is privileged?

The IRS audit manual states firmly that the identity of clients and their fee arrangements are almost never considered privileged. There is some case law on this point, but the IRS is correct that lawyers generally cannot fail to turn over the names of clients, the amounts they pay or the particulars of their fee arrangements if it is material to the audit.

Another more general potential objection to a request for such information would be relevancy. Material is generally relevant in an audit if it might have some bearing upon the correctness of the taxpayer's return. The IRS encourages auditors not only to issue Information Document Requests (IDRs) to the lawyer but to conduct personal interviews as well.

In addition to IDRs, the IRS is likely to issue summonses if the auditors have any difficulty getting documents they request. The lawyer can respond in court and try to quash the summons based, for example, on privilege. Overbroad or burdensome summonses may not be enforced, but the lawyer may need to take any dealings with the IRS seriously, including hiring counsel.

Criminal Referral

Fortunately, most examinations of lawyers will be uneventful. Yet it is worth noting that problems can sometimes escalate. 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 the auditor can simply notify the IRS's Criminal Investigation Division.

The IRS is not obligated to tell the taxpayer that this criminal referral is occurring. Normally the civil auditors simply suspend the audit without any explanation. Thus, the taxpayer might assume that the audit is over or, more likely, that the IRS is busy and will eventually pick up where they left off. The taxpayer may have no idea that the IRS believes there has been a criminal violation and that it is building a criminal case until a criminal investigation is well under way.

For an example of a tax nightmare, consider the indictment of Tennessee lawyer John Threadgill for tax evasion. His primary alleged crime was paying personal expenses from his law firm accounts. Threadgill is alleged to have used his law firm bank and payroll accounts to issue checks to third parties for personal expenditures; maintained ledgers concealing the true nature of his personal expenditures; established bank accounts for nominee trusts to disguise assets; and titled personal residences in the names of nominee trusts to disguise their ownership and put them beyond IRS.

The indictment alleges 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.

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 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 loss – are *the most likely* individual tax returns to be audited.

An aggressive mixing of or simply a sloppy differentiation between what is business and what is personal is probably more common among solo or small-firm practitioners than in the larger law firms. Many solo and small firm practitioners may see little reason to have written procedures and internal controls. An IRS audit can do much to change their minds.

However, a lax differentiation between business and personal 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. Of course, an assessment of tax or penalties also accrues interest. Sometimes, however, the matter can become criminal, as occurred in Threadgill's case.

In criminal tax cases, the IRS can pursue a felony charge of filing a false tax return.[2] This provision requires the IRS to prove beyond a reasonable doubt that the defendant filed a false tax return and 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. § 7201, as is being pursued against Threadgill. 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 fine of up to $100,000 and imprisonment of up to five years.

Some lawyers facing criminal tax charges think the government will not be able to show they acted willfully. This requires the government to show the accused knew the tax returns were false, as by claiming deductions for obviously nondeductible items. But 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 plenty of evidence sufficient to establish willfulness.

Thus, although most lawyers certainly should not fear the IRS, many might benefit from conducting their own internal audit of how they would fare if the IRS came calling. Many would probably discover that they should make some improvements. After all, even civil audits can be daunting, expensive and distracting. Be careful out there. ■

1. *See* IRS Attorneys Audit Technique Guide (Mar. 2011), *at* http://www.irs.gov/businesses/small/article/0,,id=241098,00.html.

2. *See* 26 U.S.C. § 7206(1).