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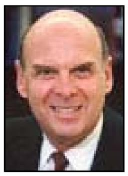
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Handling a Tax Audit: 3 Traps for the Unwary

By Mark Klein, Esq.

First impressions are lasting—and nowhere is this adage more accurate than when a tax auditor knocks at the door asking to review your client's tax returns. With federal and state governments running out of money, government auditors today are more aggressive than those of the past. As a result, we are seeing a large increase in the number and scope of tax audits. Because of this increased emphasis on generating more revenue, auditors are developing an uncanny ability to apply existing laws creatively. For example, in New York state, income tax auditors routinely engage in "above the line" audits of federal issues; sales tax auditors recharacterize transactions, long thought exempt, into taxable events; and more criminal tax prosecutions occur than ever before.

Admittedly, some areas of the law were already rife with "gamesmanship," and the government has a right—even an obligation—to enforce the law so that honest taxpayers aren't disadvantaged. But today's increased enforcement environment has significantly changed the dynamics of an audit—and the stakes have never been higher. Against this backdrop, it's easy to understand the importance of a cordial, professional relationship with the team that plans to audit your client's tax return. Accountants and other return preparers need to make every effort to gain the auditors' trust or, at least, not unnecessarily alienate them. Unfortunately, too many representatives violate some very simple rules and, in so doing, subject their clients to the risk of additional scrutiny, or worse.

There are three important things to avoid at the outset of an audit. These general rules have proven themselves true to me through hundreds of audits in almost 30 years of practice. Each audit (and the underlying facts) is unique and must be separately evaluated to determine what makes sense in each circumstance. Nevertheless, here are some clear, overriding principles to help ensure that the audit doesn't start off on the wrong foot.

1. Don't amend a tax return immediately after your client receives notice of an audit.

Here's the problem: You and your client, after a great deal of inquiry and analysis, supposedly identified all relevant tax information, reviewed all the requisite documentation and did your best to accurately reflect those findings on a tax return. Your client thoroughly reviewed the final return (yes, they really are supposed to do that) and attested to its truthfulness under penalty of perjury. The return was filed, but the minute someone wants to actually scrutinize the numbers, you admit they're wrong.

At best, this is awkward. At worst, some have suggested that a tax return amendment triggered by a notice of audit is a badge of fraud. It suggests that you or your client were trying to get away with something. In fact, criminal tax practitioners characterize such an amendment as an "admission" by the taxpayer. But this does not mean that you should hide an error from an auditor; instead, you must evaluate the circumstances behind the error.

Was it an honest mistake or transposition error, or something more nefarious? If the former, you should be able to explain it to the auditors and demonstrate where you went wrong. If the latter, you must tread very carefully—otherwise, a simple tax audit could explode into a major problem. Remember that you never want to lie to a tax auditor because that, in itself, is a crime. You may have some wonderful clients, but I'd suggest that none of them is worth your integrity, reputation, professional license or liberty.

2. Don't start an audit with an offer to settle a case.

No one wants to be audited, and even the most honest client may not enjoy the prospect of a long and tedious review of every piece of financial information relating to a number of tax years, especially considering the professional fees that may be necessary to defend the case.

But asking to settle an audit at the outset may give an already skeptical auditor the wrong idea. Many auditors will wonder what your client has to hide and may also question why your client is willing to pay any sum of money if they truly filed an accurate return.

Moreover, if you're willing to pay a certain amount of money on the first day, there may be an assumption that the "real" liability is 10, 20 or 100 times more than that amount. Once the auditor has completed the fact-finding portion of the audit, there will be plenty of opportunities to discuss settlement.

3. Clients and auditors don't mix well.

Many clients take tax audits personally, as an affront to their honesty or record-keeping skills. Often, our clients are successful business people, some who negotiate with adversaries for a living. As a result, they may feel that they are better advocates for their position than you—and they very well might be, but it is a rare client who can navigate the treacherous waters of a tax audit. More times than not, a client will say something that they (or you) wish they had not. In fact, some auditors are quite skilled at getting clients to incriminate themselves.

I once had a case involving a client who changed his tax residence to Florida, although the auditor was questioning whether the taxpayer was still a New York domiciliary. The client telephoned the auditor (before I got involved) to ask for an extension of time to respond to one of the auditor's inquiries. During the course of the conversation, the subject of politics arose and the taxpayer shared his feelings about Sens. Schumer and (at that time) Clinton. As I understand it, the taxpayer had some pretty strong opinions.

After this discussion, the auditor asked the client about his new residence in Florida and then suddenly asked him to identify Florida's senators. The client must have stumbled, since the auditor's written report of the conversation noted that the taxpayer had an "intimate" knowledge of New York politicians while he had no knowledge at all about the politicians in his "alleged home state." The auditor wondered why this "Floridian" was more up to date on the political landscape in his vacation community than he was about the politicians at "home". Later, this seemingly innocuous conversation was used against the taxpayer at a conciliation conference as evidence that the client was not "really" a Floridian. The lesson is clear: Even the most mundane conversations can create ammunition for an auditor. As noted above, clients and auditors just don't mix well.

There's an old saying that you never get a second chance to make a first impression. Tax audits are no different than any other professional interaction, and you want to start things off on the right foot. Having a heightened awareness of an auditor's sensitivities will give you a better chance of the audit proceeding smoothly and minimizing the unnecessary exposure of your clients to significant risks. Avoiding the three traps above will help ensure that you and your client have the best chance of successfully resolving what can be an otherwise extremely contentious process.

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