

## Is The Revenue Service Targeting Lawyers?

By Robert W. Wood

No, but some people may think so. Some lawyers fear that the Internal Revenue Service could take action against them or their clients - actions that could carry grave consequences. Some lawyers even believe the IRS unfairly targets them. Some of this is historical - the IRS had a well-publicized program several decades ago (dubbed "Project Esquire") that fueled these fears.

Even if one does not know of this history, similar fears could be rekindled. The IRS has released a new and updated audit guide for IRS agents to audit lawyers. See *"IRS Attorneys Audit Technique Guide"* (March 2011), available at [www.irs.gov/businesses/small/article/0,,id=241098,00.html](http://www.irs.gov/businesses/small/article/0,,id=241098,00.html). It contains much that is complex and nuanced, but several themes emerge.

The IRS expects lawyers to have good internal accounting and a good system of recording costs and expenses. For billing software, the IRS is particularly interested in seeing the adjustment log that reconciles the output of the time and billing to the appropriate accounts in the general ledger. Lawyer trust accounts are also vital sources of information. These facts should cause lawyers to verify their own systems and documentation in a kind of self-audit.

Moreover, some thought should be given to what is privileged from the IRS' eyes. The IRS devotes significant attention to attorney-client privilege in its audit guide. Although some lawyers assert the privilege on behalf of their clients, the audit guide instructs IRS agents that the privilege belongs to the clients, not the lawyers. Significantly, the guide specifically states that the identity of clients and their fee arrangements are almost never considered privileged.



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The IRS encourages auditors to issue information document requests to lawyers to mine for information and documents. These requests are standard to gather information. If you don't respond, you can expect the IRS to issue a summons. The IRS also tells its agents to conduct personal interviews with lawyers.

Most examinations of lawyers will be uneventful, but for an example of a tax nightmare consider the tax evasion indictment of Tennessee lawyer John Threadgill. His primary alleged crime? Paying his personal expenses from his law firm.

The indictment alleges that from 1986 to 2004, Threadgill evaded \$1.4 million in federal income tax, issuing checks from his law firm bank and payroll accounts to third parties for personal expenditures; creating ledgers concealing his personal expenditures; establishing bank accounts in the names of nominee trusts to disguise assets; and titling personal residences in the names of nominee trusts to disguise their ownership and put them beyond IRS reach. He is alleged to have 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 not unique to the practice of law. It occurs across a wide spectrum of small businesses. 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 individual tax returns to be audited.

An aggressive or sloppy differentiation between business and personal expenses is probably more common among solo or small-firm practitioners than in larger law firms. Larger law firms have more extensive internal controls. But wherever tax differentiation between business and personal expenses occurs, it is dangerous.

Upon encountering this problem, the IRS usually redresses it by disallowing the claimed deductions and imposing civil penalties plus interest. Sometimes, however, the matter can become criminal. A majority of criminal tax cases originate through referrals from civil auditors in normal civil audits. The regular IRS auditor simply notifies the IRS' Criminal Investigation Division.

Significantly, the IRS is not obligated to tell the taxpayer this referral is occurring. Normally, the IRS simply suspends the civil audit without any explanation and the criminal investigation ensues. Thus, you might think the IRS is just busy or has bigger fish to fry. You might not know that the IRS thinks what you did may be criminal until a criminal investigation is well under way.

In criminal tax cases, the IRS can pursue a felony charge of filing a false tax return. See 26 U.S.C. Section 7206(1). 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 a fine of up to \$100,000 and imprisonment of up to three years.

An even more serious felony charge is that of tax evasion under 26 U.S.C. Section 7201, as is being pursued in Threadgill's case. 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 imprisonment of up to five years.

Some lawyers may think the government will not be able to show they acted willfully. The government must show the accused knew his tax returns were false, such as by claiming deductions for nondeductible items. However, the government usually relies upon circumstantial evidence to prove the evidence of willfulness. By the time the government proceeds with an indictment, they usually have amassed plenty of evidence to show willfulness.

Although criminal investigations are rare, even civil audits can be daunting, expensive and distracting. Few lawyers need to worry about a criminal tax case being mounted against them. Yet a review of the IRS' new lawyer audit guide will probably reveal to most lawyers that their internal controls and documentation could be improved. Be prepared and be careful.

*This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*

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