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What Every Lawyer Should Know About IRS AUDITS

BY ROBERT W. WOOD

Although no one likes an IRS audit, lawyers may dread dealing with the IRS more than most people, especially if it means the IRS may commence poking into the financial affairs of their practice. By its very nature, law practice is confidential, and keeping a client's confidence is of supreme importance. It should therefore be no surprise that the thought of the IRS looking at a lawyer's books could provoke concern for clients as well as the lawyer.

No lawyer wants to keep clients in the dark about the risk that their identities have been disclosed to the IRS. Yet no lawyer wants to risk having clients bolt by telling them the IRS has their names either. 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. 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. In some cases, lawyers should beef up their internal controls and their documentation. Lawyers should be careful to segregate records the lawyer considers 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 the IRS expects lawyers 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 and 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. 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.

Lawyer trust accounts are also 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 his 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.

The IRS devotes significant attention to attorney–client privilege in its audit guide. There is good reason for this, because 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 belongs to the clients, not to 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 and lawyers may not even want names or financial arrangements disclosed. However, 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 these details are 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. An IDR is an informal written request for information, like a memo from the IRS to the taxpayer.

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

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, he can simply notify the IRS's Criminal Investigation Division. It will be their job to investigate and determine if there is evidence of criminal wrongdoing.

The IRS is not obligated to tell the taxpayer that this criminal referral is occurring. Normally the civil IRS 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. 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 view.

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 business. 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 income tax returns to be audited.

With lawyers, an aggressive or simply careless differentiation between business and personal is probably more common among solo or small-firm practitioners than in 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.

Indeed, wherever a lax differentiation between business and personal occurs it 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 under 26 U.S.C. § 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 tax evasion under 26 U.S.C. § 7201, as was pursued in Threadgill's case in Tennessee. 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 $250,000 and imprisonment of up to five years. After a five-day trial, Threadgill was convicted on Nov. 14, 2012, on one count of income tax evasion.[2]

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Some lawyers facing criminal tax charges think the government will not be able to show that they acted willfully. This requires the government to show the accused knew his tax returns were false, as by claiming deductions for obviously nondeductible items. But the government usually relies on 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 should not fear the IRS, many might benefit from conducting their own internal audit of their books, records and firm policies. The idea would be to assess 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.

endnotes

1. *See IRS Attorneys Audit Technique Guide* (March 2011), available at www.irs.gov/businesses/small/article/0,,id=241098,00.html.
2. *See* www.justice.gov/usao/tne/news/2012/November/111512%20Threadgill%20Conviction%20Tax%20Evasion.html.