PERSPECTIVE

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The Perils of Handling Your Own Tax Audit or Dispute

By Robert W. Wood

Should you handle your own tax audit or dispute? Usually the answer is no, for a variety of reasons. For one thing, if you are having direct communications with the IRS or the California Franchise Tax Board, the chances of a misstep are much higher. With direct communication, whether oral or written, it can be difficult to take back or correct what you say. Of course, it can be efficient to be the repository of all the information the IRS asks you, so you can respond seamlessly.

But sometimes, it is useful to add some distance between you and direct communications with the government. Many criminal defense lawyers try to keep their clients from talking to the police as much as they can. And while the risk of any tax case turning criminal is extremely small, a similar kind of reluctance can exist with direct communications with the IRS about your own tax situation.

If you are a lawyer, you are used to advocacy and documentation, so lawyers may be comfortable handling their own tax audit or tax controversy. However, most taxpayers, including lawyers, generally feel a chill when dealing with the Internal Revenue Service.

It's hard to generalize about audits, since the term is a loose one. It can start rather innocuously.

You might receive a letter from the IRS asking about one or more aspects of your return. You might want to handle it yourself and send back a simple response about the points addressed. Still, be cautious and reflective, especially in more serious matters.

Should an accountant or tax lawyer handle it for you?

Either one is better than doing it yourself. On average, I believe that taxpayers come out better if they don't represent themselves. That's so even taking the cost of professional fees into account. There are cases in which representing yourself can make sense, but they are rare. Whether a tax lawyer or CPA is better can depend on the case and the issues, as well as their procedural setting.

Note too that the point at which you need a representative is often early. Some taxpayers spend large sums with tax professionals precisely because they tried to handle the case themselves. Sometimes, you can dig a hole that is bigger, wider and deeper than if you had you handed it to a professional from the start. If you just can't help yourself from handling your tax case on your own, at least get some good accounting legwork.

Many Tax Court cases handled by taxpayers *pro se* (including by lawyers) are very poorly handled. A case in point was once-famous lawyer F. Lee Bailey.

He represented himself in Tax Court in a $4 million dispute with the IRS. See *Bailey v. Commissioner*, T.C. Memo. 2012-96 (Apr. 2, 2012). To his credit, Mr. Bailey won the major issue in the case, but he lost most of the other ones (including his claimed loss deductions for his yacht).

Worse, the court approved significant negligence penalties against him that I'm guessing he could have avoided with tax counsel. The IRS had multiple claims against Bailey. The most serious involved the IRS claim the he was taxable on client funds he was holding. The IRS wanted to tax him on nearly $6 million since it seemed to be available to him for his own use—his client was a fugitive. Amazingly, Bailey mostly won this issue, although the Tax Court did tax him on about $450,000 of the funds that he "wrongly appropriated" and later repaid.

Bailey lost on most of the other issues, as is revealed in the whopping 143-page Tax Court opinion. One expensive issue was the tax treatment of Bailey's expensive and custom-built yacht, "Spellbound." You guessed it: Bailey claimed that he operated it (unsuccessfully) as a profit-making activity. The hobby-loss part of his case wasn't worth arguing, and especially not by the very person at its epicenter—Bailey.

One of the elements of a "hobby loss" case is whether the taxpayer derives personal pleasure from the activity. Mr. Bailey said the yacht was just no fun. As the Tax Court put it:

"The Commissioner contends that Mr. Bailey took a great deal of personal pleasure from sailing on the Spellbound with his family and friends, but Mr. Bailey claims that "[i]t's no fun to drive a boat". Mr. Bailey testified that the steering wheel and navigational instruments of the Spellbound are isolated from the rest of the deck, and the pilot is therefore isolated from the party-goers on the deck.

While it may be true that Mr. Bailey did not enjoy piloting the yacht, the record belies the claim that he derived no personal pleasure from it. First, the Spellbound was built to Mr. Bailey's specifications, and he testified that it was beautiful. Second, the record does not show that Mr. Bailey always took on the job of piloting the Spellbound. PBR hired a captain and crew to sail and maintain the Spellbound, and Mr. Bailey could have used their services to pilot the yacht any number of times. Even assuming arguendo that Mr. Bailey piloted the Spellbound on every personal trip–and that he disliked the task–we find that he derived pleasure from sharing the yacht with his family and friends and that he anticipated doing so when he purchased the yacht in 1989."

All in all, the IRS prevailed on most issues. And the Tax Court upheld the penalties imposed on Bailey. Of course, F. Lee Bailey is not the only lawyer to fail in handling his own tax case. Here are two other Tax Court cases: *Hale v. Commissioner*, T.C. Memo 2010-229, and *Pace v. Commissioner*, T.C. Memo 2010-273.

In each of these cases, as in Bailey's, there were fundamental accounting problems that someone with good records could have handled. My guess is that a tax lawyer handling the case would have seen and addressed these problems early, and more competently. Seeing your own facts and documents through an unbiased and objective lens is not easy for most of us.

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