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PRODUCT & SERVICE GUIDE

Audits & Notices: Perils, Pitfalls and Questions to Consider as You Prepare to Represent Your Client

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Dave DuVal, EA • Jul. 12, 2016

With the 2016 "audit season" in full swing, there's a strong likelihood that one or more of your clients has already received – or soon will receive – an audit, notice, or other type of tax-related correspondence. From information mismatch notices, to correspondence audits, to office and field audits, to Notices of Deficiency, there are many types of letters that could land in a client's mailbox and eventually make it to your desk. Here's a list of questions to consider – and potential pitfalls to avoid – as you make plans for their defense.

Where are they in the audit cycle?

When your clients receive correspondence from the IRS or their state taxing agency, they will generally do one of three things: put it in the folder with other tax "stuff" and give it to you (unopened) next year when you prepare their tax return; open it and pay it, then tell you about it; or immediately call you and yell, "You messed up on my return!"

Regardless of when they hand it over to you, your first step should be to understand where your client is in the audit cycle to ensure you protect any rights that still may be available to them at that point. Even if your client is in the first stages of the audit process, it is important to respond immediately to the letter, as there can be long delays between when you make contact and when the examiner responds to you.

While the initial notifications for Automated Underreporter (AUR) Notices, Correspondence Audits, Office Examinations, and Field Examinations vary in content, the basic life cycle of these inquiries are similar. First, your client should receive an initial notification letter. If they do not respond to the first notification, they will generally receive a 30-day letter with a proposed bill for a "balance due." If your client does not respond to the 30-day letter they will receive a "Notice of Deficiency (NOD)," which will allow them only 90 days to resolve the case before a petition will need to be filed with the U.S. Tax Court.

If you expect that you will not be able to resolve a case before the expiration of the NOD, filing a tax court petition will be necessary to protect your client's rights to certain appeal options they may need in the event of an unfavorable outcome. While a taxpayer is allowed to prepare their own Tax Court petition, those who prepare and submit petitions on behalf of someone else must be an attorney or tax court practitioner. Enrolled agents and certified public accountants are not allowed to practice in the U.S. Tax Court unless they have taken and passed the very difficult biannual exam to allow their name to be entered on the Roll of Practitioners of the Court. Legally, you are not even allowed to assist the client in filling out the Tax Court Petition without the required designations.

Do you have the authority to represent taxpayers before the IRS or U.S. Tax Court?

To fully represent your client before the IRS, you must be an attorney, a certified public accountant or an enrolled agent. There are others who can represent taxpayers, but with many limitations. Some examples are enrolled actuaries, family members, and unenrolled return preparers who prepared the return and are part of the Annual Filing Season Program for the year they prepared the return and the year of the audit/notice. In order to represent your client in Tax Court you must be either an attorney or a U.S. Tax Court Practitioner.

Is there a conflict of interest?

Under Circular 230 §10.29, representing a taxpayer whose return you prepared could be considered a conflict of interest, as you could be in a position to have to defend how you prepared the return at the same time that you are representing your client. For example, if the audit is for the Earned Income Tax Credit, the Child Tax Credit, or the American Opportunity Credit, you could be sanctioned if you are not able to show that you asked and recorded all the required questions and your client's answers, or otherwise exercised the required due diligence. Review the case carefully to determine if either your or client's case could be compromised if you handle the representation.

Do you possess the experience necessary to competently defend the audit, and do you have the time to properly research the issues?

Circular 230 §10.35 states that you must possess the "necessary competence" to engage in practice before the IRS. You also must have the knowledge and skill to address the areas that you have been engaged to work on and the relevant areas of the tax law. This is true even when you prepare tax returns. If you are not knowledgeable or even comfortable with a subject matter (e.g., straddles, like-kind exchanges, 1120s, 1041s, Form 5471, Form 3520) then you should not contract with that taxpayer, but instead refer them to a colleague who is "competent" in that area of taxes.

Are your records organized to preserve attorney-client privilege?

The IRS Restructuring and Reform Act of 1998 created for the first time a type of attorney-client privilege for non-attorney tax practitioners. But it does not apply to the preparation of tax returns because tax returns are designed to be disclosed to a third party (i.e., the IRS or a state tax authority). Therefore, if your client wishes to maintain privilege in regard to any matter, your communications relating to tax preparation should be kept separate from communications relating to tax advice. While it sounds easy, this is difficult to implement when you have a busy practice.

Do you have substantial authority for the position you took on your client's tax return?

Google is great for pointing you in the right direction, but for tax research it's not going to cut it. If your client is found to have an underpayment that is attributable to

a substantial understatement of income tax, you as the tax preparer could be subject to preparer penalties unless you can support the position that lead to the substantial underpayment with “substantial authority” sources, such as the IRS code, statutory provisions, regulations, etc.

Is your client’s issue featured in an Audit Technique Guide?

The IRS publishes a set of Audit Technique Guides (ATGs) that its employees use to evaluate industry and issue-specific tax returns. Some examples are “Cash Intensive Businesses,” “Passive Losses,” “Child Care Providers,” and “Lawsuits, Awards, and Settlements.” These guides are a useful tool for understanding what to expect and how to prepare for an IRS audit, so be sure to include them as part of your preparation whenever possible.

Should you consider using a third party audit protection service?

Due to the complexity of audits, potential conflict of interest, issues with attorney-client privilege, and the amount of time the audits themselves take you away from your other important business, you may want to consider outsourcing your clients’ audits to a third party. If you do, be sure to take the time to evaluate the firm carefully. Any firm you select must be able to provide the same level of care and security that you provide to your clients. They should handle both federal and state audits, and they should have a secure portal for uploading, communicating, and storing your clients’ information. In addition, any outside audit representation service you sign your clients up with should include attendance at face-to-face meetings with examiners. Except for highly unusual situations, your client should never meet with the IRS.

This is by no means an exhaustive list of questions to consider as you prepare to respond to a client’s audit letter. There are numerous additional issues (e.g., injured spouse, innocent spouse, conflicts between client and spouse) that may present themselves during the audit process, and what they are will depend on your client’s relationships and circumstances. These are just some examples of what to be prepared for as you plan your client’s defense.

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