

## Winter 2004

### The IRS Audit: What Should You Do?

Although tax audits can easily seem like a remote possibility, the Internal Revenue Service has dramatically ramped up its audit efforts in recent years. Targeted industries, including law firms, should be on guard.

Among other moves, the IRS developed the Market Segment Specialization Program (MSSP), which targets specific groups, including law firms. Firms that know what the IRS is looking for, however, can minimize their risk of audit.

The IRS has released the MSSP manuals used by its auditors, which can be used to avoid or at least survive an audit. The manuals instruct auditors to look for red flags in areas ripe for tax fraud. Firms that handle large amounts of cash may be especially vulnerable, as well as those with real estate practices that take property interests in transactions.

#### **Preemptive Measures**

Knowing the financial areas likely to be targeted can help firms take preventive steps to protect themselves from the IRS. Law firms should exercise particular caution in certain areas favored by auditors:

**Client advances.** Litigation costs and living expenses advanced to clients are nondeductible items, but the IRS believes attorneys deduct these costs. The manual directs auditors to closely scrutinize categories like "other expenses," "client costs" and "costs of sale" for signs of these violations. Solo practitioners and small firms are most likely to have client advances examined.

**Client trust accounts.** The IRS looks for attempts to defer earned income to the next year by hiding it in a client trust account until year end. If an attorney had the right to remove these fees from the trust account before that time but left the funds there, the income may be considered constructively received and taxable in the earlier year.

**Employment taxes.** The MSSP manual raises the issue of employees versus independent contractors, theorizing that small practices may treat employees as contractors to avoid having to withhold and pay employment taxes. Attorneys should consider the common law test for determining whether an individual is an employee and treat the individual accordingly.

**Partner tax returns.** Partners should be required to sign annual statements verifying they have filed their personal tax returns for the year. Auditors look at money borrowed from clients but later forgiven for services provided. They also study situations where a partner received partnership or limited liability company interests in lieu of cash for services provided.

#### **Easing the Pain**

Firms can ease their dealings with the IRS in several ways. Maintaining comprehensive financial records may foster lenience from auditors. Similarly, firms that respond promptly to IRS notices quell suspicions. Any interviews should be conducted at the auditor's or the firm accountant's office so the auditor can't

compare the firm's offices to its reported income.

It's also important to keep your composure and treat the auditor professionally. If necessary, request a meeting with the auditor's supervisor or a district supervisor. An appeal can be filed with the local appeals office if necessary, but the costs of an appeal may outweigh the assessed tax.

### **Retain Outside Assistance**

A qualified financial advisor can help a firm avoid or survive the audit process, preferably without litigation. The IRS has an impressive record in matters that go to litigation, and involving a financial advisor early on can preclude costly litigation later.

### **Red Flag Items**

The top areas targeted by the IRS in law firm audits are:

- Accounting of client trust funds,
- Compliance with retirement plan requirements,
- Classification of employees as independent contractors,
- Memberships and other fringe benefits,
- Business and client development, for example, meals and entertainment expenses,
- Depreciation methods, and
- Unreported income and constructive receipt of income.



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