

AICPA Offers Guidance on IRS Financial Status Auditing

AICPA Tax Division,
Financial Status Audit
Working Group

EXECUTIVE SUMMARY

The IRS's aggressive new emphasis on the use of financial status audit techniques to ferret out unreported income subjects taxpayers to lifestyle and standard of living questions at the very beginning of an audit. The concern is the point at which the disclosure of such information will indicate the existence of tax fraud, necessitating that the CPA refer the case to a criminal tax attorney whose discussions with the client will be privileged. This article provides a blueprint of the steps a CPA may take in response to the IRS's use of financial status auditing techniques against his client.

Many AICPA members have expressed concern over the new "financial status" (formerly, "economic reality") audit approach being used by the IRS to probe for taxpayers' unreported income. The IRS has targeted small businesses and their owners with this new initiative. In response to many requests, a special AICPA Tax Division working group has prepared the following guidance, which applies specifically to the use of financial status auditing techniques.

Traditional IRS audits principally focus on books, records and other audit evidence directly related to the tax return and its preparation. In financial status auditing, on the other hand, there is an increased focus on unreported income at the beginning of the audit. As has always been the case, once an agent has a firm suspicion that fraud exists, the civil audit is suspended in favor of a criminal investigation. However, that suspicion is no longer based just on an audit of the tax return; rather, the agent uses indirect auditing techniques from the outset to gather information about the taxpayer or to support a suspicion of unreported income.

Financial status questions focus on a taxpayer's lifestyle, standard of living, and other elements unrelated to the specific preparation of the tax return. For example, agents are now asking taxpayers the following types of questions:

- What is your educational background?
- Where did you go on vacation? How much did you spend?
- Where do your children go to school?
- How many automobiles do you own? What are they? What is the payment?
- Do you own any large assets (over \$10,000) besides automobiles and real estate? What are they; where are they kept? Are they paid for—if not, what are the payments?
- What cash did you have on hand in 199X, personally or for business, not in a bank—at your home, safe deposit box hidden somewhere, etc.?
- What is the largest amount of cash you had at any one time in 199X?
- Do you have a safe deposit box? Where? What is kept in it?

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acknowledgment that any direct contact by the IRS will be referred to the CPA as the representative. If the client is interviewed by the IRS, he may unwittingly make statements that (especially in the context of financial status techniques) may be misinterpreted or create unnecessary problems or concerns. The right to representation is codified in Sec. 7521(c) to counter problems with the IRS during taxpayer interviews; thus, the engagement letter should include an acknowledgment that if the client decides to be interviewed by the IRS agent without the CPA's consent, the client does so at his own risk. (A sample engagement letter appears on page 221.)

2. Perform a "Pre-Audit" Evaluation

The CPA's pre-audit activity should include an evaluation of whether the client would generate significant interest to an agent performing an audit using financial status techniques. The evaluation should not include questioning the taxpayer about unreported income, as such communication is not privileged; rather, it should be based on a review of the tax return, the CPA's existing knowledge of the client's lifestyle and the adequacy of any business recordkeeping.

As set forth in the AICPA's *Statements on Responsibilities in Tax Practice* (SRTP) No. 3, *Certain Procedural Aspects of Preparing Returns* (1988 rev.), .05, the CPA (as tax return preparer) declares on the income tax return that "the information contained therein is true, correct, and complete to the best of the preparer's knowledge and belief 'based on all information of which preparer has any knowledge'." SRTP No. 3, .06, further states, "In fulfilling his or her obligation to exercise due diligence in preparing a return, the CPA ordinarily may rely on information furnished by the client unless it appears to be incorrect, incomplete, or inconsistent. Although the CPA has certain responsibilities in exercising due diligence in preparing a return, the client has ultimate responsibility for the contents of the return."

However, from a CPA's perspective, there is no duty imposed by the Code, Treasury Circular 230³ or the AICPA Code of Professional Conduct to request personal living expense and lifestyle information from the client.

If the CPA concludes that the agent should have little or no "financial status" concerns (i.e., the return and the taxpayer's lifestyle seem consistent), the CPA can draw on the guidance in this article as needed; however, the agent may never attempt to investigate the client's financial status. If, on the other hand, the evaluation leads the CPA to anticipate a strong "financial status" interest on the part of the agent, this guidance offers some important strategies in representing the client.

3. Request the IRS File

Before the initial conference with the IRS agent, or when the agent introduces financial status procedures, the CPA may want to request any information or documents accu-

mulated by the agent during the pre-audit investigation. This information should help the CPA assess the basis for the agent's decision to pursue a financial status investigation of the client. The request for information also reminds the agent that the CPA intends to closely monitor the use of financial status audit techniques. The agent should give the CPA any third-party information available, except informant information.

On Aug. 8, 1995, the Assistant Commissioner (Examination) issued a Memorandum to the Regional Chief Compliance Officers (IRS Memorandum), providing that:

Examiners are reminded that except for informant information, taxpayers and representatives should be provided with available third party information on request. If an examiner has indications of unreported income, there should be no hesitation to discuss this issue with the taxpayer or practitioner as soon as practical.

If denied, the CPA may choose to contact the agent's group manager to obtain the information.

4. Attend the Initial (and Subsequent) Interview Without the Taxpayer

At any time during the audit, the agent may request the opportunity to interview the taxpayer. The CPA should respond that the taxpayer has a statutory right to be represented under Sec. 7521(c); thus, the CPA should consider attending the initial (and subsequent) meetings without the taxpayer. If challenged, the CPA should explain to the agent that, as the taxpayer's representative, the CPA can and will obtain the needed information in a timely manner; so that there is no need for a taxpayer interview.

While agents should be aware that taxpayers have a statutory right to representation, they have recently undergone training that emphasizes the importance of taxpayer interviews. Therefore, the agent may continue to insist on interviewing the taxpayer, asserting that the CPA does not have first-hand knowledge of the information sought. Alternatively, the agent may attempt to bypass the CPA by contending that he is being uncooperative or is unable to provide the needed information. As the agent may try to contact the taxpayer directly, the client should be informed of this possibility and advised to refer the agent to the CPA as the taxpayer representative. Should the agent be uncooperative or over-aggressive in this regard, the CPA should consider contacting the agent's supervisor or group manager to resolve the issue.

5. Challenge the Reasons for Financial Status Questions

The National Office has agreed that indiscriminate use of financial status questions is inappropriate. The IRS Memorandum states:

...examiners must assess the facts and apply sound judgment

³Treasury Department Circular 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries*

and Appraisers Before the Internal Revenue Service ("Circular 230").

ment in determining the scope on a case by case basis.... We have been alerted to instances where in-depth initial interviews were routinely used to explore a taxpayer's financial situation when there was no indication of such a need. This may not be appropriate.... Examiners should ask the taxpayer only for the information actually needed for the examination of the return in question.... While we are required to do probes for unreported income, the degree of the probe is a matter of judgement [sic] which must be determined on a case by case basis.

During the interview, if financial status questions are raised, the CPA, as the taxpayer's representative, should ask the agent whether there is a suspicion that the client has unreported income and the basis for such suspicion. Financial status questions might include a request for personal living expenses (PLE).

According to the IRS:

...no specific authority exists to require the taxpayer to fill out a PLE. The taxpayer or POA [power of attorney] refusal should be documented. Examiner's options are to complete PLE based upon known expenditures or use BLS [Bureau of Labor Statistics].⁴

At this point, the challenge for the CPA is to remind the agent of the National Office's policy, perhaps causing the questions to be dropped.

If the agent responds that there is a suspicion of unreported income, the CPA should notify the client of the facts and consider recommending that legal counsel be retained because of the heightened potential for a criminal fraud investigation. The CPA may want to remind the client of the lack of CPA-client privilege before this discussion takes place. If the client elects not to retain counsel, the CPA should use professional judgment as to whether to continue with the engagement, including an evaluation of how significant the client's exposure might be. Again, the evaluation should not include questioning the client about unreported income, but should be based solely on information provided by the agent and the CPA's existing knowledge of the client.

6. React to the Agent's Persistent Questions

If the agent persists with financial status questions, the CPA should consider responding that the CPA needs to inform the taxpayer of the possible significance of the questions. Under Circular 230 Section 10.22(b), a representative must use due diligence "in determining the correctness of oral or written representations made by him to the Department of Treasury." Stating the need to check with the taxpayer does not violate this due diligence standard. The agent should be requested to put the questions in writing to the CPA.

To protect both the CPA and the client because of the lack of CPA-client privilege, the CPA should advise the agent that he may recommend that the client consider waiting for an IRS administrative summons under Sec. 7602, and that this action may lead to the retention of an attorney (see item #8 below).

The CPA might also suggest to the agent that he continue with the audit while the issue of financial status questions is being addressed, as the possible unwarranted use of financial status techniques may unduly prolong the audit. Again, at this point, the CPA's professional judgment must prevail. The CPA might conclude that no significant exposure exists and that responding to financial status questions can efficiently and effectively close the audit.

7. Refrain From Discussing Financial Status Questions

The client should be advised to review the IRS's questions—and reminded that any information the CPA obtains will not be privileged, so that the CPA could be compelled to testify against the client. Thus, if financial status questions are unavoidable, retention of an attorney experienced in criminal tax matters may best protect the client's legal rights (i.e., the privilege exists only between the attorney and the client or an accountant retained by the attorney).

Before the client reviews the IRS questions, it may be helpful for the CPA to summarize for him some of the IRS indicators of fraud. According to the IRS,⁵ suggested "badges of fraud" include: omission of specific income; omission of an entire source of income; personal expenditures and asset acquisitions in excess of reported income; the appearance that if additional years are examined, there will be a pattern of omissions; concealment of bank account; not depositing receipts to business account; deducting personal items as business expenses; refusing to make certain records available; admission of unreported income; keeping a double set of books; and repeated attempts to pay up and conclude the audit.

Finally, following the client's review of the requested information, the CPA should ask the client to inform him (or when) he believes engagement of an attorney might be in his best interests.

8. Wait for an Administrative Summons

Consider advising the client not to consent to an interview without an IRS administrative summons. If the client agrees with this recommendation, notify the IRS agent that a summons is required. Requiring the issuance of the administrative summons should force the agent to evaluate the strength of the case and how important the financial status questions are to the audit, and should curtail "fishing expeditions."

If the client rejects the advice to insist on an administrative summons and instead directs the CPA to provide the IRS with the requested answers, the CPA should use his pro-

⁴IRS National Office Economic Reality Training Module 3302-101, p. 3-11.

⁵Id., p. 5-6.