

The IRS Exam: Who Should Deal with the Revenue Agent?

IRS REPRESENTATION CONFERENCE

November 17, 2022

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Walter Pagano

- Walter Pagano is a Tax Partner and Tax Controversy Practice Leader. He has more than 35 years of diversified and relevant litigation consulting and forensic accounting experience. He has testified in federal and state courts, as well as at arbitration hearings, and has served as a federal, state, and bankruptcy court appointed forensic accountant and special fiscal agent. Walter's experience, knowledge, and expertise enable practicing attorneys and corporate counsel to rely on his objective and independent critical thinking and judgment as a source to ascertain the financial facts in a wide variety of civil and criminal cases that have included white collar crime, internal investigations, adequacy of internal controls, commercial disputes, civil and criminal tax controversy, internal and external fraud schemes, financial statement fraud, shareholder and matrimonial disputes, guardianship litigation, accounting malpractice and third-party asset misappropriation. Walter has served as an expert witness in diverse cases such as IRS practice and procedure, breach of accounting and tax representations and warranties, damage calculations, criminal tax prosecutions, and guardianship accounting.



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RICHARD J. SAPINSKI is Vice-Chair of Sills Cummins & Gross' Tax Litigation Practice Group. His practice involves white collar criminal defense on both federal and state levels and civil and criminal tax litigation, as well as international tax reporting and compliance issues. Prior to joining the Firm, Mr. Sapinski was employed by the Office of the District Counsel, Internal Revenue Service, Newark, New Jersey as a trial attorney from 1977 to 1984 and later with the Office of the Regional Counsel Internal Revenue Service, Philadelphia, Pennsylvania, as a Special Trial Attorney from 1985 to 1987. In the latter position, Mr. Sapinski was assigned responsibility for litigating in the United States Tax Court on behalf of the Commissioner of Internal Revenue in large and sensitive cases and for assisting IRS international examiners in developing international tax issues for litigation. He litigates matters in the United States District Court, U.S. Tax Court and the Superior Court and Tax Court of New Jersey and the Federal and State Appellate Courts. He also represents professionals before disciplinary and licensing boards and handles administrative matters involving the Examination, Collection and Criminal Investigation divisions of the Internal Revenue Service and their state counterparts. Mr. Sapinski has been selected for inclusion in the 2011-2020 editions of The Best Lawyers in America® published by Woodard/White under Criminal Defense: White-Collar and the 2016-2019 editions of Chambers USA® published by Chambers & Partners under New Jersey Litigation: White Collar.



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Sara Spodick

- Sara V. Spodick is the Director of the Quinnipiac University School of Law Tax Clinic. The Tax Clinic provides pro-bono representation of individuals with controversies with the Internal Revenue Service and the Connecticut Department of Revenue Services. Prior to joining the law school faculty in 2004, Spodick primarily engaged in tax law in the private practice setting. A fellow of the American College of Tax Counsel, her areas of interest include Internal Revenue Service operations, taxation of individuals, and tax policy. Spodick is admitted to practice in the states of Connecticut and New York, United States Tax Court, United States District Court of Connecticut, and the Second Circuit Court of Appeals. She is a member of the American Bar Association Section of Taxation and the Connecticut Bar Association.



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Your Client is being audited: Now what?

- The object of every examination by the auditor is to determine whether the tax return accurately reflects income, expenses, assets and liabilities of the taxpayer who filed it.
- What causes the return to be selected for audit: DIF Scoring; LQU change; national research project; spillover audit; judicial referrals; disgruntled employees or spouses; whistleblowers.

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How to Prepare for the Exam:

- Determine whether there are adjustments to be made from incorrect reporting or omissions including failed international form disclosures
- The level of scrutiny is based on the auditor's risk assessment of the taxpayer and the return. The more indications of inaccuracy the more probing the audit is likely to be.

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Routine vs. NonRoutine Audit

- A Routine Audit generally focuses on adjustments that are not large and recurring and are due to poor recordkeeping, mistake or ignorance and does not result in the imposition of a fraud penalty or criminal referral.
- A Nonroutine Audit occurs where an auditor may conclude that there has been fraudulent and/or criminal activity involving domestic and/or international issues.

Practitioners need to determine before the audit gets underway what issues are of concern and if the client should consult with counsel. This determination may change as the audit gets underway and issues come to light which suggest that the auditor suspects that the taxpayer has done something to intentionally cause the return to reflect lower tax or omit a disclosure.

The question then becomes how to proceed from that point knowing that the auditor may suspect potential fraudulent activity.

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Sample Kovel Letter

Dear Accountant:

This will confirm the arrangement agreed to between us on or about August 2, 2019, whereby you agreed to undertake work for us along the lines specified below.

In connection with the contemplated engagement of our firm to render legal services to Mr. A, we have express authority to retain an accountant who shall work under our direction and report directly to us. This work contemplates service of a character and quality which would be necessarily adjunct to our services as lawyers. You are authorized to bill us for your services and we, in turn, will bill the client for such services. However, we shall not be responsible for payment of your bills unless and until our bills for your services are paid by the client.

In connection with said employment, **all communications between you and Mr. A, as well as communications between you and any attorney, agent or employee acting on his behalf, shall be regarded as confidential** and made solely for the purpose of assisting counsel in giving legal advice to Mr. A. You will not disclose to anyone, without our written permission, the nature or content of any oral or written communication, nor any information gained from the inspection of any record or document submitted to you, including information obtained from corporate records or documents; and you will not permit inspection of any papers or documents without our permission in advance.

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Sample Kovel Letter (continued)

All workpapers, records or other documents, regardless of their nature and the source from which they emanate, shall be held by you solely for our convenience and subject to our unqualified right to instruct you with respect to possession and control. Workpapers prepared by you or under your direction belong to this law firm. If we request that you deliver your workpapers to us, we agree that we will retain the papers and make them available to you as you may reasonably require.

As part of the agreement to provide accounting services in this matter, you will immediately notify this law firm of the happening of any one of the following events: (a) the exhibition or surrender of any documents or records prepared by or submitted to you or someone under your direction, in a manner not expressly authorized by this law firm; (b) a request by anyone to examine, inspect or copy such documents or records; (c) any attempt to serve, or the actual service of any court order, subpoena or summons upon you which requires the production of any such documents or records. You will immediately return all documents, records and workpapers to us at our request.

Thank you very much for your attention. We look forward to working with you.

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26 U.S. Code § 7525 - Confidentiality privileges relating to taxpayer communications

- **(a) UNIFORM APPLICATION TO TAXPAYER COMMUNICATIONS WITH FEDERALLY AUTHORIZED PRACTITIONERS (1) GENERAL RULE** With respect to [tax advice](#), the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any [federally authorized tax practitioner](#) to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.
- **(2) LIMITATIONS** Paragraph (1) may only be asserted in—**(A)** any noncriminal tax matter before the Internal Revenue Service; and
(B) any noncriminal tax proceeding in Federal court brought by or against the United States.
- **(3) DEFINITIONS** For purposes of this subsection—**(A) Federally authorized tax practitioner** The term "[federally authorized tax practitioner](#)" means any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under [section 330 of title 31](#), United States Code.
(B) Tax advice The term "[tax advice](#)" means advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice described in subparagraph (A).
- **(b) SECTION NOT TO APPLY TO COMMUNICATIONS REGARDING TAX SHELTERS** The privilege under subsection (a) shall not apply to any written communication which is—**(1)** between a [federally authorized tax practitioner](#) and—**(A)** any person,
(B) any director, officer, employee, agent, or representative of the person, or
(C) any other person holding a capital or profits interest in the person, and
(2) in connection with the promotion of the direct or indirect participation of the person in any tax shelter (as defined in [section 6662\(d\)\(2\)\(C\)\(iii\)](#)).

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26 U.S. Code § 6694 - Understatement of taxpayer's liability by tax return preparer

- **(a) UNDERSTATEMENT DUE TO UNREASONABLE POSITIONS (1) IN GENERAL** If a [tax return](#) preparer—**(A)** prepares any [return](#) or claim of refund with respect to which any part of an [understatement of liability](#) is due to a position described in paragraph (2), and
(B) knew (or reasonably should have known) of the position,
such [tax return](#) preparer shall pay a penalty with respect to each such [return](#) or claim in an amount equal to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the [tax return](#) preparer with respect to the [return](#) or claim.
- **(2) UNREASONABLE POSITION (A) In general** Except as otherwise provided in this paragraph, a position is described in this paragraph unless there is or was substantial authority for the position.
(B) Disclosed positions If the position was disclosed as provided in section 6662(d)(2)(B)(ii)(I) and is not a position to which subparagraph (C) applies, the position is described in this paragraph unless there is a reasonable basis for the position.
(C) Tax shelters and reportable transactions If the position is with respect to a [tax shelter](#) (as defined in [section 6662\(d\)\(2\)\(C\)\(ii\)](#)) or a reportable transaction to which section 6662A applies, the position is described in this paragraph unless it is reasonable to believe that the position would more likely than not be sustained on its merits.
- **(3) REASONABLE CAUSE EXCEPTION** No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the [tax return](#) preparer acted in good faith.

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26 U.S. Code § 6694 - Understatement of taxpayer's liability by tax return preparer (continued)

- **(b) UNDERSTATEMENT DUE TO WILLFUL OR RECKLESS CONDUCT (1) IN GENERAL** Any [tax return](#) preparer who prepares any [return](#) or [claim for refund](#) with respect to which any part of an [understatement of liability](#) is due to a conduct described in paragraph (2) shall pay a penalty with respect to each such [return](#) or claim in an amount equal to the greater of
 - **(A)** \$5,000, or
 - **(B)** 75 percent of the income derived (or to be derived) by the [tax return](#) preparer with respect to the [return](#) or claim.
- **(2) WILLFUL OR RECKLESS CONDUCT** Conduct described in this paragraph is conduct by the [tax return](#) preparer which is—**(A)** a willful attempt in any manner to understate the liability for [tax](#) on the [return](#) or claim, or
 - **(B)** a reckless or intentional disregard of rules or regulations.
- **(3) REDUCTION IN PENALTY** The amount of any penalty payable by any [person](#) by reason of this subsection for any [return](#) or [claim for refund](#) shall be reduced by the amount of the penalty paid by such [person](#) by reason of subsection (a).

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26 U.S. Code § 6694 - Understatement of taxpayer's liability by tax return preparer (continued)

- **(c) EXTENSION OF PERIOD OF COLLECTION WHERE PREPARER PAYS 15 PERCENT OF PENALTY (1) IN GENERAL** If, within 30 days after the day on which notice and demand of any penalty under subsection (a) or (b) is made against any [person](#) who is a [tax return](#) preparer, such [person](#) pays an amount which is not less than 15 percent of the amount of such penalty and files a [claim for refund](#) of the amount so paid, no levy or proceeding in court for the collection of the remainder of such penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as provided in paragraph (2). Notwithstanding the provisions of section 7421(a), the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court. Nothing in this paragraph shall be construed to prohibit any counterclaim for the remainder of such penalty in a proceeding begun as provided in paragraph (2).
- **(2) PREPARER MUST BRING SUIT IN DISTRICT COURT TO DETERMINE HIS LIABILITY FOR PENALTY** If, within 30 days after the day on which his [claim for refund](#) of any partial payment of any penalty under subsection (a) or (b) is denied (or, if earlier, within 30 days after the expiration of 6 months after the day on which he filed the [claim for refund](#)), the [tax return](#) preparer fails to begin a proceeding in the appropriate United States district court for the determination of his liability for such penalty, paragraph (1) shall cease to apply with respect to such penalty, effective on the day following the close of the applicable 30-day period referred to in this paragraph.
- **(3) SUSPENSION OF RUNNING OF PERIOD OF LIMITATIONS ON COLLECTION** The running of the period of limitations provided in [section 6502](#) on the collection by levy or by a proceeding in court in respect of any penalty described in paragraph (1) shall be suspended for the period during which the Secretary is prohibited from collecting by levy or a proceeding in court.
- **(d) ABATEMENT OF PENALTY WHERE TAXPAYER'S LIABILITY NOT UNDERSTATED** If at any time there is a final administrative determination or a final judicial decision that there was no [understatement of liability](#) in the case of any [return](#) or [claim for refund](#) with respect to which a penalty under subsection (a) or (b) has been assessed, such assessment shall be abated, and if any portion of such penalty has been paid the amount so paid shall be refunded to the [person](#) who made such payment as an overpayment of [tax](#) without regard to any period of limitations which, but for this subsection, would apply to the making of such refund.
- **(e) UNDERSTATEMENT OF LIABILITY DEFINED** For purposes of this section, the term "[understatement of liability](#)" means any understatement of the net amount payable with respect to any [tax](#) imposed by this title or any overstatement of the net amount creditable or refundable with respect to any such [tax](#). Except as otherwise provided in subsection (d), the determination of whether or not there is an [understatement of liability](#) shall be made without regard to any administrative or judicial action involving the taxpayer.
- **(f) CROSS REFERENCE** For definition of [tax return](#) preparer, see section 7701(a)(36).

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Circular 230:

Circular 230 regulates the professional responsibility obligations of a practitioner when practicing before the IRS.

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§ 10.20 Information to be furnished

(a) To the Internal Revenue Service

(1) A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

(2) Where the requested records or information are not in the possession of, or subject to the control of, the practitioner or the practitioner's client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information. The practitioner must make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons.

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§ 10.20 Information to be furnished (cont.)

(3) When a proper and lawful request is made by a duly authorized officer or employee of the Internal Revenue Service, concerning an inquiry into an alleged violation of the regulations in this part, a practitioner must provide any information the practitioner has concerning the alleged violation and testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.

(b) Interference with a proper and lawful request for records or information. A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

(c) Effective/applicability date. This section is applicable beginning August 2, 2011.

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§ 10.21 Knowledge of client's omission.

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

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§ 10.22 Diligence as to accuracy.

(a) In general. A practitioner must exercise due diligence —

(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

(3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

(b) Reliance on others. Except as modified by §§10.34 and 10.37, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

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§ 10.34 - Standards with respect to tax returns and documents, affidavits and other papers.

- **§ 10.34 Standards with respect to [tax returns](#) and documents, affidavits and other papers.**
- **(a) Tax returns.**
- **(1)** A practitioner may not willfully, recklessly, or through gross incompetence -
- **(i)** Sign a [tax return](#) or claim for refund that the practitioner knows or reasonably should know contains a position that -
- **(A)** Lacks a reasonable basis;
- **(B)** Is an unreasonable position as described in section 6694(a)(2) of the [Internal Revenue code](#) (Code) (including the related regulations and other published guidance); or
- **(C)** Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).
- **(ii)** Advise a client to take a position on a [tax return](#) or claim for refund, or prepare a portion off a [tax return](#) or claim for refund containing a position, that -
- **(A)** Lacks a reasonable basis;
- **(B)** Is an unreasonable position as described in section 6694(a)(2) of the Code (including the related regulations and other published guidance); or
- **(C)** Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).
- **(2)** A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence.

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31 CFR § 10.34 - Standards with respect to tax returns and documents, affidavits and other papers. (continued)

(b) Documents, affidavits and other papers.

(1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

(2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service -

(i) The purpose of which is to delay or impede the administration of the Federal tax laws;

(ii) That is frivolous; or

(iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

(c) Advising clients on potential penalties.

(1) A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to -

(i) A position taken on a [tax return](#) if -

(A) The practitioner advised the client with respect to the position; or

(B) The practitioner prepared or signed the [tax return](#); and

(ii) Any document, affidavit or other paper submitted to the Internal Revenue Service.

(2) The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

(3) This paragraph (c) applies even if the practitioner is not subject to a penalty under the [Internal Revenue Code](#) with respect to the position or with respect to the document, affidavit or other paper submitted. 21

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31 CFR § 10.34 - Standards with respect to tax returns and documents, affidavits and other papers. (continued)

(d) Relying on information furnished by clients. A practitioner advising a client to take a position on a [tax return](#), document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a [tax return](#) as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

(e) Effective/applicability date. [Paragraph \(a\)](#) of this section is applicable for returns or claims for refund filed, or advice provided, beginning August 2, 2011. Paragraphs (b) through (d) of this section are applicable to tax returns, documents, affidavits, and other papers filed on or after September 26, 2007.

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Fifth Amendment

- An individual has a Fifth Amendment right against self-incrimination.
- An entity does not have a Fifth Amendment right because it is a personal right.
- An individual compelled to produce documents on behalf of an entity may have a limited act of production Fifth Amendment right in so far as the very act of producing the documents incriminates the individual.

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Hypothetical

- F is an individual who owns and operates a chain of grocery stores primarily serving immigrant inner city communities. There are multiple stores, each at a separate location also owned by F. The stores and the properties are each held by separate S corporations in which F is 100% owner.
- TNG is an accounting firm which prepares the tax returns for all the entities and for F. Mr. S is the engagement partner who signs all the returns for F and his companies. Mr. S is an audit partner at TNG. Mr. K is a partner at TNG who handles IRS controversy matters.
- All of the entities operate from a central office where F and M, his CFO, work along with other personnel with various duties involving either the operation of the stores or the real estate.
- The sales at the various stores (consisting of cash, credit/debit card charges and checks) are recorded at the store location daily and the information (and the daily receipts) are sent to the central office where the CFO records the information for each store into that entity's general ledger on a weekly basis.
- A portion of the cash received from each of the stores shown on that store's daily tally was used to pay cash payroll to employees in that store (there was also a unionization dispute going on at this time for all the stores and the cash employees were not part of the unionized staff). The remainder of the cash was deposited to F's personal accounts often in under \$10,000 amounts and a portion was used to build a large house for his family in New York City and to establish a large grocery store and related shopping/residential property in F's native country. Only a small part of the cash received daily by each store is booked into the store's general ledger by M.
- Approximately 50% of the cash F deposited to his personal accounts was used to write checks to the real estate entities and, at times, to the store entities for cash flow needs or building

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Hypothetical (continued)

renovations. The CFO recorded those payments as loans to the particular entity. The entities also paid expenses for other sister entities, which were also recorded as loans between the two entities in the books of each but were netted and grouped with F's loan transactions on the Shareholder Loan line on the balance sheets on each entity, with the result that the "Loan to Shareholder" and "Loan from Shareholder" entities were net numbers 90% or more smaller than would be shown if the actual transactions to/from each entity and F were shown separately. TNG personnel were aware of the CFO's practice netting the loan amounts and wrote an internal memo about the potential adverse tax consequences of this practice, which they shared with F and the CFO.

- F did not file FBARS or Forms 926 or 5471 relating to the money sent to fund his foreign investment project.
- IRS issued an audit letter proposing to examine the 2019 Form 1120S of X Corp., one of the grocery store entities and assigned the audit to an agent in New Jersey rather than in New York (where the stores were based and F resides) because TNG has offices in New Jersey and Mr. Sand Mr. K did not feel the audit should be conducted at the companies' office in New York and requested a transfer by claiming there was no private space at the store to use to conduct the audit there.
- However, the New Jersey agent that was assigned was someone Mr. K knew from prior experience as a SEP agent. You are a tax controversy lawyer Mr. K knows. Mr. K calls you and asks you to assist him in the examination.
- Mr. K is unaware of the cash underreporting but has learned of the netting of loan transactions and of the memo TNG wrote. The agent has become aware of the TNG memo and that TNG relied on it in preparing the return under audit and has asked for a copy.

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Hypothetical Questions:

1. Who should represent X Corp. in the audit and interact with the agent? Mr. S? Mr. K? You?
2. What concerns are there in having Mr. K work with you under a Kovel engagement with TNG in this matter? How should any arrangement be structured?
3. Is the TNG memo privileged under IRC §7525? Does it have to be turned over?
4. If Mr. K is going to be the contact person for the agent, should he be Koveled? What are the pros/cons?
5. During the audit the agent asks for a tracing of the store's daily receipts from the customer's payment for groceries at the register, through the general ledger and onto the entity's tax return. How do you advise the client to respond to this request? Why?

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