

## You Received an Audit Letter - Now What?

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ONE OF THE SINGLE BIGGEST WORRIES that business owners—especially construction companies—face is receiving the dreaded letter from the IRS or State taxing authorities stating that your firm has been selected for an audit. This is an increasingly prevalent situation. Consider these statistics: the number of IRS audited S-corporations jumped 34% from 2005, the highest level since 2000 (CNN Money, Nov 2006); the IRS Audits of partnerships rose 15% from 2005 (CNN Money, Nov 2006). S-corps and partnerships are among the most common business structures for subcontractors.

What do you do if your company receives the dreaded “You’ve been selected for an audit” letter? Do you need professional representation? What should you do to prevent/minimize your exposure? There has been a steady growth of audits in the construction industry.

After you receive an audit letter and you pick yourself off the floor (from passing out), take a deep breath, roll up your sleeves and then get to work. If you attempt to avoid the issue and dodge the auditor, you will create a more difficult situation. The first step is for you or your representative to contact the auditor immediately after receiving the letter. Acknowledge the receipt of the letter and ask for additional time to properly prepare.

Communication is essential to the process and preparation is vital. The better you prepare for an audit, the better the end

result. Do you need professional representation? To best protect yourself and mitigate your risks, the answer in most cases is yes. A professional audit representative will have years of experience handling audits. He or she will know what the auditor is looking for, what to show and more importantly what NOT to show, where to push and where to pull. This will avoid the possibility of inadvertently volunteering additional information you do not want to disclose. He or she may also have had dealings with the particular auditor on your case; this can help later on.

### The Audit Process

There are three basic phases to the audit process:

#### Phase 1: Preparation

Before meeting with an auditor you must prepare your case. The following items are needed:

1. All correspondence, notices, and reports from the Government or State Agency to your business;
2. Tax returns for the requested audit years PLUS two years preceding and two years subsequent;
3. Ancillary documentation such as receipts, books and records.

Government or State Agency correspondence enables you to spot the important issues facing your audit. The examiner will have looked at the tax returns in question, as well as the two prior years. To avoid surprises, you should do the same. Prior correspondence can be useful in convincing the auditor to abate penalties—a history of compliance is definitely a plus.

The advantage of reviewing your documents prior to an audit is that it enables you to locate any holes or potential exposure items in your records. Prior Audit Reports, Revenue Agent Reports, Tax Returns, Information Document Requests and Notices of Deficiency can contain essential information which you should inspect meticulously. Among

the documents you should have ready for the audit are:

- Information Document Requests;
- Notices of Proposed Adjustments;
- Agent work papers (near the end of the audit);
- Audit letters, Audit Reports or Revenue Agent Reports;
- Any relevant audit guidelines;
- Income Transcripts for all years involved.

#### Phase 2: Pre-Audit Review

Once your preparation is done, one primary goal is to find out what the Auditor is looking for. This is the Pre-Audit stage. Why was your company chosen for audit? Comparing prior year returns to the audited years can help identify unusually high figures or numbers that seem out of place. Explain these numbers—the auditor will definitely ask for an explanation of the variances. This will help you prepare more effectively and will save time and hard-earned money in the long run.

After identifying the likely audit issues, it is advisable to research tax law that corresponds to your specific issues. Is there a precedent to explain why there was such a large variance? If so, having case law that explains your position is always worthwhile. The IRS, and more specifically, the IRC Regulations are an excellent starting place. These sources can be used to identify leading cases and pronouncements which discuss your issues and can be used to defend your position.

#### Phase 3: The Audit

The last stage is the actual audit. Where should you have the audit take place? Auditors would like the audit to be at your place of business. They want to be able to look around, talk to people at your business and look for indications of unreported income. If at all possible, keep the audit away from your place of business. Any-

thing the auditor finds can lead to additional exposure. When working with a professional audit representative, they will most likely request the audit be held away from your office—at their office or at the auditor’s office.

How you proceed in the audit is extremely important. Your role is to provide the necessary information to the auditor to facilitate a smooth and non-confrontational meeting. This may seem obvious, but remember not to be confrontational with the auditors or be rude to them in any way. You should conduct yourself in a relaxed way, passively responding to questions without disclosing any information beyond what is asked of you.

If the Auditor trusts you and believes you are competent in tax issues, he or she is more likely to settle issues in a mutually agreeable manner. Facts should be carefully and honestly stated. Misrepresentations seriously jeopardize the audit and shed a negative light on you and your company. If you don’t know an answer to a specific inquiry, state that you will find the answer. Competence can be demonstrated by appropriate discussions of the legal and account requirements of the tax laws (referring back to your case law research).

Audits can be difficult and should never be taken lightly. An incorrect or lazily handled audit can cost your company tens of thousands of dollars in taxes and penalties for each year you are audited. If you haven’t gone through an audit, or don’t feel overly comfortable representing yourself, find a qualified audit representative—one that has experience successfully defending clients against the IRS and State taxing agencies. Most of all, communicate regularly with your auditor (and representative if you have one), prepare well, and maintain good record keeping. If you follow these steps, it is not guaranteed it will be a pleasant experience, but it should not be a tremendous burden and will most likely end with a more favorable outcome.

David Albrecht, MBA, EA, is a Tax Supervisor at Grassi & Co. CPAs & Success Consultants in Lake Success, NY, with more than sixteen years of financial and tax advisory experience. He specializes in representing clients with audit issues before State, Local and Federal taxing authorities and has worked with clients in a range of industries including Construction, Real Estate, Healthcare, Professional Services, Manufacturing and Distribution.