

## **How to Handle an IRS Audit**

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Excessive business deductions by owners and breeders of horses, livestock or general farmers--or in other businesses activities--can be a red flag that triggers IRS audits. The IRS Restructuring Act of 1998 shifted the “burden of proof” away from the taxpayer, so that the IRS has the burden of showing that your deductions are not “ordinary and reasonable”. At the same time, if you are audited in connection with a horse activity, the IRS takes the position that you have the burden of proof on the question of whether the activity is a business or a hobby unless you have two profit years in a seven-year period. If audited, it’s crucial to have documentary evidence not only to substantiate the deductions, but to show how they relate to your horse activity, and how your activity is conducted in a businesslike manner.

There are several practical points that one should observe in connection with an audit of any kind:

1. The best strategy in facing an audit is first to find out what the IRS agent is looking for prior to formally participating in the audit. This allows you or your representative to do homework on applicable law and IRS procedures beforehand.
2. You should not personally attend the audit, but instead delegate that duty to a representative (an attorney or qualified tax representative) because it is an adversarial proceeding and often the less you say, the better.
3. If the amount of money at stake is considerable, you should hire a tax attorney to represent you.
4. You should review the strength of your business records with your representative to insure they are organized in the best possible manner. If your business is owned by a corporation or LLC entity, the Corporate Minute Book should be reviewed to make sure it is updated. If you take deductions for business travel or entertainment expenses, you should make sure you are able to show how these comply with IRS Regulations.
5. At the audit your representative should provide only those documents specifically requested. Your representative should be experienced enough to sense what the agents thinking is on various issues.
6. In tax planning for the future, particularly if your deductions are significant, you should obtain a tax opinion letter from a tax attorney to support that your operations are consistent with IRS Regulations. A tax opinion letter serves an important evidentiary function to show that you are in compliance with IRS regulations according to the opinion of an expert. It can be very helpful in the event you are ever audited because the Tax Court looks favorably on taxpayers who take their business deductions seriously enough to seek out expert advice.
7. If the IRS agent asks you to “waive” the statute of limitations, don’t do it. There is no benefit to you in giving the IRS more time or opening up further opportunities for them to make a fishing expedition out of your tax returns. If you waive the statute of limitations the IRS agent can work on your case for an extended period of time, and easily extend your audit into more tax returns.
8. If you are denied the deductions and issued a 30-day letter, don’t be discouraged. You have the right to go to Tax Court or to IRS Appeals. In order to proceed to Tax Court you have to await issuance of a “deficiency notice”, giving you 90 days in which to

take action.

9. In Tax Court you have a better chance of your lawyer negotiating a settlement, provided you can provide significant evidence of the businesslike manner in which you conduct the venture. The Tax Court has an entirely different philosophy than IRS revenue agents, and if you have a good case you can end up with a fair outcome. Taxpayers who succeed at the audit phase are those who have had the best tax planning early on. That is usually the case with people who obtain a formal tax opinion letter from an attorney, because that is one of the best ways of establishing evidence that your activity is conducted in a businesslike manner vis-à-vis IRS regulations.