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First Steps in Responding to Tax Audit Notices

by Michael P. Duffy, Esq. | 508-459-8043 | mduffy@fletchertilton.com

One of the most frightening letters a person can get from the government is a notice that their taxes are going to be audited. But even though an audit can be an exhausting experience and result in real financial pain, taxpayers can implement basic strategies to improve outcomes in almost all circumstances.

STONEWALLING IS A LOSING STRATEGY

One common response to receiving an initial audit notice is for the taxpayer to simply ignore the request for information. In other cases, the taxpayer may forward the notice to their return preparer or accountant, who initially reaches out to the IRS, but then drops out of communication when problems are discovered with the underlying return.

In most audits, the odds are stacked against the taxpayer. Taxpayers have the burden to show that the deductions and credits taken on their returns are valid, which often means coming up with receipts and supporting documentation. A taxpayer will also have the burden to rebut or explain items of apparent income reported to the IRS by third parties.

For these reasons, stonewalling is rarely an effective strategy. For example, an auditor who does not receive anything from the taxpayer to substantiate travel expenses has the authority to simply disallow the entire line item. Although a taxpayer may be aware there are problems with the amount of travel expenses they actually deducted on their return, by not actively engaging with the auditor they substitute a known quantity of exposure for the auditor's worst-case scenario.

In instances when the IRS may not have a complete picture to make an assessment, taxpayers may attempt to stonewall on the basis that they don't have an obligation to provide anything to the IRS from a Fifth Amendment perspective. Stonewalling from an evidentiary standpoint is usually a losing proposition in tax cases. The Fifth Amendment almost never protects business and financial records used to compute a taxpayer's liability from discovery. This is because the documents themselves are very rarely considered Fifth Amendment protected testimonial statements. Further, a taxpayer's failure to cooperate may motivate the auditor to reach out to third parties and obtain the same records in another manner.

COOPERATING OPENS UP OPPORTUNITIES

It is always advisable at the outset to cooperate with an auditor by acknowledging calls and written correspondence, and then negotiating a timeline for responding to information requests. Establishing this baseline rapport creates opportunities for negotiations at a later date.

Being able to keep the lines of communication open is key. For example, under something called the Cohan rule, a taxpayer can overcome missing documentation by coming up with reasonably reliable estimates to support the premise that some portion of deductible business expenses must have been incurred. Inherently, using the Cohan rule is a persuasive exercise; the taxpayer needs to be in a position where they can demonstrate their representations are accurate and truthful in order to get the auditor to agree with the proposal. This is simply not possible if the relationship is completely adversarial.

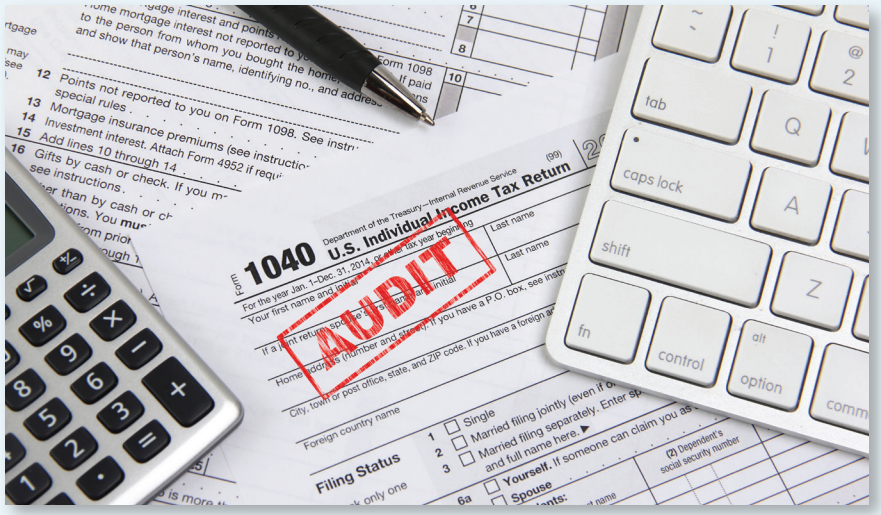
Cooperating does not mean agreeing with the auditor or rolling over on every contested issue. Taxpayers do not have an affirmative obligation to disclose noncompliance, and frequently it is not in their interests to give up more information than is absolutely necessary to respond to specific information requests. Furthermore, a taxpayer should never respond to auditors with false or misleading information, as this exposes them to increased civil penalties and potential criminal tax liability. On the other hand, a taxpayer may want to make a voluntary disclosure in certain circumstances to prevent an inquiry from spiraling out of control and leading to more serious charges. This is often advisable if the discovery of damaging information by the government is inevitable.

STRATEGY IS KEY

The hard part for many taxpayers is not knowing what strategy to employ, and whom to turn to for help. Taxpayers frequently will reach out to their return preparers for assistance in responding to audit requests. Oftentimes, a return preparer will be the party best suited to know the ins and outs of the taxpayer's return. In other cases, however, the return preparer may have simply been engaged to type numbers from forms and documents provided by the client into tax prep software. In the latter case, engaging that same preparer to assist with the audit will not add value because they will not have the requisite level of knowledge to be able to explain the numbers as they relate to the taxpayer's actual business.

Where taxpayers are under audit and there is concern that there could be a significant assessment for any reason, it is advisable that they seek competent legal counsel immediately. Although accountants and CPAs may have the technical skills to handle most complex tax matters, communications with these professionals concerning many routine disputes are not protected by any sort of accountant-client privilege. In my professional experience, this distinction can and does block frank communications between the taxpayer and their service providers in a way that does not happen when an attorney is retained.

Hiring tax counsel does not foreclose using an accountant, either. Counsel has the option of retaining accountants with respect to client matters through something called a Kovel arrangement. Because the accountant retained under the Kovel arrangement is an agent of the attorney and not an agent of the client, communications may be made between the client, accountant, and counsel without the loss of attorney-client privilege.



The right strategy also takes into consideration the taxpayer's ability to deal with the aftermath of a potential assessment, including whether penalties may be negotiated down. Sometimes fighting a proposed assessment may not be worthwhile at all when the taxpayer is insolvent or is no longer able to generate significant income due to disability or other hardships. A taxpayer's resources in these cases may be better spent dealing with the matter from a collections standpoint. Although the taxpayer may legally owe a significant amount of money, the ability of the IRS to actually collect from the taxpayer is not unlimited. Bankruptcy may alternatively be a viable option to discharge income tax debt, although the rules for discharging this type of liability are complicated. We always advise that taxpayers considering bankruptcy seek an individual with expertise in both bankruptcy and tax matters.

Taxpayers need to be cognizant when they are selected for audit as to what their real risks are and act accordingly

CLOSING

Taxpayers need to be cognizant when they are selected for audit as to what their real risks are and act accordingly. Typically, when an initial information and document request is received, the taxpayer should have some idea as to what areas the IRS wants to focus its examination on. This can be total gross receipts, particular expense types, particular transactions, or other discrete items reported – or not reported – on a tax return. This is the ideal point where the taxpayer needs to commit to some sort of strategy. If they know scrutiny could reveal significant compliance problems, they should reach out to counsel first in developing an appropriate response. **FT**

Sales Tax Problems can Kill a Small Business

by Michael P. Duffy, Esq. | 508-459-8043 | mduffy@fletchertilton.com

For a small business, one of the easiest ways to run into serious tax trouble is to not properly withhold and remit sales tax. There are multiple reasons that this tends to happen, but once a business falls behind, it is typically much harder to catch up than with income tax liability.

Below is an overview of how and why most small businesses run into sales tax trouble. I also discuss best practices for preventing sales tax liability from killing your business.

GROSS, NOT NET

The Commonwealth of Massachusetts requires retail sellers to collect from customers a sales tax equal to 6.25% of the purchase price of goods. The main reason sales tax issues tend to spiral out of control is that the liability is based on the gross amount of sales rather than the net amount of profits after expenses. This is in contrast to income tax liability, which is created only when business activity results in an economic profit. Consequently, even a money-losing business can generate a lot of sales tax liability.

Sales tax is actually the legal liability of the buyer. However, the laws in Massachusetts and most other states require that a retail seller withhold sales tax at the point of purchase and then remit the tax to the government. If a seller fails to properly withhold sales tax from the customer, the government reserves the right to hold the seller primarily liable. As such, inattentive sellers can easily become liable for taxes that should have been the responsibility of their customers.

NOT JUST SALES OF GOODS

Classically, sales tax is due when there is a retail sale of goods in the ordinary course of business . Although this seems like a straightforward concept, it can be difficult to implement in some real-world situations. For example, a particular invoice may include charges for the sale of goods, but also add separate charges for installation, shipping, or tech support. The tax treatment of these add-on line items can vary from state to state and can even depend on how invoices are drafted in some cases.

Trends have also made the general rule increasingly irrelevant; over the past twenty years many states have expanded their definitions of a taxable sale in order to cover a wider variety of transactions. Accordingly, states now collectively tax a variety of service transactions, like the sale of prepared meals, the use of tanning beds, haircuts, downloads of software, and media streaming services. The meals tax, in particular, can result in a significant liability for Massachusetts-based restaurants.

SERIOUS PENALTIES

The fact that sales tax liability will in many cases fall back onto the seller if there is a mistake means sellers need to be extra careful in determining whether their business is in compliance. Penalties of 20% or more can be assessed for negligence or serious errors. State revenue authorities, and specifically the Massachusetts Department of Revenue, impose additional aggravated penalties on retail sellers that collect sales tax from customers and then fail to remit the amounts collected to the government. Failure to remit taxes collected is a frequent fact pattern in businesses that are struggling; they view the custody of the state's funds as a source of immediate liquidity that is available to deal with emergencies. Although conceptually this is a fairly easy "loan" to take, it can prove very difficult to repay if 20%, 100%, or 120% penalties and interest are later assessed on the amount borrowed. Because of the potential exposure, small businesses should ensure procedures are in place to both properly compute their sales tax liability, and also pay over whatever is collected on a timely basis.

Legal entities that are taxed as pass-throughs for income tax purposes – such as LLCs or partnerships – are considered primary taxpayers for sales tax purposes. This means any sales tax liability for business transactions conducted by an LLC is the legal responsibility of the LLC and not of the individual owners. In many cases, though, this legal distinction does not offer much protection for individuals actively involved in the management of their businesses.

Where there is serious underpayment of sales tax, a state will go after owners, managers, and staff who are in control of company assets in a personal capacity in order to collect unpaid sales tax and penalties. The state may even pursue multiple parties for the same liability at the same time until the tax is ultimately paid. For this reason, any person in a financial management role who is working for a business that is not in compliance with its sales tax liability should seriously consider their personal exposure in evaluating their position with the company.

The state may even pursue multiple parties for the same liability at the same time until the tax is ultimately paid.

PREVENTING HARM

Because the amount of liability is based on gross sales, sales tax problems for businesses with narrow operating margins tend to be serious. This is especially the case for Massachusetts-based restaurants that are required to withhold and pay the meals tax.

Professionals familiar with sales tax reporting obligations can add tremendous value in protecting small businesses. Often, this means developing the proper strategy to deal with noncompliance prior to an audit or putting together a coherent audit response designed to limit personal liability. If you believe your business may not be in compliance with its sales tax responsibilities, it is advisable that you reach out to a professional as soon as possible for advice. **FT**

Professional Liability
An Introduction to Causes of Action

by Michael E. Brangwynne, Esq. | 617-336-2281 | mbrangwynne@fletchertilton.com

This is the fifth article in a series on the circumstances that can give rise to a civil lawsuit. Earlier articles in the series can be found on Fletcher Tilton's website under ARTICLES.

MALPRACTICE, GENERALLY SPEAKING

In the most recent past installment of this series, we discussed the negligence cause of action, which requires proof (1) that the potential defendant in a civil action owed the plaintiff a duty of care, (2) that the defendant breached that duty by failing to act in a reasonable, careful manner, (3) that the defendant's violation of his or her duty of care caused the plaintiff harm, and (4) that damages were sustained.

A cause of action for professional malpractice is simply the extension of these principles of negligence to individuals who are serving their clients in a professional capacity. While the term "malpractice" is most often associated with professionals in the medical field, all professionals owe to their clients a duty to perform their professional services in a reasonable and careful manner.

The standard of care – or the duty that is owed by professionals to their clients or patients – is the ordinary and reasonable care usually exercised by someone in a particular profession, performing the same type of service, under similar circumstances. This standard applies not only to doctors, but also to lawyers, accountants, architects, engineers and others providing specialized services. Because technology and accepted best practices in a profession are constantly evolving, the standard of care is constantly changing.

If a professional's conduct falls below the applicable standard of care, he or she may be subject to a claim for malpractice. Unlike a claim for common negligence, it will often be necessary for the plaintiff to obtain an expert opinion on whether there was a violation of the professional standard of care. Because the professional defendant is applying knowledge and skill beyond the experience of an average juror, an expert in the applicable field is necessary to explain, for example, why the surgical procedure used by a surgeon was inappropriate for a particular patient.

The next key inquiry in determining whether a cause of action for malpractice exists is whether the professional's violation of the standard of care in fact caused the plaintiff's alleged harms. For example, a property owner may suffer damages in the form of lost profits and other costs associated with a prolonged delay in the completion date of a construction project. If that delay was caused by the architect's drafting of defective plans, then the owner may be able to assert a claim against the architect for professional malpractice. If, instead, the delays and resulting damages were caused by the general contractor's failure to properly construct the project in accordance with the plans, then the owner would not have a claim against the architect.

AVOIDANCE OF CLAIMS

As with common negligence claims, the best protection for professionals hoping to avoid a claim of malpractice is to perform their services in as careful and reasonable a

manner as possible under the circumstances. Because the standard of care evolves as new developments become common practice in an industry, it is important for professionals to stay informed of those new developments and adopt them when appropriate.

Professional liability insurance is also available to protect professionals from financial responsibility for a moment of carelessness that can unfortunately result in substantial harm in many industries.

For individuals or businesses that believe that they may have been provided substandard professional services that resulted in harm, a timely investigation, often with the assistance of legal and expert feedback, can be critical in determining whether in fact a claim for professional malpractice exists. FT

Unfair and Deceptive Business Practices – Individual Claims

An Introduction to Causes of Action

by Michael E. Brangwynne, Esq. | 617-336-2281 | mbrangwynne@fletchertilton.com

This is the sixth article in a series on the circumstances that can give rise to a civil lawsuit. Earlier articles in the series can be found on Fletcher Tilton's website under ARTICLES.

THE MASSACHUSETTS CONSUMER PROTECTION ACT

Another common cause of action is for unfair or deceptive business acts or practices in violation of Massachusetts General Laws, Chapter 93A - the Massachusetts Consumer Protection Act. Under Chapter 93A, "unfair or deceptive acts or practices in the conduct of any trade or commerce" are declared unlawful. Chapter 93A enables both the attorney general and private citizens to take legal action against businesses or individuals engaged in such conduct. Chapter 93A permits claims by individual consumers - under Section 9 - and claims between businesses - under Section 11. This article focuses on claims under Section 9.

Under Chapter 93A, "unfair or deceptive acts or practices in the conduct of any trade or commerce" are declared unlawful.

UNFAIR AND DECEPTIVE CONDUCT

Chapter 93A does not define any particular conduct as "unfair or deceptive," but some examples of general conduct that have been found to violate Chapter 93A include false or misleading advertising, charging a customer a higher price than the price listed or advertised, failing to fulfill warranty obligations, and failing to inform customers of relevant information regarding a product or service that misleads the customer in any way.

More specifically, certain conduct by particular business owners has been recognized as a violation of Chapter 93A. For example, it is a violation of Chapter 93A for a landlord to lease to a tenant a rental unit that contains a condition that may endanger or materially impair the health, safety, or well-being of the tenant. A landlord who fails to hold tenant

security deposits in a separate, interest-bearing account is also subject to a claim for violation of Chapter 93A.

The violation of other Massachusetts statutes has also been held to constitute unfair and deceptive practices under Chapter 93A. For example, a home improvement contractor who fails to execute a written contract with his or her client homeowner for a home improvement project that exceeds $1,000 - as required by Massachusetts General Laws Chapter 142A - may be subject to a claim for unfair or deceptive business practices under Chapter 93A.

PUNITIVE DAMAGES

A critical aspect to a cause of action under Chapter 93A is that if the plaintiff is successful in proving an unfair or deceptive act or practice by the defendant, the plaintiff may be entitled to punitive damages, or damages meant to punish the defendant for his or her wrongful conduct.

Under appropriate circumstances, the plaintiff may be entitled to recover reasonable attorney's fees in pursuing a claim. If the plaintiff can establish that the defendant has intentionally engaged in the unfair or deceptive conduct, the plaintiff may be entitled to anywhere from double to triple his or her actual damages.

THE 93A DEMAND LETTER

For individual consumers making a claim under Section 9, the consumer must first send a demand letter to the alleged wrongdoer at least 30 days prior to filing suit that describes the wrongful conduct, sets forth the injury suffered, and gives notice that a demand is being made under Chapter 93A.

The 93A demand letter presents a potential defendant with an opportunity to avoid the punitive damages described above. If the potential defendant responds within thirty days with an offer of settlement that is "reasonable in relation to the injury actually suffered," the claimant will not typically be entitled to recover attorney's fees or multiple damages. On the other hand, failing to respond to a 93A demand letter with a reasonable offer of settlement may constitute a further independent basis for multiple damages and attorney's fees under certain circumstances.

Considering the foregoing, an individual or business faced with claims of unfair or deceptive business practices must take care to respond appropriately. In the next installment, we will consider Section 11 business-to-business claims, some best practices for avoiding Chapter 93A claims in general, and responding to claims once they have been raised. FT

FIRM NEWS

FLETCHER TILTON PC WELCOMES THREE NEW ATTORNEYS TO THE FIRM

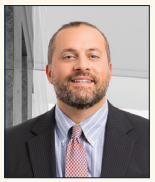
Brittany A. Bergeron is an Associate in the firm's Trust and Estate Department. She focuses mainly on estate planning and special needs planning. She also has experience in estate and trust administration, elder law matters, MassHealth applications, guardianships, and conservatorships. Brittany works primarily from the firm's Worcester office.

Tatiana S. Chiu is an Associate in the firm's Immigration Department. She focuses her practice on corporate and business immigration matters. She counsels companies and their employees on matters related to nonimmigrant and immigrant visa petitions. In her practice, Ms. Chiu advises clients in a variety of industries, including technology, business consulting, life sciences, and financial services. She also advises companies on best practices related to Department of Homeland Security regulations, green card processes and Requests for Evidence. Tatiana works primarily from the firm's Framingham office.

Anthony M. Moroso is an Associate in the firm's Litigation Department. Mr. Moroso's practice focuses on business and property litigation. His professional experience includes closely-held business and property disputes, and commercial real estate transactions. Additionally, Mr. Moroso has experience with landlord-tenant law and matters before the administrative agencies of Massachusetts. Anthony works primarily from the firm's Boston office.

FLETCHER TILTON ATTORNEYS IN THE NEWS

Mark Donahue, Esq.



Todd Brodeur, Esq.

Real estate attorneys Mark Donahue and Todd Brodeur play an important role in New England Real Estate Journal's *Project of the Month*: Galaxy Development completes first phase of major redevelopment of the Trolley Yard in Worcester.

Visit the *Firm News* section of our website to read more about this project.

UPCOMING WEBINARS

Estate Planning with attorney Michael Lahti

Tuesday, August 3, 2021 | 10:00-11:30 a.m. | Live Webinar

Tuesday, August 31, 2021 | 10:00-11:30 a.m. | Live Webinar

Tuesday, September 21, 2021 | 10:00-11:30 a.m. | Live Webinar

Tuesday, October 12, 2021 | 10:00-11:30 a.m. | Live Webinar

Tuesday, November 2, 2021 | 10:00-11:30 a.m. | Live Webinar

Tuesday, November 16, 2021 | 10:00-11:30 a.m. | Live Webinar

For details and registration, visit FletcherTilton.com/seminars

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