

Taxpayer's explanations during audit (1/23/19)

Explanations given by a taxpayer facing a tax audit become an important source of information. We have seen some typical mistakes a person makes in giving explanations to the tax authority. Mistakes are often made through lack of understanding or knowledge of the procedures. This article explores some of the aspects to consider in communicating with the tax authority during an audit.

Poor memory does not help

A person can harm their own interests in explaining the substance or details of a transaction if they say they do not remember anything because the transaction took place a long time ago. The inability to remember the circumstances of the transaction is mentioned quite often, and this is always rated unfavourably in the decision on audit results. The inability to give a detailed explanation of transactions, particular goods and their supplies, carriage, contracting conditions and terms of business will only strengthen the auditors' suspicion that depending on the circumstances, either the transaction never took place or the taxpayer is hiding important circumstances in an attempt to avoid liability for tax offences. The taxpayer is advised to be very scrupulous and strive for comprehensive explanations. It is useful to gather relevant correspondence with customers and suppliers, payment history, advertisements, etc. It is important to do this during the audit.

We are also aware of cases where in an attempt to increase the weight of information, the taxpayer calls on third parties who could confirm various events. This step should be taken with care. Of course, if there are really some persons who can testify for the taxpayer and add to the evidence, then telling this to the auditors is a welcome move. However, any fact or clue mentioned in explanations is likely to be the next subject of review.

Consistency of explanations

During the audit, the taxpayer has a chance to express their opinion several times on their own initiative or at the auditors' request. Keeping those explanations consistent is based on a clear understanding of what questions could be asked during the audit and what stumbling blocks are typically seen within the particular category of case. It is advisable to seek early assistance of professionals, who will give some pointers on how to establish facts. Neither the tax authority nor later the court will like a change in the party's position. It is important to note that early explanations usually earn more credibility, while changing an explanation after the taxpayer has been informed of the audit results will suggest to the auditors and judges that the taxpayer is trying to adjust to the discovered circumstances in order to avoid liability.

The taxpayer is unable to know the full scope of review or what steps the auditors will take during the investigation. However, knowing the period and the tax being audited, the taxpayer can identify the transactions in question and the parties concerned. It is advisable to notify them of the ongoing audit, ask them about relevant transactions, find out, for example, whether they have carried out the statutory obligation to report those transactions. This helps identify potential issues the taxpayer will need to handle, or makes sure that everything is OK. And the business partners will then be largely prepared for the interest shown by the tax authority. If the parties are asked to provide explanations during the audit, this will have a good effect on their quality.

Accuracy of explanations

The decision on audit results carefully describes all discrepancies and contradictions detected. Unfortunately, it is sometimes the taxpayer who creates those contradictions by providing explanations negligently and helping conjure up the aura of a fraudulent scheme right away. In one case, the tax auditors examined the circumstances of a loan. In his explanations, the taxpayer described how he lent the money for business development. The loan agreement implied that the loan was meant for buying shares in a private company. Although evidence of the loan payment and share purchase was later obtained, the decision on audit results included a note that the taxpayer had told the auditors that the loan was meant for buying a hotel, not shares. This is just a small example of how a careless mistake can harm the assessment of explanations.

Findings

The completeness, accuracy and consistency of explanations are values the taxpayer is able to secure while also gradually preparing the basis and arguments for a court case if the audit decision proves unfavourable. A careless attitude to giving explanations may lead to an incorrect assessment of the situation, an additional tax liability, and a lost court case.